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FAX COVER SHEET

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Date: 3 February 1999

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BA/POCL AUTOMATION PROJECT: FURTHER DISCUSSIONS WITH ICL

Issue: Briefing to assist Steve Robson in his current discussions with ICL.

Timing: Immediate.

Background:

1. In an attempt to help inform Steve Robson's consideration of how best to carry forward the current discussions, and possible subsequent negotiations, with ICL, I have been trying to think what you might find helpful.

2. Following up yesterday's material on the legal issues that I forwarded to you, I have now jotted down some thoughts around:

   - the commercials of an alternative option;
   - suggested analysis of the footfall effect on POCL.

3. I hope this is helpful.

4. As ever, I stand ready to provide whatever other help you or Steve may decide.

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BA/POCL AUTOMATION PROJECT:
DISCUSSIONS WITH ICL AROUND AN ALTERNATIVE OPTION

A. The "Commercials" of an alternative

Some general points to consider:

- Stephen Byers' letter of [ ] reiterated that ICL should not look to achieve a positive return on investment over the life of the project;
- ICL must recognise that Government/public sector is coming from a position where they hold ICL to be in breach of contract for failure to deliver; and the public sector are confident of the strength of their case;
- recognise nonetheless that the way the ICL proposals were structured around a BPC option was partly posited on the ICL/POCL partnership and "Golden Cloud", on which they were gambling to achieve in practice a positive return on investment over the life of the project - and presumably was the basis on which the Fujitsu guarantees were given; in this regard there are a number of points to make:
  - under the alternative option, it will still be possible to structure the "commercials" of the contract in a way that gives a similar - if not better - overt return on investment as would have been the case under Option 1 (actually a paper loss!), while preserving the possibility of further profits from the additional services that might accrue on the back of Smartcard - if anything, the earlier introduction of Smartcard should help secure a better ICL/POCL position in the market place to win such business;
  - the balance of risk/bankability of the project is significantly changed by replacing the BPC element with a generic Smartcard product: the latter should be marketable worldwide; and would certainly have an independent asset value - as opposed to the BPC which, by ICL's own financial advisors' admission (Hambros) has *no* asset value or other value after the contract ends;
- there are PR £££ for ICL in:
  - being seen to be working with the UK Government to help it move forward with a positive modernising agenda (as opposed to a project which could easily be seen as obsolete);
  - what Government says about a deal;

- putting history behind us: there is no escaping that ICL failed to perform and it must be of some considerable value if Government puts that on one side;

- under Option 1, over the period until 2008, DSS would have been paying POCL nearly £3.5 billion of which ICL would receive £0.9 billion, in addition to the £0.7 billion they will receive from DSS/BA direct, making £1.6 billion in total. In cash terms, it must be possible to do a "deal" which costs the Government no more, if the complex, bespoke BPC technology (and management of it) is being replaced with a generic Smartcard product;

- in return on investment terms too, there must be scope for a better deal for ICL (given the changed asset status of the product and the other points made above);

- moving to a generic Smartcard product, should de-risk the project for ICL to a considerable extent;

- on the specifics of a "commercial" deal, it will be important that ICL realise that Government will be prepared to commit to promising a similar guaranteed income stream to ICL, as under Option 1, but that that it does not have to be built on the same pattern of "volume" guarantees (which would not be suitable for a Smartcard option).

B. Possible risk to POCL revenue

1. Under a non-BPC option, the main area where POCL have said they would be vulnerable is around loss of footfall in the short-term which they believe, once lost, could not be picked up. The crux of their argument about moving to a banking/Smartcard technology via BPC is that they have longer to position themselves to protect this footfall (and to tie in benefit customers).

2. It is in the nature of a cross-Government consensus solution that all parties must be prepared to compromise: DSS/BA have already signalled that they are willing to compromise on the time table for moving to ACT, if that is in the wider public sector interest; POCL might be persuaded similarly to compromise to some extent over their footfall preference.

3. In any event, it may be helpful to analyse the footfall situation in broad terms under the alternative being posited by ICL:

   - currently, around 15 million people choose to collect their benefit cash from Post Offices via paper based methods;

   - a further 5 million people opt to be paid via ACT into their bank accounts and this number is rising steadily, given demographic changes, different money management usage among people, etc.;

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- of the 15 million who currently collect benefit cash from the Post Offices, research indicates that 90% ~~are said to~~ have bank accounts;

- the remaining 10% who do not - an estimated 1.5 to 2 million people - would, under the ICL proposals, be offered a special Post Office bank account; their footfall is therefore assured in the short-term;

- in order to assure maximum retention of footfall among those benefit recipients who already have a bank account (but who currently choose to collect benefit cash from the Post Office), when ACT is introduced it will be important that the proposed technology in Post Offices incorporates a simple "cashback" type mechanism that can be accessed in the normal way by these customers;

- this would mean that the many people who currently prefer to collect their cash at Post Offices, can continue to do so whether or not they have a special Post Office bank account;

- it will also mean that the Post Office will pull in many potential new (and possibly richer) customers in rural areas, where the banking network is receding;

- if this "cashback" technology worked in the way that it does in other retail outlets, it may well increase the *value* of the footfall effect for POCL, given that "cashback" currently operates on the basis of spending £5 or more in the retail outlet;

- another dimension is that Banks compete for strategically positioned ATMs: I gather they pay to put ATMs in prime locations, because this means they make more money from their competitors whose customers use the machine; and well-placed Post Offices could benefit from this;

- under this analysis it looks as if the footfall effects for Post Office could be minimised; and indeed, in the longer term, if Post Offices are developing a strategy to complement the banking network, footfall could well increase.

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RE: BA/POCL : 2ND FEBRUARY 1999

I attended a meeting with Stephen Hickey, George McCorkell, Sarah Graham, Laurie Cairns and Hamish Sandison.

It seems the Post Office are anxious to have a smart card though precisely what the card will do remains yet to be decided. Lots of things will need to be settled in due course. One version of the smart card might do nothing more for us than the benefit payment card would have done though if it did additional things as well it might not have any impact on us.

It is unlikely that the card would as sophisticated as say a switch card.

The Treasurer is still trying to get ICL to agree a final plan. We would then need an outline general agreement followed by a more detailed one.

Apparently Steve Robson had a meeting with Richard Christou and Keith Todd last Friday. There was a firm proposal from ICL that the benefit payment card should be abandoned and that the DSS should move to ACT. Benefit recipients could then have a bank account of their own choice or receive their money via the post office. In the latter case the benefit claimants would have an account that was only accessible via a post office.

So far as we were concerned, in that scenario we would make it clear to benefit recipients that they could either have their benefit paid to a bank account of their choice or to a special post office account which would then be accessible with the smart card.