

Company Secret
PLC/99/10

**ICL PLC
BOARD MEETING
PAPER BY J.H. BENNETT
ICL PATHWAY UPDATE**

1. Current Negotiations with HMG

The ICL proposal submitted in December 1998 has not been progressed or discussed since that date and we have now formally withdrawn it. This proposal is known as Option A and although is acceptable to POCL and is technically viable and can be delivered, has been totally rejected by BA. It is also what the current contract calls for and therefore represents all the work being done at the programme level between ICL, POCL and BA. This major disconnect is beginning to cause severe operational problems with the programme, and clarity as to the agreed way forward is therefore urgent.

In place of Option A, a new proposal has been worked up under recommendations from HM Treasury which is known as Option B1.2 and is today the only viable option being discussed short of contract cancellation.

The essential components of Option B1.2 are as follows:

- a. The bespoke BA benefit payment card is cancelled together with all the systems which support it.
- b. In its place we provide for POCL a new system to deliver Post Office Benefit Accounts, for receipt of all benefit payments to their respective recipients. This will be supported by a POCL smartcard. Benefit payments will still be made available through the Post Office on an exclusive arrangement for the near future and will be collected through this post office account. This new development will take at least two years to bring into live operation.
- c. In the meantime rollout of the POCL infrastructure will continue on the current programme plans and this will support the early POCL services.
- d. The new ingredient in this option is to support the increased determination by HMG to progress their Modernising Government initiatives as recorded in their recently published White Paper. A national infrastructure, a fully automated post office and up to 15,000,000 citizens smartcards created through the new method of paying benefits is seen across government as an essential launch platform for their other government wide initiatives.
- e. POCL will adopt their new strategy to implement a network banking service providing front office banking for the major clearing banks, who in many parts of the country are seeking to shrink their own branch networks but still provide access points in the community.

The critical issue with Option B1.2 is its cost to government and unless this can be handled, then the threat of cancellation is large.

Company Secret
PLC/99/10

2. Components of the Deal for Option B1.2

The essential components of the ICL proposition now with HMG is as follows:

- i. The contract term is extended from 2005 to 2010.
- ii. The contract is struck solely with POCL.
- iii. BA will no longer be a party to the contractual arrangements.
- iv. We have negotiated a partnership arrangement with POCL under Private Public Partnership (PPP) terms which will oblige both parties to work jointly to win new business in specific areas, particularly Modernising Government where ICL will have preferred supplier status.
- v. The commercial terms change the structure substantially away from a transaction pricing basis with all the volume risks towards availability fees which are effectively guaranteed payments for service provision. We are proposing that this balance is shifted once the Modern Government takeoff has been achieved and we are able therefore to take a higher risk reward profile.
- vi. We have incorporated compensation payments to ICL for the abortive costs of HMG cancelling Option A and the follow through impact this has on our subcontractor arrangements. These are asked for in a single payment due in 1999.
- vii. There are new timescales put together to establish the POCL smartcard banking system and the design, development, build costs for this are on a time and materials basis such that we can avoid the development risk on the currently high level service description.
- viii. We will work with POCL on an accelerated programme to win early market share for Modernising Government services and will use the PPP to ensure we have a strong seat at the table.

Overall we have attempted to produce a lower risk profile than with Option A, particularly through time and material charging and availability fees and have at the same time positioned ourselves in a risk reward environment to capitalise on modernising government should this business take off as it could. Finally, we have removed the destructive energies of BA from the contract and therefore reduced the risk of them continuing to block progress on the ground.

3. Heads of Agreement

There are two Heads of Agreement which ICL need to be party to. The first is between ourselves and POCL and the second is a tripartite Heads between ourselves, POCL and BA which is needed to disentangle BA from the contract.

The most work and the most progress has been with the POCL Heads which now stand at over 100 pages in length and contains substantial detail on most of the key issues of moving forward. A lot of areas have been resolved and broad agreement has been reached on most of the topics. Notwithstanding this, there do remain a number of large issues still to be settled. Of particular importance is an agreement on the fair value of the Pathway system on termination together with the transfer of IPR on such an event. In addition from the POCL side, they need an acceptable position on Fujitsu guarantees. No signature on the Heads is



Company Secret
PLC/99/10

possible until these outstanding points are resolved. An Executive Summary on these Heads of Agreement has been produced by Masons and is attached to this Board Paper.

