MP(96)42A

Read 29/4/96

INVESTMENT APPRAISAL COMMENTARY
BA/POCL AUTOMATION

Background

This submission seeks authorisation to enter into an 8 year contract (up to 3 years to develop and implement, followed by a 5-year contract) with one of three shortlisted Service Providers (referred to as Tom, Dick and Harry for confidentiality), for the provision of automation of all post offices, and a new card-based benefit encashment service, and provide 'in principle' approval for NRR expenditure up to a maximum of £10.0m for the implementation of the programme.

This follows on from MaPEC approval in March 1995, MP95/20, for planning costs of £5.7m for POCL's share of a joint development study with BA, amended in February 1996, MP96/24, to include a development test centre, contained within the initial authority.

Acceptance of a bid, following final evaluation of the revised bids, will be conditional upon the case delivering a positive NPV over the base case, and the risk to POCL remaining at an acceptable level.

Key Issues

Assumptions

The comparative advantage of the PFI is predicated on the key assumptions relating to the base case. Whilst considerable effort has been expended, utilising Coopers & Lybrand, in validating base case assumptions, they are only that, and therefore the delivery of the comparative NPV benefits are based on the robustness of the two sets of assumptions. The methodology has been comparably applied to both scenarios i.e. it is acceptable that there is no more risk inbuilt into the PFI, than the base case.

Any errors in the assumptions for the base case, do have a knock-on effect on the PFI case costings. However the interrelationship has not been tested, and remains a major uncertainty. Likewise, it is probable that many of the business assumptions used, are interrelated, and that delivery or non-delivery will impact on other parts of the business. It is therefore critical to monitor and track benefits and costs through a benefits management plan to identify both the incremental and inter-related charges. The base case has been prepared as the 'do nothing' option, and is based on commercial objectives which form part of POCL's business plan.

The nature of the PFI contract means that POCL will only pay for the system as it uses it, reducing revenue/cost risk.

Whilst there will be a 'floor price' in the contract with BA, and Automation derisks the propensity for BA to bring forward and prioritise, in our view, Automated Credit Transfers remains a live risk.

assumption
48m ecrs book distributed
but 12-16m cards by
~~plas~~ priority services

There remains some uncertainty on the impact of the proposal on other businesses, mainly RM. Any inter-business issues should be resolved as a priority, and the business effects quantified, but should not be allowed to cloud the overall position at PO level.

Technical

This is a major transformational project for the Post Office which will have a wider impact than just on POCL. It is therefore important that the project has an appropriate technology configuration, and that its wider impacts are clearly understood.

The Technical Concurrence does not address this wider issue, but places a condition that a formal process is established with the selected supplier to ensure that long term systems development remains consistent with PO strategy, and that safeguards are introduced to ensure that POCL is not prejudiced from taking advantage of standard software upgrades in the future without formal agreement. It is unclear as to what safeguards have been built into the contractual discussions held to date, and therefore this is addressed in the Recommended Conditions.

Of the 3 bids, the preferred bid from a financial perspective, Dick, is stated to have a significantly higher technical risk associated with a bespoke development around an innovative messaging technology, providing low commonality with industry standard retail solutions, which may preclude retail best practice in the future. The proprietary nature of this solution causes concern, and the introduction of new applications may be more difficult.

Automation
The majority (80%) of product development opportunities in POCL's business plan proposals require, or will be enhanced by, automation.

The delivery of Counters automation strategy is dependent on the successful implementation of discrete, but interrelated projects: Transaction Information Processing (TIP) and Distribution Systems Project (DSP). TIP is proceeding on the basis that BA/POCL will go ahead. DSP is standalone, but delivers incremental benefits from automation. Both TIP and DSP are at an early stage of development.

TIP goes hand-in-hand with BA/POCL automation. Unfortunately the comparative timetables are not compatible, and it has therefore not been possible to specify a 'Cost Benefit Analysis' for TIP. However BA/POCL is presented on the basis that TIP may not go ahead, and that all the costs necessary to deliver BA/POCL functionality are included, as well as those benefits deliverable by BA/POCL alone. Benefits have therefore been apportioned to BA/POCL, TIP and DSP. All 3 projects have signed up to this split. The BA/POCL case therefore excludes incremental benefits expected to be derived from automation, but delivered under TIP.

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The PFI service provider provides a discipline that Counters, if they were to progress with automation themselves, may find difficult to match. PFI takes out a major risk - project implementation - or, at least, compensates for failure.

Financials
Sunk costs to date of £5.4m, have been included in the cashflows. It is clear that the PFI delivers at best marginal direct financial benefits on any given set of assumptions. However automation itself provides a platform for Counters to exploit, and this may place a considerable challenge on the retail network to deliver incremental benefits from the enabler of automation.

The financials, prepared on an 8-year project life, have year 0 designated as 1995/96. Restructuring this to 1996/97, has negligible NPV impact on the 'best' case NPV of £45m (Dick).

Profit & loss impacts ?

To achieve its marginal return, the business case assumes new business of £77m in NPV terms over the project life. Failure to achieve this, equates to an average £15½m p.a. adverse impact in cash flow terms. It is therefore imperative that at a minimum, the forecast level of new business benefit has to be achieved if the project is to return a broadly neutral financial return; benefits from the previous aborted Counters Automation, dissipated during a lengthy development phase.

