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fio.
Copy:
Mener
Keith
Keith

10th Floor
1 Canada Square
Canary Wharf
London E14 5AG
United Kingdom

Tel +44 (0) 171-311 1000
Fax +44 GRO
Telex GRO
DX GRO

To: See list
Organisation
Fax

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Copy to

From: Chris Nicholson
Department: Government Consulting, London-CW
Telephone: GRO
Fax: GRO

Ref: cn/mp/270

Date: 16 October 1998

Subject: BA/POCL

I attach as background to Monday's meeting the current draft of our work on BA/POCL. I should stress that this is being released in a state which I would not normally be prepared to release a draft. I am mindful of the very tight timescales under which the working group is operating and therefore it is released as a working draft which cannot at this stage be relied on as a basis for decision, but which may help to inform discussion on Monday. My principal concerns are that:

- it has not been subject to any quality review.
- of necessity some of the work has proceeded in parallel with the result that there are some inconsistencies. I would in particular draw attention to the following:
  - we requested POCL to prepare banking profit assumptions on the basis that under Option 2 a banking platform would be in place by October 2001, as in the original report. The view of our banking technology consultants is that this could only be achieved if there were no pilot. It may therefore be more prudent to assume a date 6-12 months later which will affect the banking profit line throughout;
  - the more aggressive banking profit assumptions which we had assumed compared to POCL were not estimated to have any impact on the size of the network by POCL. We consider that this is an excessively conservative assumption, but has not been reworked.

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It has not yet been possible to attempt to estimate, given the current figures within the time available, of the cost of the subsidy necessary to keep the network at the same size between Options 1, 2 and 3. We hope to do this early next week.

I would also stress that within the time available and with the information available (including the constraints caused by limited access to ICL Pathway) some of the assumptions made have been somewhat "heroic".

GRO

Lis..

Adam Sharples, HMT -
Sarah Graham, DSS -
David Sibbick, DTI -
Jeremy Crump, CITU -
Geoff Mulgan, No 10 -
Jonathan Evans, POCL -
George McCorkell, BA -

GRO

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HM Treasury

Benefits Agency/Post Office Counters Limited automation project

Analysis of fall-back recommendations

16 October 1998

KPMG
Ref: cn/dt/280/hmtbrep/hmtfbrep

Contents

1 Introduction

1.1 Background

In May 1996, the Benefits Agency (BA) / Post Office Counters Limited (POCL) signed PFI contracts with ICL Pathway (ICL). ICL would set up and maintain an automated infrastructure for POCL to enable benefits to be paid to customers using a magnetic strip card and to provide a platform for other POCL business.

Ministers have been reviewing the future of the project in view of the serious delays to the implementation timetable and ICL's failure to deliver a key contractual milestone for which ICL has been placed in breach of contract.

Ministers have decided, without prejudice to sponsors' legal rights under the existing contract, to allow a period of one month for discussion between the parties to see whether satisfactory commercial terms can be agreed for continuing the project, outstanding differences on the timetable can be resolved, and a credible programme for full implementation can be agreed.

Ministers will need to satisfy themselves that the proposed way forward offers best value for money, taking account of the costs to the public sector as a whole, of the alternatives.

In broad terms, the alternatives to continuing the project are:

- to abandon the benefit payment card element of the project, but continue with the rest of the Horizon system;
- to terminate the whole project and for POCL to commission alternative technology.

1.2 Terms of reference

The purpose of this consultancy is to assist the Treasury with the analysis of fallback options. We were required to review and assess four specific issues:

- POCL's network modelling of the impact on the post office network of the loss of BA income and claimants footfall income, in particular:
  - extent of closures and losses if no subsidy were provided;
  - extent of subsidy required if closures were to be avoided.
- viability of DSS and BA's programme for an early shift to benefit payment by automated credit transfer (ACT), including the impact on the banks and their charges to customers;
- timescale and costs of implementing an alternative technology platform for POCL;
- validity (in both technical and commercial terms) of pursuing the Horizon project without the benefit payment card.

1.3 Qualifications

The timescale within which this work has been carried out has been extremely compressed and we have been heavily reliant on project costs and assumptions produced by BA, POCL and ICL Pathway, adjusted in a number of cases by KPMG. We must emphasise that the realisation of the projections is dependent on the continuing validity of the assumptions on which they are based.

This is particularly so as concerns the amount and the timing of the cash flows and the effect on cash requirements. They have been produced for the purpose of comparison of a preferred option (option 1) against two fallback options. If Government wished to proceed with either option 2 or 3, considerable further work would be required to test these assumptions and produce a business case before a decision is taken to proceed with either option

1.4 Work undertaken

1.4.1 *POCL's network modelling*

We held a number of discussions with POCL to understand the process of their network modelling. In specific areas of the modelling we queried some of the assumptions used in the network model, and asked POCL to provide further evidence to support their rationale. We also noted that POCL's inputs to Treasury were based on scenarios which were not entirely consistent with the requirements of the Working Group, and so we requested POCL to carry out some further modelling to represent more accurately the impact on the network and their profits.

1.4.2 *Early shift to benefit payment by ACT*

We investigated the feasibility of ACT migration plans with the banking industry, through a limited number of telephone based interviews.

1.4.3 *Feasibility: option 2 (Horizon without BPC) and option 3 (alternative technology platform)*

Our assessment of the technical and commercial feasibility of options 2 and 3 involved:

- a review of POCL assumptions underlying their banking strategy, and their approach to banking technology costings and timescale estimates under options 2 and 3. Discussions were held with Keith Baines (POCL), Tim O'Leary (French Thornton), and Sarah Mullen (Treasury).
- a review of Horizon architecture and ICL/Pathway proposals for banking, together with issues affecting the inclusion of banking technology. Incidental review of the impact of removing the benefits payment card from Horizon (though discussions here were subject to constraints on consultation with ICL/Pathway).
- assessment, in consultation with retail banking experts, of the technical viability of the banking options proposed for POCL and the impact of the associated risks on feasibility, cost and timescales
- construction of costing scenarios for option 3.

1.4.4 *POCL banking income assumptions*

We reviewed the basis of the banking income assumptions POCL submitted to the Treasury. We noted areas where there were differences between what POCL submitted, and what appeared in the Working Group Report. For the assumptions prepared by POCL we interviewed POCL employees to understand the basis and degree of confidence in the assumptions. We prepared an assessment of the assumptions used, and developed revised assumptions.

2 Feasibility of fall-back options

2.1 Viability of early shift to benefit payment by ACT

2.1.1 *Banks' views on the move to ACT*

Further research would be needed to obtain a comprehensive view from banks regarding the move to universal payment of benefits by ACT. However, findings of some initial interviews undertaken on behalf of the Benefits Agency suggest that, overall, universal payment of benefits by ACT is not an area of concern for banks:

- *Migration to ACT:* Banks would expect that there would be formal discussions between BA/DSS and the industry, but no problems are anticipated for a migration period of two years or three years. Notice would only be required if this necessitated changes to products, payment infrastructures or ATMs. This is assumed not to be the case;
- *Use of ACT by existing customers*: No problems or issues are anticipated here. Customers are free to use ACT methods as part of their existing account. The basis of their account is not expected to change merely as a result of increasing use of ACT methods for benefits payments. Existing ATM facilities, including free withdrawals, are expected to remain unchanged. However, it must be noted that some banks charge customers for withdrawals at any other bank ATM, a policy which is expected to continue. Some concern was expressed regarding a putative increase in counter cash withdrawals. If there was a noticeably large rise in counter transactions, banks would be likely to review the need for charges in this area. In this connection, it is a common retail bank strategy to migrate customers out of branches to ATMs. This trend is not benefits related;
- *Offering new accounts to the unbanked.* Some banks believe that they have products well suited to all sectors of the market, and are keen to extend these to those on benefits without bank accounts and the unbanked generally. Under money laundering rules the main requirement is an address, or a letter from a hostel director. There are no exclusions for social group reasons. However, in line with wider strategic considerations, a significant increase in counter transactions may cause a review of charges;
- *Use of POCL for cash withdrawals.* In a situation where post offices would offer an ATM or ATM-type facility, the banks questioned see no issue or problem with customers of the PO continuing to use post offices for cash withdrawals, and indeed were in favour of customers continuing to use them if that was their choice. Financial issues relating to the provision of such services would be dependent on a wide variety of issues, and would need to be determined on a proposition-by-proposition basis through discussion between individual banks and POCL,
- *Increasing volume of payments via BACS:* Banks do not have concerns regarding increases in BACS volumes;
- *Customers of another bank switching their existing account to the bank:* No problems or issues are anticipated here. Some banks are positively interested in attracting new customers, and believe they have attractive products to offer. Such products typically offer an on-line debit card (no cheque book), ATM withdrawal facilities at no cost (though some charge for using other bank ATMs), DD/SO facilities, and counter facilities (though some banks currently charge for counter withdrawals via such an account). Some products offer modest credit facilities to allow customers to round up ATM withdrawals to the nearest £10.

2.1.2 *Benefits Agency*

The DSS's *Departmental Review of Benefit Payment Options - Proposal for increased use of ACT* concludes that the following levels of ACT migration are feasible:

- 60% by the end of March 2002;
- 99% by the end of 2004.

