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TO 37763961

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## FAX TRANSMISSION

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From: Hamish Sandison

Client: BA/POCL

Account No: BPOCL/0001

Date: 12 November 1998

Time:

Number of pages (including this page): 23

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Sandison.

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[Draft: 12/11/98]

## MEMORANDUM

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TO: George McCorkell, BA

CC: Joe Ashton, PO Legal Services  
Jonathan Evans, POCL  
Sarah Graham, DSS  
Marilynne Morgan, DSS  
Paul Rich, POCL  
Jeff Triggs, Slaughter and May

FROM: Hamish Sandison and Hazel Grant, Bird & Bird

DATE: [ ] November 1998

RE: The ICL Proposal Dated 9 November - Key Points

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BACKGROUND

1. You have asked for our comments on the legal and contractual implications of the proposal by ICL plc ("ICL") and ICL Pathway Limited ("Pathway"), as set out in a letter dated 9 November from Keith Todd to Stephen Byers and the four attachments to that letter (the "ICL Proposal"), in order to assist POCL and BA in drawing up a joint assessment of the ICL Proposal for presentation to Ministers as part of the Interdepartmental Working Group's progress report. Our comments address three principal issues:

- (1) How far the ICL Proposal departs from the current contracts with Pathway ("the Related Agreements");
- (2) How far the ICL Proposal departs from the proposal tabled by Graham Corbett on 11 October 1998 at the end of the first round of discussions between ICL, BA and POCL ("the Corbett Proposal"); and

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- (3) How far the ICL Proposal departs from best practice in government contracts as we see it, including where relevant the guidance issued by the Treasury Taskforce on *Standardisation of PFI Contracts: Taskforce Guidance on Project Agreements* (draft dated 17 September 1998) ("the Taskforce Guidance").

We do not express any view on the acceptability or otherwise of the ICL Proposal to either of the public sector parties.

2. In the time available, we have not been able to provide a detailed analysis of the ICL Proposal. We are currently working on such an analysis. This Memorandum represents a high level summary of the key points.

3. After commenting briefly on Keith Todd's covering letter, we address the four documents attached to his letter, in the same order they were attached, as follows:

- (1) The "Heads of Agreement" for a public/private partnership between Pathway and POCL;
- (2) The "Pathway Funding Paper" describing the changes they say are needed by Pathway to enable them to raise finance for the completion of the project;
- (3) The "Acceptance" paper which contains proposals for changing the existing acceptance procedures; and
- (4) The "Commercial and Contractual Proposals" paper which lists all the issues which Pathway consider have to be resolved now in order for the project to move quickly ahead to completion.

We note that this is not necessarily their order of importance for the public sector

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parties.

4. By agreement with BA and POCL, we are submitting this Memorandum in draft form for comment by both public sector parties prior to any wider circulation within government. It represents our own views, and not necessarily those of either BA or POCL.

#### KEITH TODD'S COVERING LETTER

5. We note Keith Todd's proposed date of "no later than 31 December 1998" for the legal and contractual work to be done before "completion." We presume that "completion" means signature of any agreed amendments to the Related Agreements to implement the ICL Proposal. The significance of this is that, in effect, Ministers would not be in a position to know whether agreement had been reached or not on the ICL Proposal until that date. We express no view on whether this timetable can be achieved or improved, although we certainly agree that the legal and contractual work implied by the ICL Proposal in the context of the Related Agreements is likely to be highly complex and extremely time consuming.

6. We draw attention to Keith Todd's request to let him know with whom he should work on behalf of the public sector. This suggests - and we think this is sensible - that, if Ministers wish to take up Keith Todd's invitation to hold further negotiations, then they will need to include in their initial response to the ICL Proposal some indication of their preferred approach to the negotiating process and their proposed membership of a negotiating team on the public sector side.