NRR of £10.0m for project implementation, principally over the first 3 years, is included (over and above base case costs), and we assume includes 'decommissioning' of the project team. This should be readdressed as to whether there is any headroom for cost reductions, or whether some costs would be able to be absorbed in the concession.

The impact of VAT has been considered by Ernst & Young, and included within calculations. Group Taxation have had restricted involvement in evaluating/reviewing the assumptions of the effect upon the VAT recovery rate, but subject to changes to, and applications of, VAT law, are of the opinion that the conclusions are correct. The services generated under the contract will have the effect of raising POCL's VAT recovery rate from 22% to 26%.

The fact that the cashflows have changed significantly during final evaluation, suggests a degree of caution needs to be placed on the final NPVs, and that the these remain volatile to changes in assumptions.

Source?

The comment that the Treasury regards the deal as too beneficial to POCL, runs the risk that it may revisit Counters targets in the future.

Contractual
Ernst & Young have reviewed the contracts issued, and concluded that it is unlikely that this procurement will be on balance sheet. A conclusive statement however cannot be given until the final contracts are agreed.

When?

Not only is it important to monitor the PFI contract, but given the need to re-tender the concession, the performance against the contract will form the base on which to evaluate retendering.

The option of PO procurement appears not to be feasible:
- the financials are no better than the best bid, but at greater risks to the Post Office;
- BA are strongly against PO funding and owning the system.

Conclusions

The risks to not proceeding with the PFI option, are viewed as greater to Counters infrastructure, than the risks of not proceeding at all. These are inherent risks to POCL of not providing automation, and these outweigh downside risks built into the business assumptions. Key for POCL is to use the automation platform as an enabler to generate other business benefits.

The interrelationships to other projects, TIP and DSP, are therefore key, and will need to be stringently ringfenced to ensure they deliver incremental benefits.

The risk of contract variation during the contract, when finalised, is unclear, and therefore potential future benefits could dissipate. Sponsors should aim to minimise scope for renegotiation with both the Concessionaire and BA, and any contractual risk remaining will require ongoing stringent management.

Recommended Conditions

- The technical concurrence is unable to be definitive and final at this stage, and therefore there is a requirement to ensure that the proposed technical solution of the chosen supplier is signed off by an unconditional TCC prior to signing final contracts, as to the supplier working within the overall Post Office IS strategy (applications and infrastructure), and that POCL is not precluded from taking advantage of standard software upgrades in the future;
- Once the contract has been agreed/awarded, the financials should be re-submitted to the Secretariat, with significant variances explained, for noting at MaPEC, which should form the basis of future monitoring; and an annual report back thereafter;
- The individual assumptions detailed in both the base and PFI cases must be tracked and reported through a benefits management plan, and continued throughout the contract;
- A programme board should be set up to oversee all future retail initiatives. This must ensure that benefits/costs are incrementally identified to that initiative, and do not become subsumed within this project. CEC Solution
- The risk management plan must include provision for identification, and avoidance of, potential contract variations.

boundaries of management process why?

Recommendation

Subject to the above conditions, and Board endorsement, the PFI business option is recommended.

Signed GRO IRVINE CAPLAN (Secretary, MaPEC) Date: 29 April 1996

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MP(96)42B(i) **SUMMARY OF PROJECT INFORMATION**

GENERAL

Project Title: BA/POCL AUTOMATION
Project Sponsor: Richard Dykes/Stuart Sweetman, Managing Director
Project Controller: Paul Rich, Financial Markets Business Centre Director

NPV £m	Base Case	PFI Automation (preferred option)	PO Procurement single replacement	PO Procurement 4 yearly replacement
Income				
Benefits Agency (inc SSA)	2119	2119	2069	2069
Volume Change	(203)	77	77	77
Price Change	(196)	107	107	107
Sub Total	1720	2303	2253	2253
DSS Girocheques	325	325	325	325
Volume Change	(21)	(188)	(188)	(188)
Price Change	6	2	2	2
Sub Total	310	139	139	139
Other Clients existing & new	---	77	77	77
Savings on existing automation	---	40	40	40
Sub Total	---	117	117	117
Expenditure				
Benefits Agency	(1889)	(2112)	(2112)	(2112)
Girobank	(297)	(140)	(140)	(140)
Time Increases		(15)	(15)	(15)
Card Issue/back office		73	73	73
Training		(3)	(23)	(23)
Programme costs (sunk)	(4)	(5)	(5)	(5)
Programme costs (future)		(25)	(25)	(25)
Fraud	(1)	---	---	---
Sub Total NPV before supplier charges & risk	**(161)**	**332**	**262**	**262**
Supplier Charges/Risk	---		(122)	(191)
System Charges BES	---	(145)	---	---
POCL	---	(220)		
Other	---	(36)	(177)	(177)
VAT	---	(27)		
Total NPV	(161)	(96)	(37)	(106)

	Base Case	Tom	Dick *	Harry	PO single	PO 4 yearly
Sub Total NPV before supplier charges & risk	(161)	330	332	332	262	262
System Charges	---	---	---	---	(122)	(191)
BES	---	(145)	(145)	(145)	---	---
POCL	---	(236)	(220)	(233)		
Other	---	(36)	(36)	(36)	(177)	(177)
VAT	---	(27)	(27)	(27)	---	---
Total NPV before risk	(161)	(114)	(96)	(109)	(37)	(106)
Assesment of risk	---	(17)	(20)	(17)	(74)	(74)
Total NPV	(161)	(131)	(116)	(126)	(111)	(180)

* Preferred option