The paper, which is underpinned by a top-level project plan, identifies the following key dependencies:

- resolution of banking issues - see 2.1.1;
- agreement on policy issues relating to benefits which cannot currently be paid by ACT and to the unbankable;
- alignment of periodicity;
- introduction of secondary legislation to make ACT the normal method of payment (and possibly also to alter periodicity) by March 2001;
- implementation of IT changes including those required to CAPS.

The IT changes are scheduled to complete by the end of June 2001. The changes may well be significant - over one year's development time has been allowed in the plan but we are not aware of there being any detailed plans for the changes at this early stage. The plan shows the cost and timescale impact of the IT changes being assessed during the first half of 1999.

Given the complexity of CAPS, this dependency represents a risk. The risk is aggravated by need, we understand, for CAPS changes to be implemented over Bank Holiday weekends, increasing the impact of development slippages.

2.2 Banking viability: common assumptions and issues

2.2.1 *Scope of POCL banking service*

Development of a banking strategy for POCL is at an early stage, and is unlikely to be complete for a further 3-6 months. However, the agreed objective is for POCL to provide a delivery channel for retail banking. POCL will not be aiming to support all aspects of retail banking, nor will it become a bank in its own right. The provision of retail banking services via POCL is intended to serve a dual purpose:

- to provide a continued benefits encashment service for benefits customers on migration to ACT, and hence a means of retaining their custom;
- to offer a commercial service to generate sufficient profitable business to replace lost Benefits Agency income and secure the longer-term future of the post office counter network.

The proposed POCL banking offering has been envisaged as the equivalent of a "manned ATM". For the purposes of the viability assessment, the following assumptions have been made:

- POCL is aiming to offer services to the bulk of the personal banking market. Agreement with 8-9 significant players is believed to be necessary to achieve this;
- POCL will offer a standard service to the banks with whom they establish agreements,

- customers of banks which have entered into agreement with POCL would have access to the core "manned ATM" services at any post office

The following are regarded as the core services which must be provided as a basic banking service:

- cash withdrawal by Switch/Delta card or by cheque. Depending on the policy regarding the implementation of benefits ACT for the "unbankable", cash withdrawal by Solo/Electron may also need to be supported;
- account balance enquiries;
- inter-account transfers;
- bill payments;
- cheque deposits;
- cash deposits;
- mini-statements;
- stationery ordering.

From a technical perspective, support for PINpads is likely to be required, and, longer term, the banking infrastructure should be capable of supporting smartcards, given their likely importance in future retail and government services.

A number of further possible banking services for POCL have been discussed, but have not been reflected in this viability assessment. These are listed in appendix B.

2.2.2 *Banking viability*

Assumptions relating to the feasibility of banking which affect both options 2 and 3 are reviewed below.

2.2.2.1 *Business case for the "manned ATM"*

Options 2 and 3 (other than the simple debit terminal variant of option 3) all involve the provision of services equivalent to a "manned ATM". The business case for this will need to be substantiated.

Key information required includes further details of the geographic coverage and approach envisaged by POCL to deliver a "manned ATM" across all outlets. Decisions on the number of outlets and the form of ATM to be provided will have a significant impact on costs and timescales. Factors to be considered include:

- in locations well served by the banks and supermarkets, will "manned ATMs" within post offices offer consumers benefits over existing alternative distribution channels?
- in rural areas, will POCL be able to offer a profitable service which is more cost-effective for the banks than the provision of an ATM?
- to what extent do consumers in different types of area prefer a face-to-face service to an automated service?

2.2.2.2 *Banking software*

On the basis of the banking service outlined in section 2.2.1 above, the core software required is essentially a teller application, which would emulate an ATM to interface with banks' systems. Teller software would not necessarily be available "off the shelf", but standard development tools are generally used in this market, to develop a set of teller functions adapted for a customer's particular business environment. Software development of this nature should not present major technical problems, though a number of issues would need to be explored thoroughly, in particular:

- functional and security differences between "manned ATMs" and "real ATMs" would require investigation. For example, the first use of a card generally results in the user being prompted to change his or her PIN. It is not clear how this would be handled by the POCL counter system;
- the possible need for support of the Euro should be considered, particularly with respect to transition issues.

Adopting a "manned ATM" approach has the advantage of theoretical simplicity based on a single process for POCL staff, although depending how it was implemented it might restrict future growth of services to retail financial services customers. For example, some services currently excluded from the network banking definition - eg capture of address changes - would not be supported by the ATM protocols.

In addition to a front end teller application POCL may even under this relatively simple option, and depending on their retail banking goals, need to consider implementing systems to handle customer information, settlement, funds transfer, accounting and management information. POCL will need to outline all of these requirements in more detail to enable credible estimates of costs or timescales be provided. This will also drive out potential issues in other areas such as ownership of customer data, data protection and the extent to which banks might feel a competitive threat from POCL which would make them unwilling to co-operate.

2.2.2.3 *Bank interfaces*

The development of the proposed capability for POCL is dependent on establishing interfaces with retail banks There are three main possible approaches to this:

- *POCL interfaces with banks individually:* POCL would enter into reciprocal arrangements with a number of banks The banks would then allow a POCL "front end " teller application to emulate an ATM which interfaced directly with a bank's core banking systems, thereby acting as an additional delivery channel for that bank. The practical issues around banks granting access directly to their core systems and the controls and safeguards needed to preserve integrity are likely to result in a lengthy discussion period. Our view is that it is unlikely that banks will accept the "black box" stance on this which Pontis advocates for POCL: as parties to an agreed interface, banks will expect evidence of the appropriate security and controls;
- *POCL interfaces with banks via the LINK network:* POCL have indicated that they may wish to consider using an established intermediary such as LINK Interchange Network Ltd (LINK), which provides a switching service to members network member ATMs, as a suitable vehicle for their pseudo ATM application. However, to the best of our knowledge POCL have not approached LINK officially to discuss this idea Based on our knowledge of LINK and exploratory discussions with them, they would perhaps not readily accept a new member whose "system" was not an ATM network irrespective of how it was disguised. In addition it is likely

that LINK would have reservations about taking an organisation which had 19,000 new "ATM" outlets into a proven and reliable ATM network of approximately 15,000 LINK ATMs. Comments on the viability and likely timescale of establishing a network via LINK are not possible without involving them in detailed discussions. LINK will require clear and detailed definitions from POCL about how it proposes to meet LINK standards and preserve the integrity of the LINK network, and a strong business case for why its pseudo ATM or "manned ATM" should be accepted into the LINK ATM network. It is likely that LINK would not accept POCL without due consideration of its application and consultation with the member banks. It is envisaged that this process may take at least 6 - 12 months,

- *POCL interfaces with one bank.* This bank would in turn provide the interface with other banks for POCL. POCL may feel that they could approach Alliance and Leicester on this, as a development of their existing banking relationship with them.

2.3 Option 2: commercial and technical feasibility

2.3.1 *Option 2 commercial viability*

Drivers of the commercial viability of option 2 include:

- viability of POCL network banking;
- remuneration of ICL.

The viability of network banking in general is discussed in section 2.2.2.

ICL has provided an indication of the margin which it will forego should option 2 be implemented. Our analysis indicates that this peaks at around £60m. The HM Treasury Working Group report suggests that ICL may seek compensation for this lost revenue In considering any potential claim by ICL, consideration should be given to the fact that they have already requested an increase in charges in order to avoid losses.

The situation may be somewhat ameliorated by the early introduction of banking, with associated transaction volumes. From this point of view, a two-phase approach to the implementation of banking, with the early introduction of EFTPOS and "cashback", may be desirable. This option is discussed further below (see section 2.4 1).

2.3.2 *Option 2 technical viability*

2.3.2.1 *Removal of the benefits payment card*

Commercial sensitivities have meant that this issue has not been discussed directly between POCL and Pathway. Nor have discussions been held more broadly about the provision of banking technology by Horizon. Our own discussions with ICL have been restricted to more general coverage of the Horizon technical architecture and their proposals for banking. Working assumptions regarding the viability of removing the BPC from Horizon can be made from these findings, but the technical implications would need to be reviewed more fully with Pathway.

Our high-level understanding of the architecture supports the POCL view that Horizon has a modular structure and that removal of the BPC is feasible. [NB. It is in Pathway's interest to ensure that the Benefit Encashment System (BES) module - which has the rules and options for the counter benefit card element - can be removed, as they hope to develop Horizon for foreign markets, where it would not be required].

The impacts of removing the BPC are likely to include.

- possible need for changes to the EPOSS counter application;
- possible need for changes to the TPS host application (reconciliation);
- revisiting of capacity models and infrastructure deployment plans (number of communications devices etc);
- retesting of the modified system;
- modifications to training material.

It should be noted that the bulk of the benefit payment software has now been developed so no major development cost savings for ICL would result. From our understanding of Horizon, we do not expect the changes outlined above to be onerous, although the need for retesting is likely to give rise to a slip in the release date for New Release 2.

2.3.2.2 *Suitability of the Horizon architecture for development of a banking capability*

ICL Pathway appears confident of the feasibility of providing banking services over Horizon. This view is supported by the Pontis report. However, this assessment of feasibility is based on a high-level technical design which, in turn, is based on a number of assumptions about the business requirement and the business, technical and procedural aspects of the putative interface between Horizon and the banks.

Further definition of the business and technical requirements, and their agreement by POCL, ICL Pathway and the relevant banks, would be required before the impact on the Horizon architecture could be confirmed. We have commented on the issues involved in section 2.2.