7. We have no further comments on Keith Todd's covering letter at this stage.

#### HEADS OF AGREEMENT

8. The Heads of Agreement have been signed on behalf of ICL, Pathway and POCL, but are stated to be non-binding (with the exception of a standard

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confidentiality provision in Clause 6). In particular, we note that the Heads of Agreement are stated to be "subject to H M Government consent (including any requirements of the DTI)... any relevant legal and regulatory constraints (including competition and public procurement issues), consideration of their impact on existing contractual relationships with the Post Office or POCL and any relevant limitations on the Post Offices's powers" (paragraph 5.1), and "a satisfactory resolution of all of the issues arising as part of [the Corbett] discussions (including any issues arising with the Department of Social Security)" (paragraph 5.2). If these conditions are not met by 31 December 1998, the Heads of Agreement will lapse, underscoring the importance of the "completion" date of 31 December 1998 mentioned in Keith Todd's cover letter.

9. For these reasons, we have not reviewed the Heads of Agreement in depth. Overall, however, they do not appear to contain any financial proposals which, on their own, would serve to bridge the financial gap between Pathway and POCL which existed at the end of the first round of the Corbett discussions. It seems clear therefore that, if this gap is to be bridged, it must be bridged by other elements of the ICL Proposal which are in addition to the proposed public/private partnership envisaged by the Heads of Agreement.

## PATHWAY FUNDING PAPER

### Introduction

10. The Pathway Funding Paper sets out the changes to the Related Agreements which Keith Todd says are needed to enable Pathway to raise finance for the completion of the project. Pathway's proposals draw heavily on the Taskforce Guidance. However, as Pathway notes, and as the Treasury itself has acknowledged, the Taskforce Guidance is "more suited to accommodation rather than information technology projects" (paragraph 1.1). Accordingly, it will be important in our view for the public sector parties not to assume that suggestions contained in the Taskforce Guidance are appropriate for the BA/POCL automation project. In particular, they



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will wish to take account of comments on the Taskforce Guidance made by CCTA, the Government's IT advisory agency. (As you know, Bird & Bird are legal advisers to CCTA, and we will be happy to facilitate a read across from the CCTA view of best practice in IT contracts to the Treasury Guidance where appropriate.)

11. In its introduction, the Pathway Funding Paper also refers to the proposed restructuring of the ICL/BA/POCL relationships to establish a single interface between Pathway and POCL, as described in greater detail in the Contractual and Commercial Proposals paper (see paragraph 37 below). In doing so, ICL asserts that this revised structure is "more likely to facilitate raising additional finance from lenders" (paragraph 1.2). This is obviously not a subject addressed in the Taskforce Guidance, and need not be accepted at face value. While in principle it must be right that funders will prefer a simpler contract structure, we suspect that they will favour whichever structure is best suited to secure successful completion of the project to the mutual satisfaction of all the parties involved, including ICL, BA and POCL. Accordingly, we suggest that ICL's proposed contract structure should be evaluated on its merits, and not simply on its asserted attractiveness to ICL's lenders.

#### Acceptance Regime

12. If termination occurs on acceptance, presumably because Pathway has failed acceptance, Pathway propose that POCL should pay termination payments and guaranteed volume payments (see paragraph 2). It is not clear to us what the guaranteed volume payments would be in a scenario where acceptance had not been achieved. The reference to termination payments is also unclear, since paragraph 6.2 (ii) states that no compensation will be payable prior to the start of national roll-out in the event of Pathway default.

13. Although not expressly stated in the Pathway Funding Paper, the relaxation of acceptance procedures, criteria and remedies proposed in the Acceptance paper are clearly a key element of ICL's proposals for enhancing the fundability of the project, and the Pathway Funding Paper needs to be read in conjunction with the Acceptance

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paper. If Pathway's proposals on acceptance are not agreed, it is unclear whether the proposals contained in the Pathway Funding Paper will be considered sufficient on their own to raise enough finance to complete the project.

