Dave Miller

POST OFFICE

Post Office Counters Ltd

Stuart J. Sweetman BSc FCA
Managing Director

Steve Robson
HM Treasury
Room 113/G
Parliament Street
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9 April 1999

Dear Steve

Horizon

As we are entering the last couple of days of discussion with ICL on the Government's 'preferred' alternative, I thought that, for avoidance of any doubt, we should make our position clear about where we are, and what we must assume.

Richard Christou and I have been ensuring progress is made on developing Option B1 further. We have been working on your "preferred" Option B1 variant as agreed at our meeting last week i.e. BA to make benefit payments through BACS into restricted POCL "Bank" accounts accessed by PO smartcards - using ICL as our operator and building on much of the existing BA/POCL infrastructure.

A lot of work has been done by our respective teams to establish a common understanding of what is entailed in this solution. Where information has been available to us we have shared this to derive assumptions on which cost and risk estimates can be based. We have also shared these with your advisors as we have gone along. Of necessity many of these estimates are still very soft as you will appreciate.

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Dave,

I pulled off this e-mail as I had a call from Hilary Stewart and she wanted to know if

(a) You had seen it?

(b) Wants to know if you are happy with it.

Her's telephone No. is GRO

We have agreed that as neither ICL nor POCL have the relevant banking experience ICL will need to involve a Bank such as Girobank to help them operate these accounts. We have involved Girobank in discussions but, given that clarity on requirements has only been progressively emerging, whilst they are willing to enter into discussions they are unlikely to provide committed costs to the solution within the aggressive timescales. ICL will therefore have to make some very broad brush assumptions on the cost of supplying account management as part of their proposal to us and we have to agree amongst other things, whether it is ICL or the public sector who should take the risk of any underestimation of these. We have fed these assumptions into KPMG to be taken into account in assessing the options on the way ahead.

We have agreed with ICL that in the interests of making as much progress as we can in the limited time left we will work together on the wide range of issues that need to be resolved if we are to try to produce some draft Heads of Agreement around Option B1 by Monday.

These issues include the service specification and business rules; the prices and costs; the appointment of roles and responsibilities (with associated risks); the key dependencies and conditions (including for example, system acceptance methodology; DSS plans; and regulator issues around banking status); the principle and method of separating the past from the future in changing from Option A to B1; future contractual relationships; the broad programme timetable and length of contract guarantees; and developing a new public/private sector partnership. These are a formidable array of issues to settle even on an 'in principle' level, and we will do whatever is possible. Certainly we are making strenuous efforts with ICL today and over the weekend.

However, our view of Option B1, despite further discussions with ICL over the last few days is that, in terms of potential incremental value creation in achieving our strategic ambitions over Option A it is at best marginal and in our view we will not be able to justify the additional

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costs and risk assessments as matters stand. Certainly in helping POCL realise its network banking aspirations it provides no significant advantage over Option A. Indeed it is outside our original strategy as we would need to become a bank ourselves albeit with 'limited' accounts. In terms of our Government Gateway markets, without further Government commitment to maximise Government use of the smartcard, its introduction offers only a small advantage over the Benefit payment card in Option A, given the migration route we had already foreseen in that option.

I say this not to be pessimistic, but to be realistic. We have been consistent in this view, ever since the idea of another approach emerged following Post Office's agreements with ICL on Option A before Christmas. It took a great deal to persuade our Board that the deal we struck then was acceptable, but once we did, we were prepared to commit to it. Others were not.

You will know that Neville Bain and John Roberts have both in the last week reinforced the point I have made to you before, that the Post Office will not approve a business case that loses value from what it has already agreed.

So, it is only right that I set out now what that implies given what is emerging from our negotiations with ICL this week, and the associated assumptions. Without your agreement 'in principle' to these, I will not be able to sign any Heads of Agreement with ICL of any status that commits the Post Office. Richard Christou is fully aware of this. It would be irresponsible to mislead him. The scale of the NPV gap to be bridged in the Post Office business case could be, from the figures I have seen this week (both from ICL and taking into account DSS input to KPMG and ourselves), up to £1bn from Option A. It is in this context that we are continuing to face up to ICL to try to progress matters. But we now <u>must</u> bring matters to a conclusion, or decide on another option.