The other area which will require more thorough technical review is the impact of on-line banking authorisation requirements on the current Horizon architecture. One option for the transmission of the messages constituting the authorisation dialogue is the Riposte infrastructure. Riposte is essentially a batch system, albeit with frequent batch transmissions (at 15 minute intervals). The ICL design relies on the use of "priority messages" which will cause a batch transmission to be "forced". ICL is confident that Riposte is sufficiently robust to be used in this way. However, this is an area of potential technical risk since we understand there to be no Riposte implementations of this size in existence, let alone any with significant on-line elements. Pontis has highlighted this as a risk area.

2.3.2.3 *Potential for early introduction of EFTPOS and cashback*

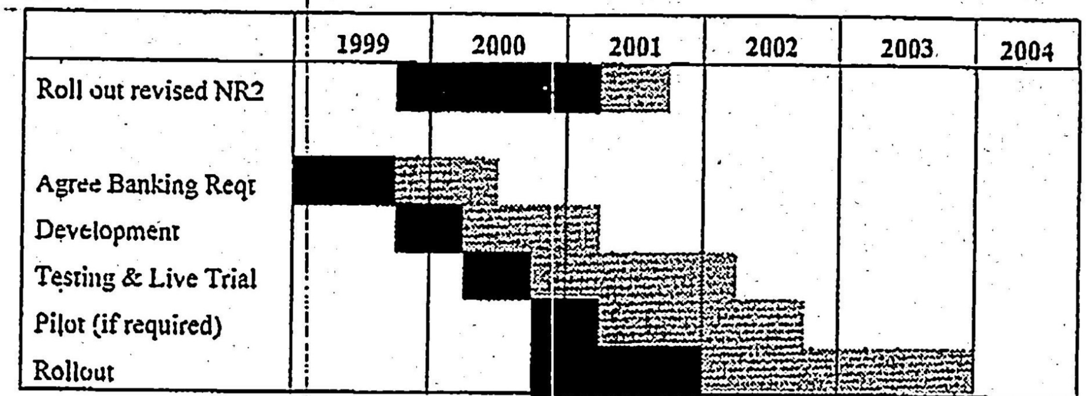
There is already an intention, although not a commitment, to introduce EFTPOS capability into Horizon. Given the risks associated with the establishment of a network banking interface, it may be appropriate to consider introducing EFTPOS into Horizon in advance of the move to full network banking. This would prevent the loss of customers moving to ACT should the full network banking implementation be delayed.

2.3.3 *Option 2 timescales*

It is necessary to consider both·

- the timescale for the national rollout of a revised version of New Release 2. This is needed to obtain benefits from the order book control system (electronic stop notices) and the automated payment and point of sale systems. Optionally, EFTPOS capability could also be included,
- the timescale for the release of full network banking.

Without discussion with ICL, discussion with the banks, detailed analysis of existing plans and detailed planning of the new activities, the estimation of timescales for option 2 is somewhat problematic. However, to facilitate the comparison of options, we have established the indicative range of timescales depicted by the figure below based on our high-level understanding of the project plans and methods, and the system architecture.



Note: Light grey bars denote potential slippage either within the task or as a result of slippage of predecessors

The individual tasks are described below.

Roll out revised NR 2	The release content of NR2 must be revised to exclude the benefit payment card. In order to ensure that rudimentary banking capability is available in time for ACT, EFTPOS may be added to the NR 2 definition. The removal of the benefit payment card is likely to necessitate some development and retesting, although the impact of this may be mitigated by the fact that there will be less user functionality to test. Given that there may be a decision to include EFTPOS in the release, we have estimated the net slippage as 3-9 months. The achievement of a timescale in this range with EFTPOS would be dependent on a rapid agreement of the detailed requirement.
Agree banking requirement	A definition of the requirement for banking agreed by POCL, ICL Pathway and the relevant banks is an essential prerequisite for the start of development. We view this as a risk area. On the basis that work on the banking strategy is already in progress, we have allowed around one year from now for the definition of the requirement. However, discussions with

	POCL suggest that the actual timescale might be up to 9 months later, for example if protracted negotiations with the banks cause delay.
Development	We have estimated 6 to 9 months for the development of the banking functionality. This may include detailed technical work with the banks. This timescale also assumes that there will be a single external interface to network banking, eg to LINK
Testing and Live Trial	We understand that testing and live trial of current Horizon releases takes around 9 months The reduction in functional complexity arising from the replacement of benefit payment with banking may reduce the timescale. However, stringent acceptance approaches on the part of the banks may increase it. We have therefore estimated 6-12 months.
Pilot (optional)	There is a possibility that the banks/LINK would expect to pilot the operation of network banking before full rollout began. Such a pilot would involve a larger number of outlets than the live trial. We have allowed 6 months for this. Because this is an "optional" activity, we have shown the "best case" bar in the plan running concurrently with the rollout. The possibility of the pilot being required is reflected in potential slippage (the grey bar).
Rollout	We have estimated a "rollout" rate of 300 per week. Rollout timescale will be dominated by: ■ time to install PINpads if these are not installed as part of the rollout of NR 2. We would expect that ICL Pathway would seek to distribute the upgraded software from the centre by electronic means; ■ time to train users in network banking; ■ rate at which LINK/a bank would accept additions to its network of connected systems.

Given the plan outlined above, it is likely that POCL and ICL would wish to consider merging New Release 2+ with the banking release. Components of that release not directly dependent on the banking requirement - for example the key management service - could be developed while definition of the banking requirement was in progress.

2.4 Option 3: commercial and technical feasibility

Two main scenarios have been considered here.

- simple debit terminals;
- a full Horizon replacement, including all the non-banking functionality which Horizon is intended to support (other than the benefit payment card and - given the likely timescale for procurement - the order book control system), as well as network banking (the "manned ATM").

The scenario favoured by Treasury is an initial implementation of simple debit terminals, to provide a basic cash withdrawal service quickly, followed by the full Horizon replacement.

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We have also considered a further option which involves the provision of network banking without any other services. This option would delay the provision of cash withdrawal as compared with debit terminals and would also delay the provision of any richer infrastructure (eg support for electronic access to government services) suitable for POCL's longer term strategy. Consequently, this option - which was not carried forward into the Treasury figures - has not been analysed further here.

2.4.1 *Simple debit terminals*

2.4.1.1 *Simple debit terminals: commercial viability*

The simplest "non-Horizon" banking option for POCL is to install debit terminals and provide a service allowing customers to purchase existing goods or services from POCL and also to withdraw money from their bank accounts via cashback. To provide this type of service POCL would need to enter into agreement with a merchant acquirer, a bank who would act as the intermediary between POCL and the card issuer.

This option has not been put forward as a long-term commercial prospect, but as an interim solution which enables POCL to develop a basic banking service as quickly as possible, to prevent the loss of benefit customers on migration to ACT which is envisaged if no post office banking facilities are in place in time. It is not, however, taking POCL into retail banking.

The viability of this therefore rests on the feasibility of system delivery within the ACT migration timescales, together with the impact which it might have on the implementation of a fuller banking service.

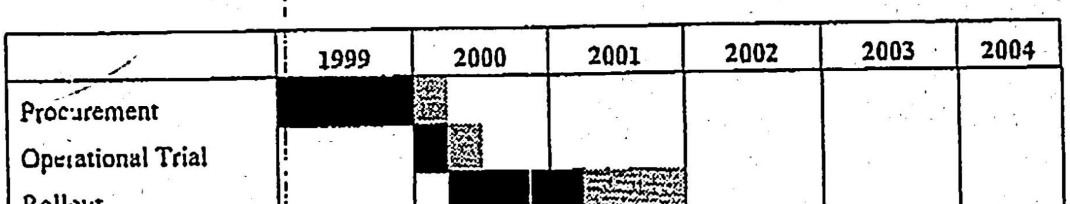
2.4.1.2 *Simple debit terminals: technical viability*

Based on our current understanding, this option appears relatively straightforward from a systems perspective, with POCL simply behaving as any other retailer who takes debit cards and passes the transactions on to a merchant acquirer.

Under a typical agreement with a merchant acquirer the necessary equipment will be provided by the acquirer on a rental basis with a percentage charge per transaction value levied for the service provided by the merchant acquirer, as intermediary. These intermediary services include the transaction handling, authorisation and settlement.

2.4.1.3 *Simple debit terminals: timescales*

Detailed implementation planning would be required in order to establish timescales with any degree of certainty. However, for planning and comparison purposes, we have derived the following timescales, primarily from POCL estimates with which we have no reason to disagree.



Note: Light grey bars denote potential slippage either within the task or as a result of slippage of predecessors.

The specific tasks are described below

Procurement	We have based our estimate of 12-15 months from the start of 1999 on the POCL estimates provided in the paper *Option 3 - Alternative Technology for POCL*, taking account of the fact that work on the banking strategy has already begun.
Operational Trial	We have taken our estimate of 3 months from POCL's estimates.
Rollout	We have taken our estimate of 12-18 months from POCL's estimates. The driver for the rollout timescale will be the logistics of installation and training.

Note that our costing models assume the earlier dates for these activities.

2.4.2 *Non-Horizon "full functionality" option*

Under this option, POCL provides network banking services, as described in section 2.2.1 above, together with a full functional replacement for Horizon.

With respect to the banking component, the general commercial and technical issues raised in section 2.2.2 again apply.

