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Dear Paul

BA/POCL AUTOMATION PROJECT

Further to our discussion yesterday, I am now able to give you a more definitive statement of what we are asked to do.

The main elements are:

- where POCL should be aiming to get to in ten years time. The assumption is that whatever decisions are taken on this project POCL will, in this period, face the challenge of losing its current major source of income and customer flow. There are broadly two ways it can respond;

- it can try to build on its strengths and win new business
- it can try to cut costs by changing the size and shape of the network.

In practice, POCL will almost certainly have to do both and Ministers are now looking for a more convincing and coherent strategy for achieving this than we have so far been able to give them.

- what technology it needs to get there. In particular, if the benefit payment card were dropped, what technology would POCL need to provide the services which are realistically deliverable as part of its longer term strategy. Is it necessary, for example, to:

- install the same equipment across the whole network, including part time offices?

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- Could offices with a low volume of business be catered for with much simpler technology?
- How quickly could a generic banking/retail system be installed and what would it cost compared to continuing with the Horizon system? What key functionalities would such a system lack, and how might these then be provided?

- how far POCL could reduce the costs of the network and, at the margin, what is the extra social benefit HMG would be buying for the extra cost of any subsidy - explicit or implicit - which might be put in. For example, we have very little information on what it costs to keep open the marginal post offices and how much they are used - in particular it would be helpful to know what it would cost to keep open those post offices which are located in areas which lack other local facilities such as banks and shops;

We need to ensure that the paper you are helping us to prepare responds to the issues raised as fully as possible. We would therefore be grateful for your considered views on these issues.

Copies go to Mike Whitehead and Isabel Anderson here.

Yours ever

GRO**DAVID SIBBICK**

Director-Posts

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THE FUTURE OF POST OFFICES OVER THE NEXT 10 YEARS

The role of post offices today

1. Post offices matter to people - nearly 30m people visit 19000 of them every week. They have an essential and popular role in UK life today; for example nearly 20 million people choose to pick up their benefits at post offices today even though 16 million of them have bank accounts. The infrastructure behind them plays a vital part in the smooth operation of the UK economy; POCL handles £140bn cash pa of the total cash turnover in the UK of £235bn. POCL has been a successful business to date; although operating on slender margins, it has delivered its financial targets, maintained its network and made significant service improvements in recent years.

The need for change

2. Society expects the status quo to continue, but the basis on which POCL is founded is unsustainable for the future. Government is seeking to re-cast its relationship with citizens, new markets are developing and competition growing and there is greater customer choice in service delivery as new channels open up, and pressure from POCL's Government clients to be free to use them. Ten years hence, post offices will transact only such business as POCL is able to secure from willing buyers on fully commercial terms. POCL will rely on its ability to attract customers and partners. There is no option, therefore, to maintain the status quo. POCL recognises that, embraces the need for change and is resolved to reshape itself for the future. That is why POCL's Management Board acted to set a new strategic intent for post offices by commissioning a major strategic review earlier this year, using the McKinsey consultancy firm.

Why post offices have a future

3. Post offices' unique selling points, its competitive strengths, will endure and become more important as markets develop despite significant competition. From research, they are known to be the trust in which it is held by citizens, its unrivalled reach (over 95% of the UK population live within a mile of a post office compared with 60% for banks/ building societies and 30% for supermarkets) and the ability to deliver services which matter to people (getting benefits, sending things and dealing with officialdom are the services most associated with post offices).
4. The challenge for POCL is to apply these enduring strengths to new markets as they develop. The major review it undertook provides substantial strategic analysis which shows that, in the future, post offices can provide a trusted bridge between the financial and technological haves and have-nots, and between a wide range of central government, local government and commercial interests. With their social and perceived "official" role, they represent an infrastructure which can be relied upon when others, based on different aspirations, cease to exist, or decline to participate. Their existence keeps open the possibility of a proven delivery channel for many services for either the Government or the private sector.