The tripartite Heads of Agreement between ICL, BA and POCL has made less progress. There is a scoping document, there are points to discuss and discussions are in hand to progress this. The key issue for ICL is that this Heads must be subservient to the POCL Heads of Agreement and when signed must withdraw all claims and remedies of all parties.

Although not visible to ICL, there is another important negotiation required between POCL and BA in order for BA to fulfill their obligations to POCL in a way which allows POCL to sign their Heads of Agreement with us. The conditions here surround the work needed by BA to support Option B1.2 and the conditions attached to this. POCL have been in discussion with BA recently and are finding progress painful and slow.

All these documents need to be agreed before an individual one can be signed and although we are continuing to press for such signature to be legally binding, this is not something the sponsors have agreed to or wish to take place.

4. **Financial Implications of Option B1.2**

A summary of the financial position for ICL should Option B1.2 be accepted as it stands is given in Appendix 2.

5. **Ministerial Discussions**

The most recent discussions between ICL and Ministers took place on 5th May when Keith Todd, Richard Christou and George Hall had a meeting with Stephen Byers DTI Secretary of State. At this meeting we underlined the basis of the ICL proposal and more importantly the strength of the business case for modernising government for both the Post Office, the DTI and for HMG at large. The meeting was business like and supportive and we can expect DTI and the Post Office to strongly support Option B1.2 and our proposals to deliver it.

On the evening of the 5th May there has been a joint meeting between Stephen Byers, DTI, Alastair Darling, Secretary of State for DSS and Alan Milburn, Chief Secretary of HM Treasury. This has been a follow up meeting from their indecisive meeting of two weeks ago. We have been informed that the meeting reached no decision, and that further work is being undertaken to consider if the POCL business case is capable of improvement. Whereas all parties recognise the deadline for a clear decision on this programme, it is still a possibility that further work will be needed in order for the ministers to make a final decision, which could be into week beginning 10th May.

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Company Secret
PLC/99/10

6. **Timescales for Resolution**

HMG understands both at a senior official level and a ministerial level that ICL and Fujitsu needs to resolve their end of year accounts during the week of the 10th May and this has to have audit approval. They know in addition that Company's House has written personally to the directors of the subsidiary company ICL Pathway Ltd making it clear that as individuals, we are subject to criminal proceedings if we fail to lodge the ICL Pathway accounts for 1997 by 12th May. There is no intention to be in breach of this regulation.

7. **Programme Status**

Whilst the above discussions and negotiations take place the programme has to continue to operate to the contract which is essentially Option A. On this we have made sound progress notwithstanding difficulties with BA and their attempt to invoke further delay. All the 200 post offices running release 1c have been successfully converted to NR2 which is running well in terms of the day to day transaction operations. There are however, major problems with the cash account balancing which takes place on a Wednesday evening and this has been analysed as much more to do with business processes, business support and the skill knowledge of subpostmasters, rather than structural issue with the Pathway system. Nevertheless, it will require joint effort to straighten out.

On the weekend of the 8/9 May we plan to convert our data centres from Release 1c to NR2 and the plans for this are all in place notwithstanding attempts by BA to again delay this activity.

We are therefore close to beginning live trial and are now well into the acceptance phase of the programme which we are determined to complete to enable POCL infrastructure to rollout as planned starting in August of this year.

It is however absolutely essential that we resolve the conflict of delivering Option A on the ground when it has been rejected politically. The management tasks of directing and motivation our own staff and controlling the activities of our subcontractors is becoming more and more untenable by the day.

J.H. Bennett
6.5.99



Company Secret
PLC/99/10**Pathway Current Business Plans****Introduction**

The financial outlook for the Pathway project has been extensively reworked to reflect the latest business and technical solutions, ICL's commercial offer to HMG and the Heads of Agreement in late stages of drafting with the Post Office.

Revenue

The forecast of revenue breakdown is as follows:

£M

Universal banking (BA related)	419
Network banking	100
Government Gateway & Smart card	814
Availability fee	425
Other POCL client transactions	555
	<hr/> 2313

Abortive work on Payment Card	50
Cancelled subcontracts (Payment Card)	30
Restructuring fee	100
	<hr/> 180

Time and materials development work	<hr/> 100
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Total	2593
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It is assumed that the proposed one-off charges to HMG (the three items grouped above totalling £180m) will be agreed unconditionally and that these will directly benefit cash flow.