"Full functionality" in a non-Horizon context has not been explicitly defined to date. For the purposes of this assessment, we have assumed, in consultation with POCL, that the requirement would be for the existing committed Horizon functionality with the benefit payment card and order book control services removed, and banking added. Further details of these assumptions are provided in appendix C.

2.4.2.1 *Non-Horizon "full functionality". technical viability*

Whilst suppliers may propose various technical options for this, some of the issues applicable to option 2 will be relevant here too, in particular:

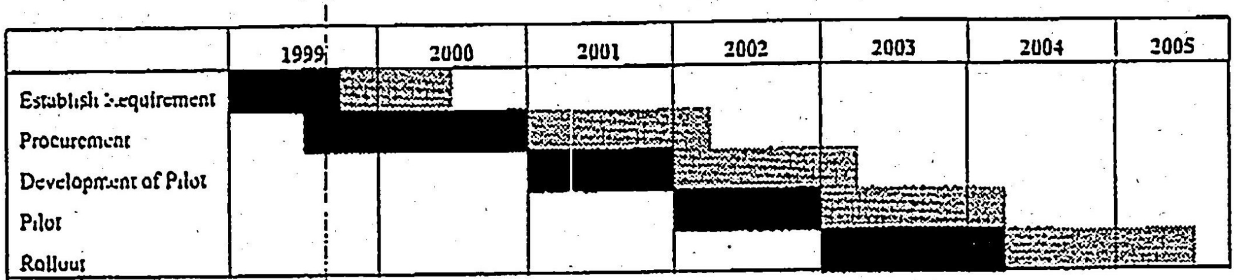
- the need to reconcile meeting standards for banking services (eg. the ATM interface) with POCL's potential need for commercial diversification;
- the need to ensure a software basis which enables new applications to be added readily. This suggests a PC/Windows front end based on generic software, rather than a system based on a more specialist banking package.

It should also be observed that a full-function Horizon replacement is unlikely to be significantly simpler - or necessarily cheaper - than its predecessor. In particular:

- the connection of the Horizon replacement to banks' systems or LINK, and the associated approval processes is analogous to the connection of Horizon to BA systems, and will have similar programme management requirements for the careful planning and execution of acceptance tests;
- although the banking application may be simpler than the benefit encashment application, much of the complexity of the overall infrastructure - eg the systems management architecture - may remain

2.4.2.2 *Non-Horizon "full functionality" timescales*

Given that the system requirement - in particular the interface with the banks - has not been defined and that the supplier and solution are unknown, any planning at this stage must necessarily be very approximate. Nonetheless, for planning and comparison purposes, we have derived the timescales shown below.



Note: Light grey bars denote potential slippage either within the task or as a result of slippage of predecessors

The specific tasks are described below.

Establish Requirement	A definition of the requirement for banking agreed by POCL, ICL Pathway and the relevant banks is an essential prerequisite for the start of development. We view this as a risk area. On the basis that work on the banking strategy is already in progress, we have allowed around one year from now for the definition of the requirement. However, discussions with POCL suggest that the actual timescale might be up to 9 months later, for example if protracted negotiations with the banks cause delay.
Procurement	Our timescale estimate of 18-24 months is based on our experience of procurements. There would be some potential for concurrency between the early stages of this activity and the finalisation of the requirement.
Development of Pilot	We have assumed that it will take around one year to build a pilot for rollout to around 1% of sites.
Pilot	We have assumed that operation of the pilot - including rework - will take around 1 year.
Rollout	We have assumed a rapid rollout at a rate of 300 per week.

Note that we have used the earlier of the timescales shown in our consolidated cost model and that there is risk attached to those timescales. That overall earlier timescale - 5.25 years - is in line with POCL's estimates.

3 Discussion of key assumptions

3.1 POCL network modelling

3.1.1 *Profit impact and network closures*

There is a close inter-relationship between the figures for 1st round impact on POCL profits, estimated profit from banking and the size of the post office network. Table 1 summarises these inter-relationships. The precise impact on the size of the network will depend on both the effect on sub-postmasters and whether they continue in business ("unmanaged closure") and the effects on POCL and the measures that they take to reduce their fixed cost base ie. close post offices in the locality ("managed closure"). If POCL are successful in managing closure they succeed in both reducing the fixed cost base and in maintaining their income flow. Of critical importance to the extent to which POCL is forced to carry out closures, is the extent to which banking income can replace Benefits Agency income and hence maintain the viability of the network.

Key assumptions made by POCL are:

- that in a managed closure scenario they migrate 60% of the PO business to other offices. This assumption is based on very little information from a small closure programme in the mid 1980s and from results from office relocations. Whilst these are rather unreliable guides, we have no reason to change this assumption,
- that footfall from the Post Office side of the business to the private side is in the range 27-36%, that this percentage of retail customers are PO dependent in footfall terms. This is based on a survey which interviewed customers of the retail side of the business as to whether they had also visited the Post Office. The core assumption is that if customers had not been visiting the Post Office they would not otherwise visit the retail side of the business. This is an extreme assumption and is contradicted by other survey evidence from POCL which indicates that between 20% and 65% of customers of the retail and post office side would still have visited the shop that day even if the post office were not there. However, the footfall assumption only affects the unmanaged closure scenario under Option 3, where as a result the estimates of Post Office closures are likely to be overestimates.

The differential impact on the number of post offices between Options 1, 2 and 3 is generated by POCL's success in retaining BA recipients as banking customers rather than order book/BPC customers. As discussed in section 3.3, outlining assumptions in the derivation of banking profits is critically determined under Options 2 and 3 by the speed with which POCL can get banking technology and contracts with banks in place in order to achieve a seamless transition of customers to accessing bank accounts through POCL.

3.1.2 *Compensation to sub-postmasters*

POCL have assumed that they will pay an amount equivalent to 26 months compensation to sub-postmasters in respect of all network closures. This level of compensation is the current arrangement if post offices are compulsorily closed It is arguable that declining sub-postmaster profits will lead to voluntary closures, but we accept the judgement that there will be a lot of pressure to compensate sub-postmasters for closures resulting, indirectly, from a government action to move to payment of benefits by ACT.

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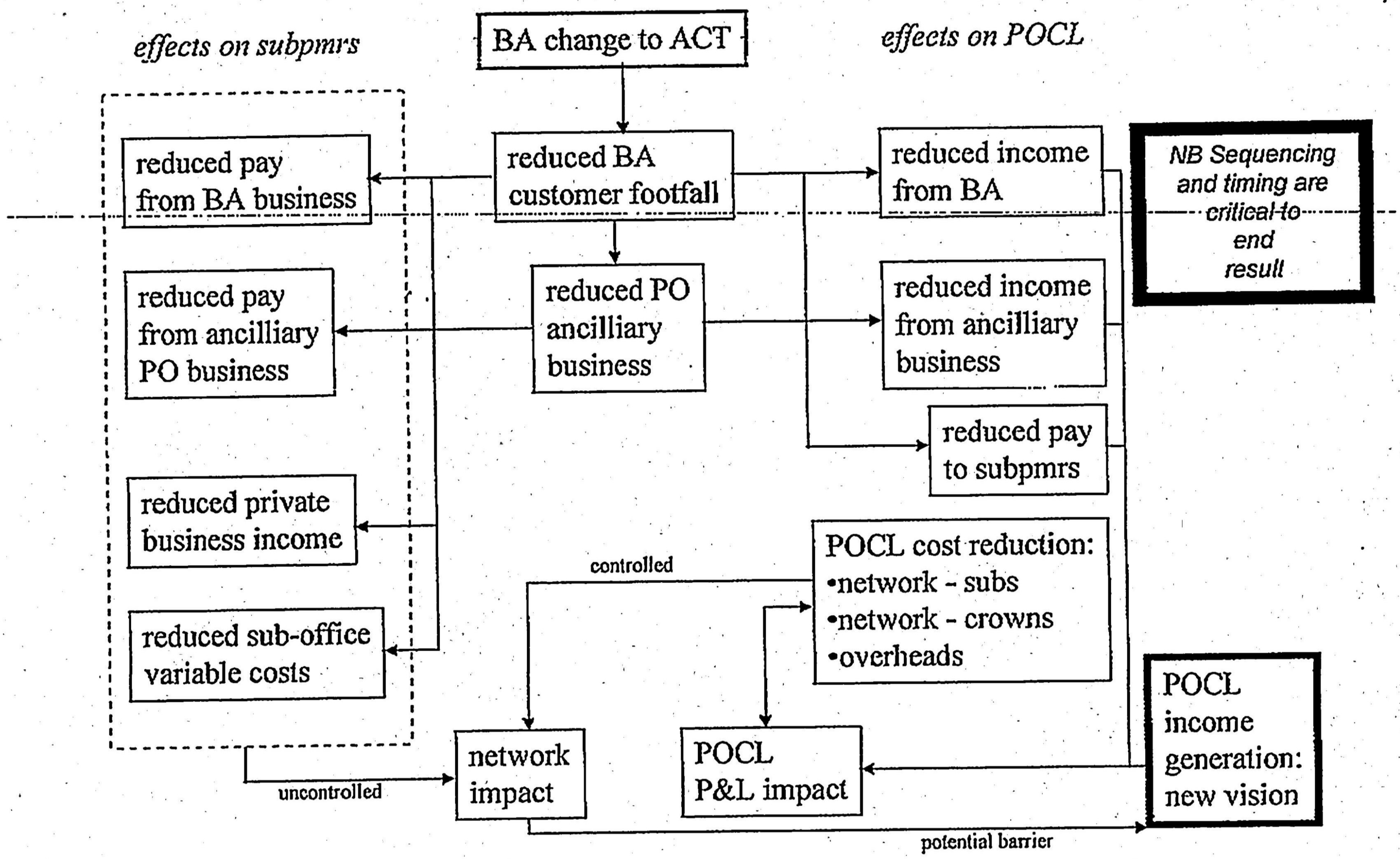

3.2 Cost of banking technology

3.2.1 *Option 2*

Setup costs are assumed to be £20m in the early years (£10m for software development costs and £10m for hardware) We continue to include these costs.