#### Termination by POCL

14. Pathway propose to limit POCL's present termination rights. As now, POCL would be entitled to terminate after a force majeure event for a specified period, voluntarily on payment of compensation (ie, termination "for convenience"), on the occurrence of Pathway default, and on breach of the prohibition against corrupt gifts (subject to modifications described below) (see paragraph 3.1). However, POCL would not be entitled to terminate in the event of a change of control of Pathway, eg, if it were taken over by another company (see paragraph 3.4). Moreover, termination for Pathway's default would require either proof of "persistent and material breach of a material obligation" (coupled with a new regime for written warnings and a further breach of that obligation before termination would be allowed) or an unspecified accumulation of "performance deficiency deductions" (see paragraph 3.2(i) and (iii)).

15. POCL's termination rights would also be subject to the step-in rights of Pathway's lenders (see paragraphs 3.3 and 10). Under a so-called "Direct Agreement" between the lenders and POCL, the lenders would be allowed to step in and take over Pathway's obligations or to appoint a substitute entity to replace Pathway. Although such step-in rights are endorsed by the Taskforce Guidance, it may be questioned whether they are appropriate in complex IT services contracts and whether it is realistic to suppose that a lender could step in and take over the services.

#### Termination by Pathway

16. Unlike the present Related Agreements, which do not give Pathway any rights of termination (with the minor exception of a breach of IPR licence agreements), Pathway propose that they should be entitled to terminate in a number of circumstances, including non-payment of charges in excess of £250,000 and force

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majeure lasting for a specified period of time. This change is in line with the Taskforce Guidance, but is contrary to existing government contracting practice, and the public sector parties must ask themselves whether they are prepared to place the performance of statutory functions at risk of termination in this way.

### Compensation on Termination

17. Unlike the present Related Agreements, Pathway propose that they should be compensated in the event of termination, including termination for their own default. The level of compensation would vary according to the event which led to termination (see paragraph 6.1). In the event of voluntary termination (*ie*, termination "for convenience") and termination for POCL default or force majeure (neither of which entitle Pathway to terminate at present), Pathway would be entitled to repayment of all outstanding debt under any third party loans ("Lender Liability"). In addition, in the case of voluntary termination and POCL default, Pathway would be entitled to repayment of all ICL equity, loan stock and third party equity raised in the future to invest in the project ("Equity"), termination costs (including the costs of terminating funding and hedging agreements and sub-contractors' agreements), and a return on the Equity for the remainder of the project (see paragraph 6.2). Compensation to Pathway in the case of POCL's default is in accordance with the Taskforce Guidance, but only on the basis that POCL would be entitled to recover the project assets, as Pathway have proposed here (see paragraph 50 below).

18. In the event of termination for Pathway's default, Pathway would be entitled to repayment of Lender Liability and the costs of terminating funding and hedging agreements, less rectification costs capped at an undefined level reducing over the period of the project (see paragraph 6.2(ii)). Depending upon the level of capping, this formula is presumably intended to allow a net repayment to Pathway's lenders even after termination for Pathway's own default. This is not in accordance with the Taskforce Guidance.



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### Change Control

19. Pathway propose a new regime for change control (see paragraph 7.1). Curiously, they propose that changes should no longer be permitted "without their consent," which is no different from the present position under the Related Agreements. Apparently, regardless of who proposed the change, Pathway expect POCL to meet the cost of implementing the change if Pathway could not finance the change themselves after having used reasonable endeavours to obtain funding. Under these circumstances, POCL would be expected both to fund any capital expenditure by making a lump sum payment to Pathway, and also to fund any increase in Pathway's operating costs by an increase in the charges. If Pathway were able to meet the cost of the change, the guaranteed volume payments would still have to increase in order to repay Pathway's indebtedness in full. This is broadly in line with Taskforce Guidance, although the Taskforce make clear that the customer should have the right to market test the supplier's changes and should not be required to proceed with a change if the charges for it are unacceptable.