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What the network might look like

5. If POCL is to have a viable future in an environment in which it contracts only with willing buyers on fully commercial terms, it must have a fit for purpose network which is competitive in price with alternative channels offering comparable service. At the same time, it must maintain the qualities which underpin both its social value to the nation and its commercial attractiveness, ie its reach into all types of community, town, suburban and rural. It is probable, however, that such an objective could be achieved with a significantly smaller number of physical post offices than today's 19000.
6. A possible network for the future might look like 700-1000 major post offices in the largest centres, some 10000 to 12000 smaller sites in local high streets, urban neighbourhoods, village shops and out of town centres, supplemented by some 5000 to 10000 electronic access points. Most of the reduction in physical network would come from merging or closing redundant sites in towns and cities, together with natural attrition in rural areas. The Post Office believes that a period of some 10 years would be required to achieve such a transition in a way which meets customer expectations, and does not destabilise the market in post offices or the small businesses associated with them (subpostmasters currently have a £1bn stake in these). To provide customer reassurance during the change, it would be best to define the network's ubiquity in terms of accessibility criteria rather than in terms of actual post office numbers. That is important because market analysis projections show that some 75% to 80% of transactions in the future will still be done in physical post offices using face to face contact if customer aspirations are to be met. POCL estimate that these changes could reduce network operating costs substantially; although there would be costs associated with making them, they will almost certainly be significantly less than those associated with uncontrolled change.

What they might do

7. Although competitive threats will increase, POCL will fight hard to retain the business it currently has, as well as competing in new areas. Many services that post offices do today will continue and be modernised in terms of their delivery; in addition, there is a real opportunity for the Post Office to develop new services and markets based on its strengths, and upon a better and closer understanding of its customers' needs. This will enable it to widen both its service offer to the customer and to its client base.
8. In particular, analysis shows that there are three critical markets in which a future POCL will operate:
 - in simple financial services and transactions, including offering a network to all banks and financial organisations for simple banking services (eg taking cash out, paying cash in, savings, bill payment) in a way that supports the bank's strategies to reduce the £4bn worth of bank branch costs they currently have. This will be the market into which benefit encashments will also migrate over time into universal banking;
 - in 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

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- 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);
 - in 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.
9. In addition, the Post Office will provide a world class infrastructure to underpin this re-shaped network. This will consist of a suite of best-in-class systems to modernise key business processes, such as logistics and processing transactions, and to provide fast and accurate customer and management information. This will enable POCL to:
- make its core operating processes far more efficient through technology (operating savings of up to £50m pa are targeted in the medium-term assuming Horizon);
 - continue to provide, to an even greater extent, the wholesale movement of cash throughout the UK as a strategic, competitive service, in partnership with the private sector;
 - build a more direct relationship with, and understanding of, its millions of customers to build new services in a way that meets modern needs drawing information and advice perhaps, from many Government Departments (for example, in setting up a new business or finding out about benefit entitlement);
 - offer a multi-service Post Office smartcard (see para 20 below).
10. The integrated economics of a transformed POCL in 10 years' time are based on prudent assumptions about the share and the size of the prizes it could gain from those markets outlined above. The contribution ranges (c£400m to £700m pa before fixed costs) represent the prospect of a healthier business than today's, and a far better prospect than if no change of strategic direction were taken.
11. The strategic direction is not only coherent, but based upon credible market analysis and desire to change.

How it will get there

- 12 The Post Office is confident that its key competitive strengths will endure and be relevant (see para 3 above). There is also good evidence to date that major organisations in the market place find these strengths attractive: for example, in banking, POCL has undertaken work with Lloyds TSB and the Co-Op bank recently, as well as for its traditional clients, Alliance and Leicester and DNS. However, there are some critical steps
- POCL needs to harness technology to make it fit to compete, both at outlet level post offices and within its infrastructure;
 - commercial relationships with both Government and the private sector need to be forged (eg with the banks);
 - the reshaping of the network needs to be evolved over time;
 - organisational capability to develop services, and to make change happen needs to be enhanced (including relevant public/private sector partnerships)