The main component of this cost is the recognition that POCL will need to remunerate ICL for their investment, because the loss of revenue for the BPC significantly outweighs any cost savings they can achieve at this stage. Option 2 in the Working Group Report included a cost to POCL of £75m per annum from 2001/02 to 2006/07 regarding remuneration of ICL, assuming ICL could reduce costs by about 20%.

We asked ICL if they could provide us with information on their reduction in margin if the BPC was discontinued. We made a slight adjustment to their calculations (as they had assumed compulsory migration of ACT from 2005/06 so therefore had included an extended revenue flow from OBCS in partial offset of reduced BPC revenue). The result is a much lower cost to POCL (NPV reduction of £112m).

3.2.2 *Option 3*

3.2.2.1 *Debit terminals*

The letter from Sarah Mullen (HM Treasury) to Helen Corlett (KPMG) of 7 October 1998 indicates that the costs used for debit terminals in the HM Treasury Working Group Report were derived from POCL estimates of a setup cost of £18M and running costs of £60M per annum. The derivation of these is presented in the letter from Mena Rego (POCL) to Isabel Anderson (DTI), 13 July 1998.

POCL quote the following setup costs for debit terminal operation:

Item	Quantity	Unit Cost £	Total Cost £M
Outlet modifications labour	19,000	75	1.43
Outlet modifications materials	40,000	50	2
Installation and training	19,000	200	3.8
ISDN connection	19,000	300	5.7
Subtotal			12.93
VAT			2.26
Project Management	60	50000	3
Total			18.19

These costs appear reasonable for working purposes, although the installation-related costs may be underestimated since:

- we understand that some outlets may need significant modification;
- man-day rates of £150-200 are assumed for the installation and training - these might be too low if contract staff are being employed.

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POCL quote the following running costs for debit terminals, assuming 500M transactions per year

Item	Quantity	Unit Cost £	Total Cost £M
Terminal rental	40,000	468	18.72
ISDN rental	19,000	400	7.6
Call charges	500,000,000	0 025	12.5
Consumables	40,000	10	0.4
Transaction charges	500,000,000	0.04	20
Call centre for fall-back transactions	40	50,000	2
Turnover training	4000	100	0.4
Relocation costs	380	525	0.2
Sub-total			61.82
VAT			10.82
Fraud risk	500,000,000	0.025	12.5
Total			85.14

Further work would be required to confirm the nature of the call centre requirement and corresponding cost. Our research indicates the following running costs for debit terminals:

Item	Unit Cost
ISDN rental per year	350
Visa debit transaction cost	0.08
Switch/Solo transaction cost	0.045
Debit terminal rental per year	180

Sources. BT, Indicative costs obtained informally from a merchant acquirer

Substituting these figures into the table and assuming an even distribution between transaction types, we obtain:

Item	Quantity	Unit Cost £	Total Cost £M
Terminal rental	40,000	180	7.2
ISDN rental	19,000	350	6.65
Call charges	500,000,000	0.025	12.5
Consumables	40,000	10	0.4
Transaction charges	500,000,000	0.0625	31.25
Call centre for fall-back transactions	40	50,000	2
Turnover training	4000	100	0.4
Relocation costs	380	525	0.2
Sub-total			60.6
VAT			10.6
Fraud risk	500,000,000	0.025	12.5
Total			83.7

These costs are very similar to those quoted by POCL and are reasonable for working purposes However, further work would be required to confirm the call centre costs Note that these figures assume a transaction volume of 500M. In our consolidated costs for option 3, we have assumed lower transaction volumes to reflect the phasing of the introduction of ACT

3.2.2.2 *Full-function Horizon Replacement*

The letter from Mena Rego (POCL) to Isabel Anderson (DTI) of 7 August 1998 indicates that the original POCL estimate supplied for input to the HM Treasury Working Paper for a replacement full-function Horizon was a one-off cost of £109M with ongoing running costs of £74M.

The letter also indicated that subsequent work had led to a revised estimate of a one-off cost of £30M-60M and running costs of £60M-100M.

We understand from discussion that at least the initial estimates were derived from the Pathway charges for the service which would be being provided (ie banking and no benefit payment card).

It is our view that comparison with Pathway charges may not be an appropriate means of estimating the likely future costs of a Horizon replacement. This is for the following reasons:

- The number of transactions passing through the replacement will be lower than would have passed through Horizon since the number of banking transactions will be less than the number of benefit transactions. All other things being equal, this would cause the supplier to raise transaction charges correspondingly.
- The nature of the proposition will be different in market terms. For example, an increased emphasis on banking and electronic government may encourage suppliers to view the opportunity as worthy of strategic investment - this would tend to lower charges. Alternatively, suppliers may perceive the opportunity as being high risk because of the fate of Horizon - this would tend to raise prices. Furthermore, the revised mix of services required may give rise to a competition very different in character from that of the original procurement.
- The winning supplier might take a different approach from that adopted by Pathway, for example making more use of existing infrastructure, thereby allowing charges to be reduced.
- The detail of the requirement is not yet known and may differ significantly in complexity from that of Horizon.

In order better to assess the potential range of costs for a Horizon replacement, we have modelled the possible costs of a Horizon replacement and then determined the revenue which a supplier would require for the project to have an Internal Rate of Return of 15% - a (conservative) industry-standard figure for bid/project evaluation.

In order to reflect the range of influences on price, we have modelled a number of scenarios of which three are shown here:

- Scenario A - integrated solution largely constructed from scratch for the project; high implementation capex; significant proportions of support infrastructure dedicated to project; rollout at 200 offices per week; high proportion of contract staff.
- Scenario B - significant element of reuse in development and support; implementation capex and ongoing operational costs reflect significant economies of scale and very strong purchasing power; rollout at 300 offices per week; no contract staff.

- Scenario C - as scenario B but with the contract staff proportions and equipment costs of scenario A.

Scenario A and scenario B represent extremes - the former would be likely to represent an uncompetitive solution while the latter would require an unusually strong combination of human, knowledge and infrastructure assets. Scenario C represents a potentially realistic point between these extremes and has a per-terminal cost consistent with other managed service projects known to us.

The models are based on the following assumptions:

- Initial development takes 1 year and is followed by a pilot rollout to 1% of sites. This assumption is primarily driven by the issues relating to acceptance of the infrastructure by the banks. In making the timescale assumption, we have assumed that only a single external interface - whether to an intermediary such as LINK or to a single bank which then provides the interface to other banks - is required.
- Full rollout begins one year later. This assumption derives both from consideration of the Horizon experience and, again, from the need to have acceptance from the banks prior to full rollout.
- It is assumed that there are 19,000 post offices with 40,000 counters. The average number of counters in crown, urban and rural post offices is assumed to be 5, 3 and 1 respectively.
- Full functionality is assumed to comprise current Horizon without the benefit card but with network banking. Further detail is provided at appendix C to section 3.
- Rather than consider possible charging models in depth, we have modelled a flat revenue stream starting from the beginning of rollout
- Both inflation and the deflationary pressure on technology costs are ignored.
- A 10-year contract is assumed.
- It is assumed that the service is being purchased as a managed service. However, we have not assumed PFI-type risk transfer either in the costings or in the required IRR.
- Some provision has been made for ongoing enhancement of the system but there is no provision for major technology refresh.

It should be stressed that the estimates of cost bear a very high margin of error since no detailed system requirement yet exists.

It is useful to note that the principal cost drivers emerging from the modelling exercise were:

- manpower costs - projects of this size frequently involve large numbers of contract staff with annual costs in excess of £100,000;
- capital cost of implementation, particularly the cost of counter equipment;
- operational costs, particularly systems management, support (1st to 4th line) and maintenance.

Note that the costs presented below exclude VAT.

Scenario A

Item	1	2	3	4	5	6	7	8	9	10
Headquarters Functions	4	4	4	4	4	3	3	3	3	3
Design & Development	17	17	12	8	5	5	5	5	5	5
Initial Implementation	30	10	91	90	0	0	0	0	0	0
Operation & Support	16	20	28	36	46	46	46	42	36	36
Total	67	51	135	138	54	54	54	51	45	45
Assumed Revenue excl VAT	0	0	110	110	110	110	110	110	110	110
Cash Flow	-67	-51	-25	-28	56	56	56	59	65	65
IRR	15%									

Scenario B

Item	1	2	3	4	5	6	7	8	9	10
Headquarters Functions	1	1	1	1	1	1	1	1	1	1
Design & Development	6	6	4	3	2	2	2	2	2	2
Initial Implementation	29	11	104	26	0	0	0	0	0	0
Operation & Support	8	10	15	20	25	26	25	24	20	20
Total	44	28	124	50	29	28	28	27	23	23
Assumed Revenue excl VAT	0	0	67	67	67	67	67	67	67	67
Cash Flow	-44	-28	-57	17	38	39	39	40	44	44
IRR	15%									

Scenario C

Item	1	2	3	4	5	6	7	8	9	10
Headquarters Functions	2	2	2	2	2	2	2	2	2	2
Design & Development	9	8	6	4	3	3	3	3	2	2
Initial Implementation	30	12	135	34	0	0	0	0	0	0
Operation & Support	8	11	16	20	26	26	26	24	21	21
Total	49	33	159	60	31	31	31	29	25	25.1
Assumed Revenue excl VAT	0	0	79	79	79	79	79	79	79	79
Cash Flow	-49	-33	-80	-19	48	48	48	50	54	54
IRR	15%									

3.2.3 *Cost of banking technology - LINK charges (both options 2 and 3)*

Connection to the LINK network is a potentially attractive option for the implementation of network banking, although the agreement of LINK to such a proposition is by no means certain (3.2.2.3 refers).