### Change in Law

20. Pathway propose a new regime for changes in law. Where the change is a "discriminatory change", POCL would be required to indemnify Pathway's costs (see paragraph 8.1). A "discriminatory change" is defined as any change in law discriminating against the project, against Pathway or against PFI suppliers generally, and includes any legislation affecting the operation of post offices or the payment of benefits. This approach is broadly in line with the Taskforce Guidance, but is more onerous than the present Related Agreements, which call for a negotiated adjustment in prices, but not an indemnity against costs for change in law. By contrast, the indemnity proposed by Pathway would require payment by POCL of a lump sum equal to the cost incurred (see paragraph 9.3).

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### Force Majeure and other Relief from Liability

21. Pathway propose a new regime to relieve them from liability for delays resulting from events beyond their control which are not currently within the definition of force majeure in the present Related Agreements (see paragraph 9.1). The extent of this further relief is not defined. *If the delay is caused by POCL*, Pathway propose that they should be allowed not only additional time to perform but also should be paid the full value of forecast transaction volumes over the period of the delay. This proposal is not supported by the Taskforce Guidance, which suggests that any compensation should be based on the supplier's actual losses and his duty to mitigate those losses; it also goes much further than the "reasonable additional costs" allowable under the present Related Agreements in such circumstances.

### Lenders' Security

22. Pathway propose that their lenders should have first security over project assets and Pathway's rights. In the event of Pathway's insolvency or loan default, this proposal would defeat POCL's rights under the present Related Agreements to buy back the project infrastructure, and would pose a threat to the continuity of service which this buy-back option is intended to assure.

### Corrupt Gifts

23. Where an employee or sub-contractor makes a corrupt gift without their connivance, Pathway propose that they should be allowed 30 days to remove that person from the project or terminate that sub-contract before POCL could terminate for breach of the corrupt gifts clause. This is broadly in line with Taskforce Guidance. Under the present Related Agreements, however, the right of termination is immediate.

### Dispute Resolution

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24. Pathway proposes a commercial dispute resolution procedure which would be separate from and additional to the expert determination procedure proposed for technical disputes under their Acceptance paper (see paragraph 13.1). The proposed commercial dispute resolution procedure is broadly in line with the Taskforce Guidance, but it is not clear how far it would prevent POCL from resorting to the courts to resolve commercial disputes, which is allowed under the present Related Agreements.

25. Under the new commercial dispute resolution procedure, POCL would not be able to withhold or set off any payment in dispute above a cumulative cap which would ensure that cash flow to Pathway was not "materially diminished" (see paragraph 13.2). This is coupled with a more general proposal that POCL should not be entitled, as at present, to set off any sum due from Pathway against a sum due to Pathway above the permitted cap. Taken together, these proposals would significantly limit POCL's ability to withhold or set off payments against amounts owed to Pathway. This would be especially serious in the case of a termination for Pathway's default, where lenders would have first call over project assets but POCL would be unable to set off its claims against money owed to Pathway.

#### Interest on late payments

26. In line with Taskforce Guidance, Pathway propose that POCL should pay interest on any late payment. However, unlike the Taskforce Guidance, they propose that the rate of interest should be the equivalent of the default rate specified in their lenders' funding agreements. This is likely to be much higher than the rate of interest normally payable in IT services contracts.

#### Performance Deductions/Service Credits

27. Pathway propose unspecified changes in the present provisions for "performance deductions", by which they presumably refer to service credits for non-conforming services (see paragraph 16). They want "an objective regime" for

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calculating performance deductions, and a cumulative cap on the deductions available.

#### Transfer/Change of Status by POCL

28. If POCL were to transfer its agreement or change its status, Pathway propose that there should be a "credit enhancement" of the charges, possibly through POCL purchasing credit enhancement insurance. At present, POCL's freedom to transfer its agreement or undergo a change in status is unfettered.

#### Fraud Risk

29. Finally, Pathway propose significant changes in the present provisions on fraud risk. At present, subject to a list of excepted risks, Pathway is liable for all fraud losses in relation to the services. Pathway propose to reverse this transfer of risk by providing that Pathway will only be liable for fraud where POCL can prove both its loss and that the loss was within a specific risk expressly transferred to it by Pathway (see paragraph 18). This proposal will substantially reduce the level of Pathway's liability for fraud losses.