Profit and Loss, and Cash Flow

Inclusion of Network Banking and Modern Government within contract scope, and the replacement of the BA branded magnetic stripe card by a Post Office branded full function smart card as infrastructure enabler, improves the financial outlook and reduces business risks relative to the Option A position of a year ago.

Profit and maximum borrowing forecast are as follows:

£M

Lifetime project PBT at Pathway level	216
Lifetime project PBT at Group level	279
First year of profit release	2003
Maximum borrowing requirement	431



HEADS OF AGREEMENT – EXECUTIVE SUMMARY

Heads of Agreement – Executive Summary**1. Introduction**

- 1.1 This is a high-level summary of the draft Heads of Agreement between POCL, ICL Pathway Limited and ICL Plc ("the Heads") as at 5 May 1999. The Heads set out the basis upon which the Pathway project is to continue.
- 1.2 The Heads will give effect to Option B1.2, as discussed with HM Treasury, which envisages that the Benefit Payment Card and related services which were to be provided to the DSS under the Related Agreements will be terminated and replaced with a new Benefit Payment Service ("the BPS"). The BPS will include the operation by Pathway of Post Office Accounts for those entitled to benefits, into which benefits will be paid by the DSS via BACS. The Order Book Control Systems (the "OBCS") will be retained as a POCL service during the transition period of the BPS.
- 1.3 The DSS Agreement between ICL, DSS and POCL will be cancelled under a "Tripartite Agreement" between ICL, DSS and POCL, which will also set out the basis of settlement of all disputes between the parties to the Related Agreements.
- 1.4 A further agreement will enable Pathway to provide services to POCL in addition to those contracted to be provided under the Related Agreements and to take advantage of the opportunities arising out of the White Paper: Modernising Government ("the PPP Heads"). The PPP Heads are in an agreed form annexed to the Heads and are to be executed simultaneously.
- 1.5 Fujitsu is to provide a guarantee as to Pathway's performance under the Heads and a legal opinion as to the validity of that guarantee. ICL is to maintain the guarantee provided to POCL under the Related Agreements.

2. Terms of the POCL Heads of Agreement

- 2.1 A number of Schedules to the Heads set out the principles for pricing, timetable, acceptance, commercial issues and issues relating to termination.
- 2.2 Pricing
The impact of the new proposals on pricing, at the current stage of negotiations is set out in the Business Plan.
- 2.3 Timetable
- Amongst other dates, for the Core System Release and the BPS Release respectively 15 November 1999 and 31 December 2002 are provided as final deadlines for acceptance, and national roll out is due to commence by 23 August 1999 and 1 July 2002.
- 2.4 Acceptance
- If Acceptance is not achieved by the required date, Pathway has a further 3 months for each Acceptance Phase in which to remedy defaults. During this period POCL is entitled to claim liquidated damages. If Acceptance is not achieved by the end of this period, POCL is entitled to terminate the Updated POCL Agreement.



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- If the parties do not agree Acceptance Specifications or whether a fault is an Acceptance Incident, the dispute is to be referred to a nominated external expert. The expert's decision is to be binding, save where vetoed by POCL on stated limited grounds. In those circumstances POCL will pay Pathway the additional costs associated with any extra work.

2.5 Commercial issues

- From 1 January 2006, Pathway may require counter equipment to be upgraded at POCL's cost, and before that time, by agreement ("Technology Refresh"). POCL may elect to use third party suppliers to effect the refresh.
- This Schedule apportions the costs of site preparation and modification costs for roll out between the parties. These costs were previously the subject of dispute.

2.6 Termination issues

This Schedule is complex and some important details are still to be negotiated. Points already agreed:

- The parties will review the Related Agreements' trigger events for termination to ensure materiality and will clarify which breaches of service level will lead to an entitlement to POCL to terminate.
- If POCL terminates OBCS, it shall pay Pathway the anticipated OBCS Scorecard revenue subject to a number of discounts.
- Pathway is entitled to terminate for failure to pay £30 million or for an event of Force Majeure (as defined).
- If POCL terminates for convenience or due to its Default, Pathway will receive a compensation payment and will be required to transfer the hardware and software (or rights to use software) of the Core System and the BPS ("the Project Assets") to POCL. The extent of this transfer is not yet agreed by the parties.
- For termination due to Pathway's Default terms have yet to be agreed.

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