For the purposes of costing, we have assumed such a LINK connection. On the basis of informal discussions with LINK, we would expect the following charges to be incurred:

- a joining fee payable on entry to the network - £250,000 approx - amount is at the discretion of the LINK board;
- a LINK switch connection fee is payable for new members connecting directly to the LINK central switch - £80,000 approx depending on the complexity of the technology used by the connecting financial institution,
- a fixed monthly membership fee, varies according to size of the institution and is set at the discretion of the LINK board - £1,000 - £2,500 depending on the size of the members ATM network (more expensive the fewer ATMs the member has) - assume £1,000 for POCL;
- a monthly processor fee is payable by those members whose system is connected directly to the LINK switch - £1,000 flat fee for connection, £750 comms charge and £100 per ATM to a maximum of £8,000;
- a switch fee is paid to LINK by the card issuer for every transaction that crosses the switch, with significant discounts for volume - 7.18 pence to 0.49 pence sliding scale banded rates based on number of transactions processed. These terms will not necessarily affect POCL since POCL will not be a card issuer. However, this charging regime underlines the fact that POCL would be charting new territory in joining LINK

3.2.4 *Consolidated costs for option 3*

This section consolidates the costs for the implementation of simple debit terminals followed by a full-function Horizon replacement. It assumes the following:

- Scenario C for cost of Horizon replacement
- Debit terminals rolled out over the course of year 1999/2000 to 2000/1.
- Rollout of Horizon replacement - and hence payment of flat rate - starts in January 2003. In 2002/3, therefore, 25% of flat charge is incurred and 10% of banking transactions go through Horizon replacement.
- Rollout completes April 2004. In 2003/4, 60% of banking transactions go through Horizon replacement.
- POCL costs of procurement and management of Horizon replacement not included.
- Debit terminal transaction costs take account of phasing of migration to ACT.

All costs in £M

Item	99/2000	2000/01	2001/2	2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10
Debit Terminal											
Setup of Debit Terminal incl VAT	9	9									
Fixed Running Costs incl VAT	5	15	20	18	8	0	0	0	0	0	0
Transaction Costs incl. VAT			2 916	5 832	5.346	0	0	0	0	0	0
Horizon Replacement											
Horizon Replacement Cost ex VAT			19 75	79	79	79	79	79	79	79	79
VAT on Horizon Replacement			3 45625	13 825	13.825	13.825	13.825	13.825	13.825	13.825	13.825
LINK Connection Fees incl VAT			0.38775								
LINK Running Costs incl VAT			0	0.152	0 152	0 152	0.152	0 152	0 152	0.152	0 152
Total Incl VAT	14	24	46.51	116.809	106.323	92.977	92.977	92.977	92.977	92.977	92.977

3.3 Banking profits

POCL have estimated future income from banking with reference to consultancy provided by McKinsey and to some of their own, limited, research. The drivers of total income are the amounts banks are willing to pay, and the number of customers and transactions POCL are able to attract.

3.3.1 *Payment from banks*

POCL based their calculations on an income per account per annum of £25 (which Treasury revised downward to £20 in the Working Group Report). However this is value is based on discussions which McKinsey held with banks regarding how much they would be prepared to pay for their customers to be able to use POCL for banking transactions should the bank wish to reduce the size of its network to achieve cost savings.

Our discussions with banks indicated that payment on a 'per transaction' basis would be more likely and around 50p - 60p is a frequently quoted range. We asked POCL to assume 50p per transaction in their revised modelling.

3.4 Key DSS assumptions

3.4.1 *Costs of ACT*

DSS administrative savings estimates include the cost of transferring cash by ACT into benefit recipients' bank accounts. However, in addition to this cost there will be a cost to the banks of customers withdrawing cash from their accounts which is estimated to lie in the range of 50p-90p (dependent on whether the withdrawal is through an ATM or over the counter and the extent to which fixed costs of the branch network are included in the calculation). In the case of the "unbanked" a provision has been made in the estimates of £32 million per annum payment by DSS to the banks for them to take on this business without charging their customers for cash withdrawals.

Discussions with the banks held by both DSS and KPMG have not indicated that banks would seek to charge for such services and indeed there is considerable interest in attracting new customers even though they are benefit recipients. There is some concern about large additional numbers of customers using their branch network at a time when banks are seeking to transfer cash withdrawals to ATMs. However, this illustrates the potential for the Post Office to develop its banking business alongside the move to ACT.

In the case of the "banked", DSS have assumed that banks would not seek to recover any additional costs. There is a number of possible justifications for this.

- banks would obtain additional money flowing into bank accounts, the interest on which would help offset any additional costs,
- individuals would manage their accounts and their pattern of cash withdrawals in such a way that they do not incur additional charges.

Whilst this might appear to be a somewhat extreme assumption, in the course of our (limited) interviews with the banks this has not been seen as an issue. Our judgement, therefore, is that in view of the existing provision for possible costs of the unbanked which appears to be quite prudent, there is not the need to make any additional provision for this sum. Indeed, the prospective move to ACT for benefit recipients may be a useful trigger for the banks to consider seriously the banking proposition being made by POCL

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4 Summary of financial results

4.1 Definition of options

4.1.1 *Option 1: Continue with project*

Option 1 involves continuing the project including the benefits payment card but with amendments to the contract, in particular extension of its duration

This option has been subject to refinement as a result of the work being undertaken by the Independent Advisor, who is facilitating discussion between the parties to see whether:

- satisfactory commercial terms can be agreed for continuing the project;
- outstanding differences on the timetable can be resolved;
- a credible programme for full implementation can be agreed.

For the purpose of establishing a fixed position in the time available to complete our consultancy, we will define option 1 according to the assumptions in the core case (30 September) and in the Independent Adviser's proposal (11 October).

Year ended Mar	*'99*	*'00*	*'01*	*'02*	*'03*	*'04*	*'05*	*'06*	*'07*	*'08*	*'09*	*'10*
Roll out of system:												
- starts		√										
- completed			√									
POCL introduces banking services:												
- limited facilities				√								
- full facilities						√						
BA moves to ACT								√	√	√		
BA floor payment to POCL ends										√		
ICL contract ends with:												
- BA										√		
- POCL												√

Additional details of option 1 are as follows·

- ACT migration rate of 20:40.40 over 2006-2008
- POCL to accept refresh costs
- Cancel 3% pa price reduction from 2006 onwards
- POCL to agree to banking business guarantees at a level consistent with reasonably achievable targets

- Some increase in volume guarantees from BA to POCL

4.1.2 *Option 2: Continuation of Horizon without the benefits payment card*

Option 2 involves restructuring of the project without the benefit payments card (BPC) to allow an earlier move to ACT and parallel provision of banking services in post offices. BA withdraws from all contracts with ICL for the development of the BPC on the grounds of failure to perform, and POCL works with ICL to implement Horizon technology

Year ended Mar	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10
Roll out of system												
- starts		√										
- completed			√									
POCL introduces banking services:												
- limited facilities				√								
- full facilities						√						
BA moves to ACT				√	√	√						
BA floor payment to POCL ends						√						
ICL contract ends with:												
- BA	√											
- POCL						√						

4.1.3 *Option 3: Horizon cancelled*

Option 3 involves cancelling the whole project (on the basis of ICL's breach of contract for failure to meet agreed timetable) and POCL commissions an integrated technology platform to enable it to offer banking services as soon as possible.