#### ACCEPTANCE

30. Pathway propose wide changes to the acceptance procedures. Broadly, this would result in final acceptance occurring before live trial.

31. If acceptance is achieved after the equivalent of model office testing, the public sector parties would lose their rights to termination for subsequent failed acceptance. If acceptance was not achieved at this stage, then they would be required to give Pathway a cure period until the end of live trial. If acceptance was not achieved after the end of live trial, there would be a right of termination, subject to the conditions described below.

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32. Once live trial has commenced, the Authorities would only have a right of termination in the event that Pathway failed to meet the acceptance criteria after a 6 month extension period, and only if that failure is due to the exclusive default of Pathway. As a result of these changes, the public sector parties would find it almost impossible to terminate due to failure to achieve acceptance, once the live trial had been completed. This is because it would be almost impossible to prove that failure to achieve acceptance was due to the exclusive default of Pathway.

33. In effect, the public sector parties will be required to accept the services before they have been trialled "in the field." A further complication is that it is not clear whether the acceptance procedures would simply relate to NR2 for single benefits, in which case the services would not be tested for multi-benefits before the termination rights were lost.

34. Pathway propose that the criteria for termination should also be amended. The effect of their proposal is that up to nine acceptance incidents could occur in each of the 23 test streams and the termination rights would still not arise. The relevant acceptance incidents would be category A or B, both of which have a significant effect on business.

35. Pathway propose that they should self-certify readiness of releases after acceptance.

36. Pathway propose that any disputes relating to acceptance be automatically resolved by an expert. This is an amendment to the present procedure, which requires the agreement of the parties to use an expert determination procedure.

## COMMERCIAL AND CONTRACTUAL PROPOSALS

### Introduction

37. The paper on "Contractual and Commercial Proposals" comprises two main



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elements (see paragraph 1.1):

first, there are the amendments proposed by Pathway to reflect the original Corbett Proposal tabled on 11 October 1998 at the end of the first round of discussions between Pathway, BA and POCL;

second, there are amendments proposed by Pathway to reflect the latest ICL Proposal.

In addition, there are three further proposals for a contingency and sharing mechanism, for the resolution of outstanding contractual and commercial issues (the so-called "running sores" issues), and for the restructuring of the Related Agreements. Our comments below on these proposed amendments are focussed mainly on the question of how far they depart from the original corporate proposal.

#### **Amendments to reflect Corbett Proposal**

38. Subject to some clarification and checking of the figures, the amendments proposed under this heading appear to us to capture accurately the main elements of the original Corbett Proposal on contract term extension (see paragraph 2.1(i) and (ii)), forecast transaction volumes (see paragraph 2.1(iv)) migration to ACT in the last three years of the BA contract (see paragraph 2.1(v)), POCL funding of technology refreshment (see paragraph 2.1 (vi)) and service point pricing for the last five years of the POCL contract (see paragraph 2.1(vii)). We cannot assess the proposal for banking services (see paragraph 2.1(iii)) without taking further instructions from POCL.

#### **Amendments to reflect the ICL Proposal**

39. Under this heading (see paragraph 3.1), Pathway propose twelve amendments as follows:

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## (i) Pathway Funding Paper

40. Pathway propose amendments to enable them to seek limited recourse of funding after acceptance. These are detailed in their "Pathway Funding Paper".