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13. If these steps are taken carefully and in the right sequence then a managed transition of change will happen that will be in the public interest - both for Government, and for the Post Office, and for the citizen as customer and taxpayer. This path is most closely aligned to Option 1 in the Horizon Treasury Report. Options 2 and 3 are much higher risk, and likely to cost more and gain less strategically, because some steps will be out of sequence leading to a probable spiral of decline and social disruption. For example, there is no single benefit which has greater than 33% use of ACT at the moment, and four benefits (Incapacity Benefit, Single Parent Allowance, the Social Fund and Income Support) representing over 14 million entitlements, make no use of ACT at all. So, the scale of change is challenging, and from customer research, is likely to be very unpopular if imposed; it needs to be planned in an orderly way with post office involvement to make it work.
14. POCL needs the Horizon platform not only for banking services and benefit payments but also to enable it to compete for all of the markets and services outlined as part of its future. The platform will play an important role in winning new services, automating current services, modernising processes through front-end data capture, and understanding more about customers. A simple banking solution alone is not in itself enough to keep the strategy coherent and economically credible. Banking will represent an important part - but still a minority share (c40%) - of POCL's total business in 10 years time. However, without the banking business (including benefits migration) the funding of the technology becomes unaffordable.
15. Moreover POCL needs a banking capability based on industry standards in order to minimise development costs and risks and to interface with the rest of the banking system; Horizon is future-proofed for this. This is because services that POCL would need to provide to fulfil its banking ambitions are:
 - cash and cheque deposit
 - cash withdrawals on a stand alone basis (ie no purchase required)
 - account balance and mini statement provision
 - cheque book and statement ordering
 - inter account transfers
 - and supporting and developing Corporate Banking Services (especially for small business users) to fulfil its wholesale cash ambitions.
16. By contrast, a "simple generic" banking terminal (only able to handle debit cards such as SOLO or ELECTRON) would not be capable of supporting POCL's commercial offer to the banks, and the key part that has to play in retaining customers. It is imperative this is recognised in any planned transition to ACT.
17. In addition to the right type of banking technology POCL's minimum requirements in technology terms from Day 1 would also be to continue to maintain and extend its current automated functionality for bill payment and electronic accounting. Practical considerations mean that the only viable solution is a single system that covers both banking and current automated functions. To seek to provide the capability through separate systems would create insuperable problems in terms of space at the counter as well as prolonging lengthy and error prone processes. POCL also has a separate major programme for its back end systems that are in urgent need of replacement and modernisation. Work is already in hand to introduce world class systems which will

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enable significant efficiency improvements. These all pre-suppose the existence of front-end, error free, data capture and accounting provided by a system such as Horizon. Delay to delivery of the front-end system will result in additional costs for maintaining hybrid systems and deferred cost savings from operational efficiencies.

18. In addition POCL's other clients such as DNS, DVLA also want to modernise and re-engineer their products and services over the next few years and are looking to delivery of POCL's front-end system to enable this activity.

In terms of future aspirations it will also provide:

- the front-end data capture and the accounting system that will enable transactions to be carried out and recorded quickly, accurately and efficiently;
- the necessary information and support to enable staff to handle a wider range of disparate transactions;
- an extensive communications infrastructure that can also support the introduction of kiosks and possibly ATMs in post offices (though the front-end will differ to enable effective customer interaction);
- extensive data analysis building on its significant data warehousing and data mining capability;
- a highly secure system and the capability to support a multi-application smartcard.

19. Implementing Horizon and the benefit payment card has the following strategic advantages.

- the benefit payment card itself has considerable advantages to Government, DSS, and the customer, in its own right:
 - it is more fraud-proof than ACT (it requires pick up of cash each time);
 - it is popular with customers (trial offices research documents this), whereas ACT is typically not;
 - it enables proper reconciliation for DSS and so will prevent its accounts being qualified;
 - it allows greater customer service options to beneficiaries that are popular and well-used (eg use of agents, being able to pick up cash at any post office securely, being able to receive short term benefits easily);
 - it is as cost-effective to the UK economy as ACT (simple 2p ACT costs ignore the cost of getting cash into hands which if done in scale by the banks would result in likely charges to those customers least able to afford them);
 - it avoids heavy exit costs from cancelling the service with ICL Pathway (in the order of £250m legal claims are likely).
- the Horizon infrastructure and equipment provides an integrated platform to help enable the modernisation of all existing and future post office services and processes.

