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To:

SECRETARY OF STATE) separate
MR MCCARTNEY) copies

From:

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6 November 1998

BA/POCL COUNTERS AUTOMATION PROJECT: HORIZON

Issue

An update on where matters now stand, with particular reference to John Roberts' letter of 4 November (attached). (NB the supporting documentation referred to is that circulated under cover of Isabel Anderson's minutes of 27 and 28 October.)

Recommendation

2. (i) To reply to John Roberts in terms of the attached draft.

(ii) To note the position reached in the discussions between ICL and the Post Office.

Timing

3. Routine, though the letter to John Roberts should ideally issue today (Friday 6 November)

KEY DEVELOPMENTS: THE FIRST FOUR WEEKS

4. Ministers decided on 9 September to allow a further month for negotiations between BA/POCL and ICL to try to reach agreement on revised contractual terms for carrying Horizon forward (Option 1). They also commissioned two additional and parallel strands of work. The first was on the alternative options of proceeding with Horizon but without the benefit payment card (Option 2), or of terminating Horizon as a whole(Option 3), so that value for money comparisons could be made between all three options. Second, the Secretary of State was charged with taking

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forward five specific points relating to the Post Office and the counters network. These three strands of intensive activity were overseen by the Treasury-led interdepartmental Working Group, whose report on progress by the end of the month specified by Ministers is at Appendix A.

(i) <u>The negotiations</u>

5. To assist with the first strand of work, the negotiations between BA/POCL and ICL, Graham Corbett, Deputy Chairman of the MMC and former Finance Director of EuroTunnel was appointed to chair the negotiations. KPMG were appointed to assist him, particularly in understanding and validating the business cases of each of the contracting parties. Mr Corbett's report is at Appendix B.

(ii) <u>The fall-back options</u>

6. KPMG were also asked to undertake a major piece of work on the second strand of activity, that of enabling value for money comparisons to be made between the three options. KPMG's report is at Appendix C.

(iii) <u>The five points</u>

7. Most of the work on the third strand, the five points addressed to the Secretary of State, consisted of dialogue between ourselves and the Post Office, the outcome of which is recorded at Annex A to Appendix A. However, on the transparent funding/social value of network issue, Price Waterhouse Coopers (PWC) were commissioned to carry out a first quick cut at the problem of attributing social value to the network. Their report is at Appendix D. The Post Office also commissioned PA Management Consultants (who had been used by Adrian Montague's Expert Panel) to carry out an audit or evaluation of the changes that had been put in place to the Horizon programme management.

<u>RESULTS FROM THE FIRST FOUR WEEKS</u>

(i) <u>The negotiations</u>

4. By the end of the four weeks the negotiations chaired by Graham Corbett between BA/POCL and ICL, **had failed to find a commercially acceptable basis for continuing with Horizon.** However, at the eleventh hour, ICL signalled that if some form of joint venture or joint working with POCL could be devised to give ICL confidence that the full commercial potential of Horizon would be aggressively exploited, **it might then become possible to close - or at least to substantially narrow - the gap between the two sides**. Ministers subsequently agreed to a further period of two weeks for talks between POCL and ICL, who are to report back by 9 November.

(ii) <u>The fall back options</u>

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5. The work carried out by KPMG has demonstrated that, on a like for like basis, **in value for money terms there is little to choose between the three options**, and that such differences as there are fall well within the margins of error. Comment: However, when the **other advantages of continuing with the project** - minimising the risk of damage to the network of post offices, to ICL, to the credibility of the PFI process especially for this type of project, and to prospects of inward investment from Japan - are taken into account, the case for continuing **appears overwhelming provided a sensible commercial deal can be negotiated;**

(iii) The five points

6. On the third strand of work, the responses we were able to give on the five points to the interdepartmental Working Group are at Annex A to Appendix A. **On the first four**, namely strengthening Horizon project management, giving POCL management a more commercial focus, exploring the scope for partnerships between POCL and the private sector, and developing Horizon to support social banking and broader account-like services, the Working Group's reaction (set out at paragraph 4.2 of Appendix A) was that **the Post Office is belatedly moving in the right direction, though in some areas much remains to be done.** On the fifth point, concerning a transparent funding regime and the social value of the network of post offices, preliminary work by Price Waterhouse Coopers suggests that the **"extra" cost of delivering benefits through post offices rather than ACT is more than offset by the social value added.**

7. A more detailed summary of the main elements of the work described above is at Appendix

TWO FURTHER WEEKS

The gap to be bridged

8. At the end of the first four weeks, a deal was on the table that would have given ICL a "profit" (expressed as a positive net present value, or NPV) of around £50 million **on the project from this point onwards.** But ICL insisted that they had already sunk or committed some £250 million and that the proposal therefore required them to accept a loss of some £200 million on the project overall. This was unacceptable.

9. However, ICL's remuneration under the contract is on the basis of a fee per transaction handled by the system. The calculations shown above were based on POCL's forecasts of transaction volumes. ICL believe that these forecasts are unduly pessimistic, and that if they were able to join with POCL in marketing the system a great deal more effectively than POCL alone will be capable of doing, substantial additional traffic could be generated. This in turn would generate

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additional payments to ICL and would improve the NPV of their business case. If, for example, sufficient additional volumes could be generated to increase payments to ICL by some £50 million over the remainder of the contract period, the loss to ICL overall would reduce from £200 million to £150 million. At that point, ICL would need to come forward with an offer to absorb at least a significant proportion of the remaining £150 million, and the public sector side would then make a judgement on whether it was prepared by one means or another to bridge whatever gap remained.

10. This in essence is what the last two weeks have been about. ICL have made three demands. First they want a structure in place for the joint development of Horizon's commercial potential. The Post Office agree that there is potential through working with ICL to develop Horizon's commercial potential more fully than their own business plan envisages, but they want to keep such cooperation to a working arrangement, under which they retain full control of their commercial destiny. Second, ICL want POCL to designate them preferred supplier for all POCL's IT requirements. The Post Office are willing only to concede minor elements of this. Third, ICL want POCL and ICL Pathway to take cross-shareholdings in each other. The Post Office see no commercial case for conceding this.

11. ICL were due last night to submit a final set of interlocking proposals to the Post Office last night. We expect to get a read-out of these later this morning, together with initial reactions from the Post Office. At this stage, however, the prospects of a deal which would satisfy the criteria set out in the Chief Secretary's letter of 30 October do not look promising.

DAVID SIBBICK