## (ii) Guarantees

41. Pathway propose a number of changes to the present guarantee payments structure which they say are needed "to facilitate funding." They also state that the proposed guarantees will not apply to the level of future additional business, although it bears noting that they are proposing a guaranteed minimum payment in relation to the new banking service. The proposed changes are as follows:

- (a) They propose guaranteed payments at 80% of new transaction volumes forecast for the core business of BA and POCL. This compares with 75% proposed by BA under the Corbett Proposal.
- (b) They propose a 90% payment guarantee on forecast banking transaction volumes. This was not part of the Corbett Proposal.
- (c) They propose a £40m minimum charge for PAS (Payment Authorisation Services) and CMS (Card Management Services) in the last year of the BA contract. This is presumably in addition to the 80% guaranteed payment for these services. This was not included in the Corbett Proposal.
- (d) They propose that present discount bands should be revised to apply only above guaranteed transaction volumes, and that the bands should be raised to align with the revised guaranteed transaction volumes. This was not included in the Corbett Proposal and of course represents a significant price increase.
- (e) They propose to revise the algorithm for guaranteed payments during national roll-out so that guaranteed payments are calculated by multiplying the proposed guarantee percentage by the revised forecast

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transaction volumes. This was not included in the Corbett Proposal. It would mean that payment was guaranteed regardless of the rate of roll-out. By contrast, under the present Related Agreements, guaranteed payments are tied to physical implementation and benefit migration. In addition, they propose that late delivery of national roll-out for which Pathway were responsible would be subject to unspecified liquidated damages. Curiously, this is a departure from the present Related Agreements, which do not provide liquidated damages for delay in roll-out, only for delay in the Start Date and/or End Date of Operational Trial.

(iii) Acceptance and Termination

42. Pathway state that the application of revised guaranteed transaction volumes and compensation for failed acceptance will require associated alterations to the provisions on acceptance and termination. These are discussed in their papers on Acceptance (see paragraph 30 above) and in their Pathway Funding Paper (see paragraph 10 above).

(iv) Acceptance

43. Here Pathway summarise their proposals for acceptance of New Release 2 which are detailed in their Acceptance paper (see paragraph 30 above).

(v) Indexation

44. Pathway propose that prices should be indexed by RPI minus 2% from April 1999. For BA, this represents a departure from the Corbett Proposal, which was based upon the current indexation provisions, namely, a year on year price reduction of 3% starting in 2001/2, with no price increase for RPI up to 6%, and a 50% sharing of any RPI increase above 6%. For POCL, Pathway's proposal also departs from the Corbett Proposal, which suggested only canceling the 3% per annum reduction from

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2006 onwards.

(vi) Payment

45. Pathway propose adjusting the present payment terms from monthly in arrears to quarterly in advance. This is contrary to standard government contracting policy, and there is no obvious basis for it in the Taskforce Guidance. It clearly represents a hidden price increase.

(vii) Term of POCL Agreement

46. Pathway propose that the term of the POCL Agreement should roll-over annually from 2007 (at POCL's option) subject to eighteen months' notice of termination, the earliest termination date being September 2008.

(viii) Past liquidated damages

47. Pathway propose to remove the provisions for liquidated damages for delay in the present Related Agreements. As noted above, these relate only to delays in the Start Date or End Date of Operational Trial, which have already passed. The only issue, therefore, in our minds is whether the liquidated damages already accrued will be considered recoverable under Pathway's proposal or not. In the spirit of the Corbett Proposal, it was envisaged that all past claims such as these would be waived as part of the overall settlement. Thus, assuming that an overall settlement is agreed, this proposal appears to present little difficulty.

(ix) Dispute Resolution Procedure

48. Pathway propose a new commercial dispute resolution procedure based upon that proposed in the Taskforce Guidance. This is discussed in greater detail elsewhere (see paragraph 24 above).

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(x) **Change Requests**

49. Pathway propose that their right to raise change requests should be embodied within the revised Related Agreements. This proposal is puzzling, as the existing change control procedure already allows any party to request a change.

(xi) **Transfer of service infrastructure**

50. Pathway propose that the service infrastructure should be transferred to POCL on the expiry of the POCL Agreement in accordance with a revised formula reflecting "additional value created by the exploitation of future additional business opportunities." This formula is not specified. This is a departure from the present POCL Agreement, which gives POCL an option to buy these assets but does not require them to do so.