Year ended Mar	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10
POCL introduces banking services:												
- basic technology				√								
- full banking services						√						
BA moves to ACT				√	√	√						
BA floor payment to POCL ends				√								
ICL contract ends	√											

4.2 Financial results

4.2.1 *Financial results: floor payment from BA to POCL ends when ACT migration complete*

NPV of the options discounted at 6% to 2009/10

Note NPV figures for options 2 and 3 assume no compensation is paid either to or by ICL

£billion	Option 1	Option 2	Option 3	Option 3V
DSS administrative savings	0.4	1.0	1.1	1.0
DSS programme savings	0.9	0.8	0.8	0.8
Net impact on DSS	1.3	1.8	1.9	1.8
Net impact on POCL	0.2	-0.4	-0.9	-0.8
Overall NPV savings	1.5	1.4	1.0	1.0

4.2.2 *Financial results: floor payment from BA to POCL ends when ACT migration begins*

NPV of the options discounted at 6% to 2009/10

Note NPV figures for options 2 and 3 assume no compensation is paid either to or by ICL

£billion	Option 1	Option 2	Option 3	Option 3V
DSS administrative savings		1.3	1.3	1.3
DSS programme savings		0.8	0.8	0.8
Net impact on DSS		2.1	2.1	2.1
Net impact on POCL		-0.6	-0.8	-0.8
Overall NPV savings	n/a	1.5	1.3	1.3

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN ACT MIGRATION COMPLETE

2 Continuation of Horizon without BPC, move to ACT (compulsory from 2001/02), floor paid until 2003/04

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @6% to 2010	NPV @6% to 2005
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-10	-15	-35	-15	25	75	120	435	435	435	435	435	1,306	87
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked"		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-205	-115
Total DSS savings (£m)		-20	-28	25	75	118	168	213	528	528	528	528	528	1,864	385
first round impact on POCL profits £m		0	5	10	20	30	40	-32	-163	-198	-183	-168	-151	-427	58
compensation to subpostmasters		0	0	0	0	0	0	0	-94	-94	-94	-94	-94	-263	0
cost of banking technology for POCL		0	-3	-33	-71	-51	-51	-51	-31	-21	-1	-1	-1	-228	-195
profits for POCL from banking £m		0	0	0	11	38	78	104	116	117	119	120	120	493	161
Total impact on POCL		0	2	-23	-40	17	67	21	-172	-196	-159	-143	-126	-426	25
impact on PO network	rural	0	0	0	0	0	0	0	-200	-400	-600	-800	-1,000		
	urban	0	0	0	0	0	0	0	-1,200	-2,400	-3,600	-4,800	-6,000		
	total	0	0	0	0	0	0	0	-1,400	-2,800	-4,200	-5,600	-7,000		
NET IMPACT ON PUBLIC SECTOR														1,438	410

3 Horizon cancelled: ACT compulsory for all claimants from 2001/02, floor ends 2003/04

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @6% to 2010	NPV @6% to 2005
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-10	-15	-35	-15	25	75	120	435	435	435	435	435	1,306	87
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked"		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-205	-115
Total DSS savings (£m)		-20	-28	25	75	118	168	213	528	528	528	528	528	1,864	385
first round impact on POCL profits £m		0	5	10	20	30	40	0	-136	-137	-138	-135	-134	-302	79
compensation to subpostmasters		0	-108	-108	-108	-108	-108	0	0	0	0	0	0	-429	-429
cost of banking technology for POCL		0	-14	-24	-46	-117	-106	-93	-93	-93	-93	-93	-93	-554	-293
profits for POCL from banking £m		0	0	0	-7	-22	76	100	116	117	118	119	120	428	98
Total impact on POCL		0	-117	-122	-141	-217	-98	7	-113	-113	-113	-109	-107	-856	-545
impact on PO network	rural	0	-800	-1,200	-1,800	-2,400	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000		
	urban	0	-1,400	-2,800	-4,200	-5,600	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000		
	total	0	-2,200	-4,000	-6,000	-8,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000		
NET IMPACT ON PUBLIC SECTOR														1,008	-160

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN ACT MIGRATION COMPLETE

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6% to 2010	NPV @ 6% to 2005
Baseline															
% of claimants paid by ACT		30%	32%	33%	35%	36%	38%	39%	41%	42%	44%	45%	47%		
% of transactions made by ACT		13%	15%	16%	18%	19%	21%	22%	24%	25%	27%	28%	30%		
DSS administrative costs		530	530	525	525	525	520	520	515	515	510	510	505		
CAPS costs		100	20	20	20	20	20	20	20	20	20	20	20		
total administrative costs inc CAPs		630	550	545	545	545	540	540	535	535	530	530	525		
DSS programme savings (ESNS)		70	70	70	50	50	50	50	50	50	50	50	50		
POCL profits £m		30	25	20	10	0	-10	-20	-50	-50	-60	-60	-70		
POCL network	rural	9,000	8,800	8,600	8,400	8,200	8,000	7,800	7,600	7,400	7,200	7,000	6,800		
	urban	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000		
	total	19,000	18,800	18,600	18,400	18,200	18,000	17,800	17,600	17,400	17,200	17,000	16,800		
1 Continue with project: ACT migration 2005/06 to 2007/08, floor until 2007/08 (per GC 11/10/98)															
% of claimants paid by ACT		30%	32%	33%	35%	36%	38%	39%	45%	64%	88%	100%	100%		
% of transactions made by ACT		13%	15%	16%	18%	19%	21%	22%	25%	52%	77%	100%	100%		
DSS net administrative savings (£m)		-25	-80	-60	-20	40	60	60	40	30	40	400	400	426	-49
contingency		0	0	0	0	0	0	0	0	-10	-10	-10	-10	-22	0
DSS programme savings (£m)		0	5	110	135	135	135	135	135	135	135	135	135	868	490
payment for "unbanked"		0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total DSS savings (£m)		-25	-75	50	115	175	195	195	175	155	165	525	525	1,272	441
first round impact on POCL profits £m		0	5	10	20	30	40	50	80	32	69	-205	-204	11	113
compensation to subpostmasters		0	0	0	0	0	0	0	-31	-31	0	0	0	-38	0
cost of banking technology for POCL		0	-3	-3	-1	-1	-1	-1	-1	-1	-1	-1	-1	-11	-8
profits for POCL from banking £m		0	0	0	3	5	14	23	45	74	107	123	123	289	31
Total impact on POCL		0	2	7	22	34	53	72	93	74	175	-83	-82	251	136
impact on PO network	rural	0	0	0	0	0	0	0	0	0	0	0	0		
	urban	0	0	0	0	0	0	0	-500	-1,000	-1,000	-1,000	-1,000		
	total	0	0	0	0	0	0	0	-500	-1,000	-1,000	-1,000	-1,000		
NET IMPACT ON PUBLIC SECTOR														1,523	576

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN ACT MIGRATION COMPLETE

3V Variant - Horizon cancelled: ACT compulsory for all claimants from 2003/04, floor ends 2005/06

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @6% to 2010	NPV @6% to 2005
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-5	-10	-50	-20	20	70	120	435	435	435	435	435	1,291	73
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked"		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-206	-116
Total DSS savings (£m)		-15	-23	10	70	112	163	213	528	528	528	528	528	1,849	369
first round impact on POCL profits £m		0	5	10	20	30	40	50	80	-134	-136	-135	-134	-130	113
compensation to subpostmasters		0	-108	-108	-108	-108	-108	0	0	0	0	0	0	-429	-429
cost of banking technology for POCL		0	-14	-24	-46	-117	-106	-93	-93	-93	-93	-93	-93	-554	-293
profits for POCL from banking £m		0	0	0	0	5	20	36	76	100	116	117	118	334	42
Total impact on POCL		0	-117	-122	-134	-190	-154	-7	63	-127	-113	-111	-109	-779	-568
impact on PO network	rural	0	-800	-1,200	-1,800	-2,400	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000		
	urban	0	-1,400	-2,800	-4,200	-5,600	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000		
	total	0	-2,200	-4,000	-6,000	-8,000	-10,000	-10,000	-10.000	-10,000	-10,000	-10,000	-10,000		
NET IMPACT ON PUBLIC SECTOR														1,069	-198

Notes
1 A negative saving means an addition to costs
2 Baseline assumes "business as usual" with no Horizon
3 Each option is expressed as a change relative to the baseline
4 NPV figures for option 2 and 3 assume that no compensation is paid either by or to ICL.
5 VAT is included in payments to Pathway by both BA and POCL, and is included in the cost of new banking technology in option 3

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN COMPULSORY ACT MIGRATION BEGINS

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6% to 2010	NPV @ 6% to 2005
Baseline															
% of claimants paid by ACT		30%	32%	33%	35%	36%	38%	39%	41%	42%	44%	45%	47%		
% of transactions made by ACT		13%	15%	16%	18%	19%	21%	22%	24%	25%	27%	28%	30%		
DSS administrative costs		530	530	525	525	525	520	520	515	515	510	510	505		
CAPS costs		100	20	20	20	20	20	20	20	20	20	20	20		
total administrative costs inc. CAPs		630	550	545	545	545	540	540	535	535	530	530	525		
DSS programme savings (ESNS)		70	70	70	50	50	50	50	50	50	50	50	50		
POCL profits £m		30	25	20	10	0	-10	-20	-50	-50	-60	-60	-70		
POCL network	rural	9,000	8,800	8,600	8,400	8,200	8,000	7,800	7,600	7,400	7,200	7,000	6,800		
	urban	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000		
	total	19,000	18,800	18,600	18,400	18,200	18,000	17,800	17,600	17,400	17,200	17,000	16,800		

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN COMPULSORY ACT MIGRATION BEGINS

2 Continuation of Horizon without BPC, move to ACT (compulsory from 2001/02), floor paid until 2001/02

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @6% to 2010	NPV @6% to 2005
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-10	-15	-40	10	95	190	290	435	435	435	435	435	1,568	349
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-206	-116
Total DSS savings (£m)		-20	-28	20	100	187	283	383	528	528	528	528	528	2,125	646
first round impact on POCL profits £m		0	5	10	-1	-30	-41	-52	-213	-198	-183	-188	-155	-603	-74
compensation to subpostmasters		0	0	0	0	0	0	0	-94	-94	-94	-94	-94	-263	0
cost of banking technology for POCL		0	-3	-33	-71	-51	-51	-51	-31	-21	-1	-1	-1	-228	-195
profits for POCL from banking £m		0	0	0	11	36	78	103	116	117	119	120	120	490	159
Total impact on POCL		0	2	-23	-61	-45	-14	0	-222	-196	-159	-163	-130	-604	-109
impact on PO network	rural	0	0	0	0	0	0	0	-200	-400	-600	-800	-1,000		
	urban	0	0	0	0	0	0	0	-1,200	-2,400	-3,600	-4,800	-6,000		
	total	0	0	0	0	0	0	0	-1,400	-2,800	-4,200	-5,600	-7,000		
NET IMPACT ON PUBLIC SECTOR														1,521	537

