

Rww/1/05.

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From:

DAVID SIBBICK
DIRECTOR POSTS

GRO

151 Buckingham Palace Road

GRO

27 April 1999

1. Mr Fagg 28/4
2. Mr Paul 28-4
3. Mr Chubb 28/4

BA/POCL AUTOMATION PROJECT: HORIZON: MEETING WITH DR NEVILLE BAIN AND JOHN ROBERTS ON WEDNESDAY 28 APRIL 1999.

ISSUE

1. The line to take at your meeting with Neville Bain, Post Office Chairman and John Roberts, Post Office Chief Executive tomorrow morning at 10.30am.

PURPOSE OF MEETING

2. You have called the meeting to discuss progress on developing Option B1, and in particular ways of bridging the £700 million NPV funding gap (which has now been reassessed at some £850 million) between Option B1 and Option A. The meeting will take place against the background of the letter you received yesterday from the Post Office Chairman making it clear **that without very substantial Government funding there is no commercial case for Option B1, and that without Government guarantees that such funds will be made available the Board will not support it.**

BACKGROUND

3. Since you met with your colleagues last Wednesday evening to discuss the way forward there have been further intensive discussions between all the parties. You may find the following points helpful to inform your discussion with Dr Bain and Mr Roberts:

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- ICL/Fujitsu have agreed to allow negotiations to try to find a way forward to continue up to an absolute deadline of 10 May. Steve Robson has written to ICL on behalf of Ministers promising a decision by then, and promising to pay ICL's audited costs up to that date and subject to a ceiling of £8 million. Steve Robson's letter identifies POCL as the channel of payment, but despite the agreement we understand you have with the Chief Secretary, **the Treasury have so far failed to give POCL an assurance that they will be reimbursed for the payment, and the Post Office have said that they will refuse to release the payment until they have received such an assurance.**
- The table below sets out in column 2 the **additional costs to POCL (POCL's own figures) of Option B1 over Option A.** Column 3 shows the £180 million "up front" compensation for dropping the benefit payment card which ICL require within 30 days of signing Heads of Agreement. Column 4 sets out the **savings to the Benefits Agency (DSS/BA figures) of paying benefits through BACS into bank accounts/PO benefit accounts.**

Funding requirements for Option B1.2

Year	POCL required funding (£m 1998/99 prices)	ICL Pathway required funding (£m 1998/ 99 prices)	Potential available funding from DSS (£m 1998/99 prices)
1999-00	-20	-180	-90
2000-01	-70		-50
2001-02	-130		-40
2002-03	-190		40
2003-04	-310		190
2004-05	-310		340
2005-06	-430		540
2006-07	-440		540
2007-08	-250		540
2008-09	-120		540
2009-10	-100		540
	-2370	-180	3090

- **These figures need further verification, but if substantiated show that the Government could if it wished fund the entire incremental cost of Option B1**

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over an 11 year period from the savings the BA will make over the same period by not proceeding with the benefit payment card.

- However, within these totals there is a substantial disconnect in the phasing of the two streams, with BA showing negative savings in the early years and only catching up with POCL's funding requirements by 2004/5 (though moving rapidly ahead thereafter). One way of helping to overcome this disconnect would be through adjustment in the PO's EFLs in the early years. Another would be through borrowing, though **the Post Office will want any arrangements for funding Horizon to be ring-fenced from their strategic plan. Even with Government funding as set out above, the returns from Horizon are likely to be low, and the Post Office will not want the project to pre-empt other, more profitable, investments elsewhere within the Post Office.**
- As to how the necessary levels of funding could be channelled into POCL, it would clearly be desirable for ICL's **£180 million compensation demand to be paid separately and "up front" to deal cleanly with the past and avoid distorting the future costs of the project.** Another possibility would be an **early contribution to the costs of setting up some 15 million PO benefit accounts which, it is believed, can never be profitable.**
- However, the bulk of the funding is probably best channelled in the form of **payments to POCL for the delivery of Modern Government services.** There are a number of advantages to this route. The footfall it will bring to both the private side and the PO side of the business will usefully leverage the beneficial effects of the payment, whilst at the same time minimising the risk of a state aid challenge. **There are however two important points to note here:**
- **First, POCL's business plan already requires the business to generate an £800 million contribution towards the costs of Horizon from the delivery of Modern Government services.**

And second, because this is already an ambitious and stretching target, the Post Office would require a clear Government commitment that additional volumes of Modern Government business would be available within the necessary timescales, and that a sufficient proportion of it (perhaps something of the order of 50% as a target) would be reserved for POCL before the Board could incorporate it as contributing to the business case for Option B1. From the Government's viewpoint, the case for so doing (probably on a strict cost-plus basis and subject to stringent efficiency criteria) is that if for social reasons the Government is anyway committed to contributing to the maintenance of the network of post office counters - and more than half the business conducted at them is public sector business of one sort

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or another - the true marginal cost of delivering Government services through them will be very low.

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- Grateful to PO for spelling out concerns. Will ensure that they are all taken fully into account when reaching this very difficult decision shortly.
- In particular recognise the Board's need for a clear understanding of the Government's position on funding in order to establish the business case for Option B1. Officials are continuing to work on this.
- Appreciate the efforts of PO team in contributing to the search for a solution. Hope that the PO will continue to explore ways in which they might help to minimise the substantial NPV gap between Option B1 and Option A.
- Given the history of the project so far, and in particular the difficult public sector relationships that have characterised it, have grave doubts whether Option A is in practice deliverable. Know that ICL share these doubts. And anxious to avoid termination if at all possible because of the damage it will do to ICL, to our relations with Fujitsu, the largest Japanese inward investor, and the delay that would be caused to modernising POCL and the payment of benefits.

WHITE PAPER ISSUES**OUTSTANDING FINANCIAL ISSUES**

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The Post Office Board meet today (27 April). I understand they will have been informed that the Post Office is not clear on the essential elements of the reform package even though publication is firmly set for May, and in particular that Neville Bain has had no response to his letter to you of 9 March. As you know we cannot respond until the Treasury has given their view on several points and you have judged whether they are acceptable or not (hence my submission of 19 April with a draft letter asking the Chancellor for a timely response). They are likely to be looking for an early meeting, particularly in view of your meeting with the CWU next week.

LINE TO TAKE

Understand your concern. I will have a follow-up meeting on the White Paper with you as soon as I can.

DAVID SIBBICK