(xii) **Incorporation of other proposals**

51. In addition, Pathway suggest that their proposals on a contingency and sharing mechanism, the resolution of "running sores" and restructuring of the Related Agreements should be incorporated as amendments to the present Related Agreements. These proposals are discussed in greater detail below.

52. Finally, under this heading, Pathway note that the ICL Proposal is conditional upon agreement by all parties to a final version of all Acceptance Specifications, of which 23 have so far been produced by Pathway for approval by the public sector parties (see paragraph 3.3). It should be noted that there are still significant commercial and technical issues outstanding in relation to these specifications.

**Contingency and Sharing Mechanism**

53. In order to avoid what they call a "blame culture", Pathway propose a new "Contingency and Sharing Mechanism" (see paragraph 4.1). In essence, they propose



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that a contingency fund of £80 million should be established by an increase in transaction charges paid by the public sector parties rather than by an advance payment by them. In the event that certain contingencies identified by Pathway do not arise, the pre-paid amount would be shared equally between BA, POCL and Pathway. In other words, Pathway would keep one third of the pre-paid amount and would refund the remaining two thirds to BA and POCL in equal shares by way of a credit note against future invoices.

54. We have a number of comments on this proposal. First, it is radically different from the Corbett Proposal, which envisaged the establishment of a jointly managed contingency fund by means of an advance payment from the parties; where the contingency did not arise, the surplus was to be released in equal shares to Pathway and the public sector parties on a 50/50 basis. Thus, under the Corbett Proposal, there was no automatic price increase, Pathway were required to substantiate a claim from the contingency fund, and all the parties were incentivised to avoid or at least minimise the contingency event. By contrast, under the ICL Proposal, Pathway receive an automatic price increase, the public sector parties bear the burden of claiming back their share of the contingency fund, and Pathway is incentivised to deliver late in order to keep the price increase. Second, we note that Pathway's proposed contingency and sharing mechanism is intended to operate without any regard to fault. Thus, even if Pathway were exclusively responsible for a project delay, they would be entitled to keep the contingency funding in full. All in all, therefore, this proposal appears to us to be another hidden price increase.

#### Resolution of Running Sores

55. In line with the Corbett Proposal, Pathway propose to resolve the "running sores" (the outstanding contractual and commercial issues which have stood in the way of completing the project) as part of the overall settlement. Their list of the principal running sores coincides with our own. Their detailed statement of the running sores and their proposals for resolving them are set out in an attachment to the Commercial and Contractual Proposals paper (Attachment C). We are still

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studying their proposals, and will wish to discuss them with the public sector parties before providing a definitive assessment of them.

#### Restructuring the Related Agreements

56. As noted already, Pathway propose a fundamental restructuring of the present tri-partite contractual relationship between Pathway, BA, and POCL, to create a "single client interface" between Pathway and POCL under a single contract between them, backed up by a "fully managed service relationship" between POCL and BA under a single contract between them (see paragraph 6.2). These new contractual arrangements would replace the current arrangements from the start of national roll-out (i.e. following successful acceptance) in July 1999.

57. The legal and commercial implications of this restructuring proposal require very careful consideration. In the time available, we can offer only our initial observations. Further study and discussion will undoubtedly raise additional issues.

58. First, there is the question of how to achieve this restructuring. Pathway suggest that it can be achieved simply by "assigning" to POCL the DSS contracts for CMS and PAS. This is a serious over-simplification.

59. The PAS and CMS services are currently embodied in the contract between Pathway and the DSS ("the DSS Agreement"), and it is true that this Agreement could be transferred by the DSS to POCL. (Technically, this would be a "novation", by which POCL would step into the shoes of the DSS under a new agreement with Pathway on the same terms as the DSS Agreement. An "assignment" would mean that the benefit of the DSS Agreement was transferred to POCL while its burdens remain with the DSS - presumably not the intention here.)