3 Horizon cancelled: ACT compulsory for all claimants from 2001/02, floor ends 2001/02

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @6% to 2010	NPV @6% to 2005
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-10	-15	-40	10	95	190	290	435	435	435	435	435	1,568	349
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-206	-116
Total DSS savings (£m)		-20	-28	20	100	187	283	383	528	528	528	528	528	2,125	646
first round impact on POCL profits £m		0	5	10	45	35	27	0	-138	-137	-136	-135	-134	-288	94
compensation to subpostmasters		0	-108	-108	-108	-108	-108	0	0	0	0	0	0	-429	-429
cost of banking technology for POCL		0	-14	-24	-46	-117	-106	-93	-93	-93	-93	-93	-93	-554	-293
profits for POCL from banking £m		0	0	0	-6	-21	76	100	116	117	118	119	120	430	100
Total impact on POCL		0	-117	-122	-115	-211	-111	7	-115	-113	-111	-109	-107	-841	-529
impact on PO network	rural	0	-800	-1,200	-1,800	-2,400	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000		
	urban	0	-1,400	-2,800	-4,200	-5,600	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000		
	total	0	-2,200	-4,000	-6,000	-8,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000		
NET IMPACT ON PUBLIC SECTOR														1,285	117

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HORIZON: SUMMARY OF CENTRAL OPTIONS - BA FLOOR PAYMENT TO POCL ENDS WHEN COMPULSORY ACT MIGRATION BEGINS

		1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	NPV @ 6% to 2010	NPV @ 6% to 2005
3V Variant - Horizon cancelled: ACT compulsory for all claimants from 2003/04, floor ends 2003/04															
% of claimants paid by ACT		30%	30%	42%	53%	70%	88%	100%	100%	100%	100%	100%	100%		
% of transactions made by ACT		13%	14%	22%	34%	53%	73%	96%	99%	100%	100%	100%	100%		
DSS net administrative savings (£m)		-5	-10	-50	10	90	190	290	435	435	435	435	435	1,565	346
contingency		-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	-84	-56
DSS programme savings (£m)		0	5	90	130	135	135	135	135	135	135	135	135	847	469
Payment to banks/POCL for "unbanked		0	-8	-20	-30	-33	-32	-32	-32	-32	-32	-32	-32	-206	-116
Total DSS savings (£m)		-15	-23	10	100	182	283	383	528	528	528	528	528	2,122	1,643
first round impact on POCL profits £m		0	5	10	20	30	73	50	-76	-134	-136	-135	-134	-205	136
compensation to subpostmasters		0	-108	-108	-108	-108	-108	0	0	0	0	0	0	-429	-429
cost of banking technology for POCL		0	-14	-24	-46	-117	-106	-93	-93	-93	-93	-93	-93	-554	-293
profits for POCL from banking £m		0	0	0	0	5	20	36	76	100	116	117	118	334	42
Total impact on POCL		0	-117	-122	-134	-190	-125	-7	-93	-127	-113	-111	-109	-854	-545
impact on PO network	rural	0	-800	-1,200	-1,800	-2,400	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000	-3,000		
	urban	0	-1,400	-2,800	-4,200	-5,600	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000	-7,000		
	total	0	-2,200	-4,000	-6,000	-8,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000	-10,000		
NET IMPACT ON PUBLIC SECTOR														1,268	99

Notes
1 A negative saving means an addition to costs
2 Baseline assumes "business as usual" with no Horizon
3 Each option is expressed as a change relative to the baseline
4 NPV figures for option 2 and 3 assume that no compensation is paid either by or to ICL
5 VAT is included in payments to Pathway by both BA and POCL, and is included in the cost of new banking technology in option 3

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[redacted]

4.4 Summary of key assumptions

4.4.1

Assumptions underlying financial results for options - where the floor payment from BA to POCL ends when migration to ACT is complete			
	Option 1	Option 2	Option 3
% of claimants paid by ACT			
Underlying rate	1.5%	1.5%	1.5%
BA moves to ACT	2005/06 - 2007/08	2001/02 - 2003/04	2001/02 - 2003/04
Rate of migration when 'compulsory'	20:40:40	34:33:33	34 33 33
% of transactions paid by ACT			
Lag between migration of customers and transaction	Periodicity mix: current average periodicity of paperbased > ACT	Periodicity mix: current average periodicity of paperbased > ACT	Periodicity mix: current average periodicity of paperbased > ACT
DSS net administrative savings			
BA floor payment to POCL ends	2007/08	2003/04	2003/04
Incremental investment in CAPs	Yes - for interface with Horizon	-	-
Contingency			
ACT costs	c10% of ACT costs	c10% of ACT costs	c10% of ACT costs
Cost of withdrawing cash by the "banked", when moving to ACT	-	-	-
DSS programme savings			
Benefit encashment fraud savings (incremental to savings from ESNS)	c90% of estimated fraud - accrues with BPC (then ACT)	c90% of estimated fraud - accrues with ACT	c90% of estimated fraud - accrues with ACT

Assumptions underlying financial results for options - where the floor payment from BA to POCL ends when migration to ACT is complete

	Option 1	Option 2	Option 3
Changes to periodicity	-	-	-
Payment for the "unbanked"			
Incentivise banks (eg remunerate for costs of low value cash withdrawals)	Upfront £10/account + on-going £20pa for half of the "unbanked"	Upfront £10/account + on-going £20pa for half of the "unbanked"	Upfront £10/account + on-going £20pa for half of the "unbanked"
First round impact on POCL profits			
Migration of non-BA business from closed PO to other PO	60%	60%	60%
Retail custom dependant on PO footfall	27-36%	27-36%	27-36%
PO vision: new services included in modelling	Banking only	Banking only	Banking only
Accessibility value to customers of loss of nearest PO (est 70-80p/visit)	Excluded	Excluded	Excluded
Compensation to subpostmasters			
26 months remuneration due on incremental closure of POs	Paid whether compulsory or voluntary closure	Paid whether compulsory or voluntary closure	Paid whether compulsory or voluntary closure
Level of remuneration	Variable subpostmaster remuneration = midpoint of before and after migrates to ACT	Variable subpostmaster remuneration = midpoint of before and after migrates to ACT	Variable subpostmaster remuneration = midpoint of before and after migrates to ACT
Costing of banking technology for POCL			
Technology	Horizon	Horizon + POCL remunerates ICL for 'reduced margin' re BPC	Debit terminals initially, then full functionality system procured

Assumptions underlying financial results for options - where the floor payment from BA to POCL ends when migration to ACT is complete			
	Option 1	Option 2	Option 3
Profits for POCL from banking			
Revenue	50p per transaction	50p per transaction	50p per transaction
Transactions per customer per annum	30	30	30
Market share of benefit customers migrating to ACT	2001/02 10%; 2002/03 15%; 2003/04 35%; 2004/05 50%; 2005/06 65%	2001/02 40%, 2002/03 50%; 2003/04 65%	2001/02 30%; 2002/03 40%; 2003/04 50%
Market share of other cash withdrawal	Increasing to 7.5%	Increasing to 7 5%	Increasing to 7 5%
Impact on PO network			
Closures	Managed	Managed	Avoid loss of control

Appendix A: List of documentation made available to the review

Benefits Agency / Post Office Counters Automation Project - a note by the Prime Minister's Policy Unit and the Treasury

Review of the Benefits Agency / Post Office Counters Automation Project - Working Group Report - July 1998

BA / POCL Automation Programme Review - Report of the Independent Panel - July 1998

Post Office Counters Limited - ICL Pathway Technical Architecture Study - Pontis Consulting September 1998

POCL Strategy - Integrated Economics - Post Office Counters Limited Presentation to HM Treasury August 1998

Horizon Banking Infrastructure - ICL Pathway Ltd - version 1.1 - 5th August 1998

POCL Banking Costs (miscellaneous faxes) - HM Treasury and POCL

Option 3 analysis (Jonathan Evans, POCL to Adam Sharples, Treasury, 2.9.98 and 4.9.98)

Departmental Review of Benefit Payment Options - Proposal for increased use of ACT, DSS, September 1998

Appendix B: Banking functional assumptions

In addition to the core "manned ATM" services assessed in 2.2.1 above, a number of further services have been discussed by POCL, which have not been reflected in the viability assessment. These are listed below, together with the rationale for excluding them from the service scope

Service	Comments
Information on banks' financial products	Service would require careful negotiation with banks, and may raise regulatory issues re. giving financial advice Propose that this is not included in the banking validation scenario. (This would not preclude provision of simple product details).
Corporate banking for small business users	Represents a distinct service area, which may have different market requirements. Extension into this area may also be resisted by banks.
Passbook withdrawals	This raises logistical issues, particularly given the different passbook printer standards and practices for different institutions.
Opening and closing accounts	Banks are likely to want to retain full control of account openings and closures. Assume that POCL will provide no more than a form-filling service here.