20. The benefit payment card also provides a smooth path to the part of the POCL's strategic direction that ties the components together for the customer, and that will enable services to be delivered securely and in a trusted way for Government and the private sector. That is a smartcard, branded and run by the Post Office. Such a card would:

- be given to all benefit card holders to create an 'instant' new 20 million customer base and so achieve critical mass for such a card;

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- be connected to all banks' standards (eg VISA, MONDEX) to enable cash withdrawal in the reshaped post office network and at other outlets for many banks;
 - have encryption technology developed for Royal Mail electronic mailing services that provides very high levels of security for an electronic 'digital' signature so that it can be used with confidence to allow the citizen to interact confidentially with various parts of Government for eg information and advice, licences, personal medical histories, or as voluntary identity card;
 - be able therefore to be used to combat other larger types of fraud (eg benefit entitlement fraud or housing benefit fraud) as well as method of payment fraud;
 - be useable for future postal services;
 - be used as the key to establish customer relationships and customer loyalty with the Post Office;
 - be used to form partnerships with other retailers through joint use or joint branding of the card.
21. In time, and with the kick start of the benefit payment application, there is a strong likelihood that the Post Office card would become as natural for most citizens to use, and have equal access to, as the post office network is now - but for a much greater variety of services and partners, and not exclusively at post offices.

The other suggested options on Horizon (Options 2 and 3)

22. Strategically, these options (cancellation of Horizon in part or in whole and a quicker move to ACT), would lead to the uncontrolled decline in network, at dissonance with society's expectations, arising from the sudden loss of business or customer footfall likely to arise from them, or extensive overt subsidy. In reaching a decision, it is important to recognise the serious and far reaching consequences, and the high profile nature of it. Short term budget considerations are not enough in themselves - and these may well not provide net savings anyway when the consequential costs of termination are taken into account.
23. In terms of the consequences on post offices, POCL's cost structure is typical of that of a network business, with the majority of its cost fixed or semi variable by volume and number of outlets. That allows it to support the marginal outlets within the nationwide network and still make a modest profit. The smallest 4000 to 5000 post offices (typically in rural areas where other banking or shopping facilities are absent) perform less than 2% of POCL's business and therefore could be said to lose POCL around £20 to £30m which it absorbs within its total business cost structure. Such a regime, however, only works effectively at the margin. It relies on the main core of POCL's network remaining viable so as to meet the non recoverable elements of infrastructure cost. If volume, income and customer footfall in that core network were to be subject to sudden and unmanaged fall and itself become unstable, then the number of offices requiring support is likely to rise in inverse proportion to POCL's ability to support it. In those circumstances, confidence in the sub post office market would collapse, and POCL and Government would face the prospect of uncontrollable network decline. In effect, instead of managing and reshaping the network, we would be into an unmanaged spiral for which it is difficult to predict an end point, and from which large job losses, and compensation claims by subpostmasters would result.

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24. Not only would there be serious damage to the post office network, and an inevitable decline in customer footfall and probably service in post offices, POCL credibility in the marketplace to attract replacement business - or indeed alternative technology partners - could be seriously undermined. In effect, the Post Office brand would be damaged.
25. In terms of technological capability the other options offer, the inadequacy and lack of affordability has already been set out above. In addition, the timing would be out of step with what POCL would need to retain and replace customer footfall and business.
26. POCL has also considered the option of having reduced levels of core functionality across different parts of its network (as part of a joint study with ICL and DSS earlier this year). The conclusion was that no worthwhile cost savings could be achieved via this route because:
- only 3000-5000 out of the total 40,000 serving positions would be candidates for such a reduction and therefore any savings would be at best a proportion of 7% of total equipment costs in post office;
 - the added complexity of having to develop and support two different systems would add costs and delay delivery, which would more than outweigh any cost savings;
 - the alternative would not have provided the detailed data capture capability needed for POCL's back end process and therefore additional cost would be incurred in supporting ongoing manual accounting;
 - it was considered undesirable to identify 5000 small rural offices as having a reduced service, and therefore a high risk of potential closure.

Summary

27. The strategic direction the Post Office has set out for the future of post offices is one of growth and managed change for its network and its commercial relationships. There is a real opportunity for post offices to create an exciting future if that is grasped now.
28. This direction is in the public interest, and should set the framework for Government policy to bring post offices and their services, as part of the modernised Post Offices into a role in the next century where they will help deliver solutions for UK citizens in dealing with everyday life.
29. That transformation, given serious commitment by all involved, is not only manageable, but also credible, coherent and attainable. The best strategic route for the Government is Option 1 for Horizon and is recommended as the positive way forward and a strategic signal of intent for post offices.