60. However, the DSS Agreement does not represent the sum total of Pathway's obligations and liabilities to the DSS. To mention only one example, Pathway's liability to the DSS in respect of fraud risk is contained in Clause 808 and Schedule

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B8 of the Authorities' Agreement, the tri-partite agreement between Pathway, BA and POCL. Thus, to achieve a complete transfer of BA's rights (and obligations) in relation to Pathway, it would be necessary not only to novate the DSS Agreement to POCL, but also to strip out all of the relevant provisions of the Authorities' Agreement and transfer them by means of a novation agreement to POCL. Given the size, complexity and myriad interfaces of the three Related Agreements, this is a drafting assignment of very considerable magnitude.

61. The second implication of Pathway's restructuring proposal is a question of timing, which will also impact upon the mechanics of negotiating the transfer from the DSS to POCL. As proposed by Pathway, the transfer will not take place until after acceptance has been achieved. We think this must be right, because there would be little point transferring services which had not yet been accepted by the ultimate customer. What this means, however, is that at least until July 1999, there will still be a tri-partite contractual relationship between Pathway, BA and POCL; after July 1999, or whenever acceptance occurs, this will be replaced by a chain of bi-lateral contractual relationships between Pathway and POCL, and between POCL and BA.

62. This in turn raises a question which the ICL Proposal does not address: which changes does Pathway require pre-acceptance; and which changes does it require post-acceptance? Or to put it another way, which changes will need to be negotiated and agreed tri-laterally with all three parties; and which changes can be negotiated and agreed bi-laterally between Pathway and POCL? One obvious example in the former category is the new acceptance regime proposed by Pathway, which will need to be agreed by the DSS as well as POCL. But what about the other contractual and commercial proposals discussed above, such as the contingency and sharing mechanism, the running sores, and so on. Many of these will require resolution pre-acceptance by all three parties; others, such as the funding proposals, are presumably not intended to be implemented until after acceptance. We will need to seek clarification from Pathway as to which of their proposals fall into which of these categories.

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63. The implications of this for the mechanics of any negotiation with Pathway will also need to be carefully thought through. Our initial thinking is that the first task will be to identify and distinguish pre-acceptance issues from post-acceptance issues, *i.e.*, the tri-partite issues from the bi-partite issues. Then there will need to be a two track negotiation: one involving Pathway, BA and POCL; the other involving Pathway and POCL. Finally, all three parties will need to return to a single stream of negotiation pulling together all the separate strands in an overall tri-partite settlement. Again, the scale of this negotiating task is not to be under-estimated.

64. The third implication of Pathway's restructuring proposals which occurs to us is that the restructuring of the Pathway/BA/POCL relationship cannot be completed without a re-negotiation of the BA/POCL relationship. In this context, we believe it is common ground between the public sector parties that such a re-negotiation must be governed by two basic principles.

65. First, if BA withdraws from its direct contractual relationship with Pathway, it will wish to ensure that all of its rights and remedies against Pathway are assumed by POCL, subject of course to any amendments agreed by BA as a result of the Corbett Proposal or the ICL Proposal. For example, if BA can no longer claim its fraud losses from Pathway under the Authorities Agreement, it will wish to claim them from POCL, who will in turn need to be able to re-claim them from Pathway. We refer to this as the "back to back" principle.

66. Secondly, if POCL wish to make concessions to Pathway which are not acceptable to BA, such as a price increase or a reduction in Pathway's fraud liability, POCL will obviously be free to do so in its own commercial judgement, but BA will wish to ensure that its position is no worse off as a result. In other words, BA will wish to be held harmless from such concessions. We refer to this as the "hold harmless" principle.

67. This in turn suggests two further implications. First, BA will need to be quite closely involved even in the bi-lateral negotiations between Pathway and POCL, so

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that POCL is aware when it is giving a concession to Pathway that BA expects to be protected from it under the hold harmless principle. Second, POCL and BA will need to hold parallel negotiations between themselves to keep pace with the Pathway/POCL negotiations in order to ensure that any POCL concession to Pathway which is acceptable to BA is embodied in the BA/POCL agreement under the back to back principle.

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