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I would need Government agreement to the following to enable me to put a recommendation to John Roberts and the Post Office Board:

1. As a minimum first step, to reinstate the essential commercial position that POCL reached during and after the Corbett discussions, including:

(a) A contract with DSS (or another Government department) for providing services to enable benefits to be withdrawn in cash at post offices until 2008

(b) Guaranteed level of payments during this period, per the floor income, with its associated structure and terms, under our Contract A with BA as agreed with them in principle before Christmas (recorded in our draft Heads of Agreement with BA at the time)

(c) Again as agreed at the time, back to back cover for associated ICL system charges (per our contract B with BA for their services from Government)

2. Government agree to settle finally, without any adverse impact on the Post Office, any past aborted costs of Option A from ICL, including that proportion of their proposed so called availability fees under Option B1, which in fact relate to the change in solution and not to future charges (ICL agree that this division is correct). This is in line with the principle of separating the past from the future that we have already agreed with you.

3. Even with these essential planks of a financial framework in place this will still leave c£500m NPV (at 12%TDR) in <u>extra</u> running costs that would fall to POCL plus an extra basket of risks (including FSA compliance costs; costs of minimum capital and liquidity requirements extra fraud risks of the new solution; extra costs to us of managing these new risks; potential programme and solution finalisation delays and costs of any EC procurement challenge). These are not possible to quantify fully at this stage, but we are happy to work with your advisors to assess the cover required.

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I would stress that these extra costs must include the costs of the smart card, which, as we have said, we view as essential to this new solution (without it, we see no real furthering of wider government services compared with Option A).

4. HMT commits to pay the Post Office for these extra costs and risks related to the new service. The mechanism for so doing will need to be agreed. However we would point out that this could build out from existing provisions in our contracts with BA which cover their obligations should they wish to withdraw from services under Option A. Smartcard services and provision may however need mechanisms other than contracts with sponsors. We are prepared to discuss other mechanisms (but would stress that any concept of subsidising is unlikely to satisfy the Board that this is a commercially acceptable deal), including incremental ideas around our new financial regime which we understand is likely to emerge as part of the White Paper on the Post Office.

5. DSS and BA confirm that they will co-operate fully in the necessary plans, protect against any changes in periodicity, the appropriate usage and transfer of customer data, and agree to fund their own internal costs, associated with this change. We do not believe DSS will have a role in future contractual relationships or direct programme management with ICL. However, there is likely to be a need for ongoing contractual relationships between BA and POCL to deal with migration as well as the service provision for the most difficult or disadvantaged customers in society through, eg emergency or alternative payment arrangements. The business rules of the services will be set by the Post Office as part of the specification to ICL.

6. DSS confirms that provided the system has been fully accepted by POCL and meets the essential requirements of the FSA and the BACS interface BA will commence using the system without imposing further acceptance requirements of its own.

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7. HMT arranges (with a suitable sponsoring Government Department) for ICL and POCL to work together on a few identified new wider government services (building out from the recent OFT and Electronic Government Reports) to put onto the smartcard following roll out as part of the new partnership. ICL and ourselves have some ideas about which these could be, which we would be happy to share next week. This work, albeit secondary to the core of the programme's delivery will enable early use of the smartcard for Government, and also give ICL some firmer commitments to Fujitsu about their wider business case under 'Golden Cloud'.

8. HMT help support and accelerate the necessary FSA or other banking processes as far as they are able.

In addition to the above agreement from yourselves, we are also seeking from ICL as pre -conditions to any agreement both:

(a) Confirmation that their commitment to and timetable for other contracted POCL services on the system remains (this looks likely to be the case from what they have said to date);

and

(b) Confirmation that Fujitsu will continue to guarantee the future programme, in a legally enforceable way, under the new proposals.

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I trust that these proposals help to focus decisions now within Government as we have to commit to ICL soon. I will be happy to discuss these issues with you. Alternatively John Roberts has already offered a meeting with you, him, and the DSS Permanent Secretary very early next week, upon your return, which would be another way forward.

Yours sincerely

GRO

STUART SWEETMAN

cc John Roberts
David Sibbick
Paul Rich