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To:
MR MCCARTNEY

ci: Secretary of State
Sir Michael Scholar
Mr Macdonald

From:
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GRO
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20 July 1999

HORIZON NEGOTIATIONS: MEETING WITH ALISTAIR DARLING 22 JULY 1999

HORIZON NEGOTIATIONS

Issue

1. You have arranged to meet Alistair Darling at 11.00 a.m. tomorrow (Wednesday 21 July) to find ways of enabling Post Office Counters Ltd (POCL) and the Benefits Agency (BA) to make progress in the negotiations on the back-to-back agreement which needs to accompany POCL's agreement with ICL.

Recommendation

2. That you should seek to make progress along the lines set out in the following speaking notes.

Background

3. The background to the meeting is set out in the exchange of correspondence between yourself and Alistair Darling attached as Annex A. The latest position in the parallel sets of negotiations is set out below.

A. POCL/ICL negotiations

4. All outstanding issues have been resolved. The mechanical task of drawing up the agreement and the accompanying schedules is taking a little longer than expected

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but both sides accept that the documentation in final form should be ready for signature by Thursday or Friday of this week. The Post Office Board is currently meeting to consider the agreement, and as I understand doing so against the background of a strong recommendation from POCL that the agreement should be signed. The Board seems likely to accept the POCL recommendation but to refuse to sign until a satisfactory BA/POCL agreement is also in place. The agreement in principle with ICL signed on 24 May provides that if the full agreement is not signed by the end of July the project in its entirety falls and ICL receives a termination fee of £150 million.

B. BA / POCL agreement

5. Negotiations between the two sides continued up until close of play last night, today, but ended in stalemate. There are essentially three issues in contention.
6. First, acceptance testing. Broadly speaking, BA want to transfer their acceptance testing rights from their present agreement with ICL into POCL's new agreement with ICL. They say that they are not willing to enter into a contract with POCL worth in excess of £100 million without being able to satisfy themselves that the system will in fact work. POCL's position is that BA have fought for years to get out of their contractual relationship with ICL, and cannot expect to retain rights, exercised through POCL's agreement with ICL, when they no longer have contractual responsibilities. At a more practical level there is no doubt that two sets of acceptance testing would inevitably delay what is already an extremely tight timetable if national roll-out of the Horizon platform is to be completed by end March 2001. POCL's suggested compromise, which seems a reasonable one, is that they will share fully and openly with BA the results of all their acceptance testing, in return for which BA will drop their insistence on separate testing.
7. Second, floor payments. POCL have argued that the minimum guaranteed payment levels, or "floor" under their existing contract with BA which runs until 2005 should remain in place unchanged. The BA position is that they would like the floor removed from the agreement altogether. It seems unreasonable that the floor should not remain in place until 2003, during which period Ministers have guaranteed that existing paper-based methods of paying benefits at post offices will continue unchanged. Equally, however, Post Office demands that the floor should remain in place unchanged between 2003-2005, when BA will be migrating the majority of benefit recipients to payment by ACT, look excessive. A reasonable compromise here might be that the floor should remain unchanged until 2003, which ought not to cost BA anything unless, as some in POCL fear, BA are plotting to accelerate the take-up of ACT in advance of 2003 and contrary to the clearly expressed collective position of Ministers. A revised floor would then be put in place to cover 2003-2005 which took

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proper account of the planned migration of most benefit recipients to ACT during that period.

8. Third, and the most contentious, is how much the Benefits Agency should pay POCL for operating the order book control system (OBCS). POCL claim that the Horizon platform will cost them in round figures £1 billion (this figure seems correct once POCL have properly added the VAT which they will have to pay on the purchase from ICL). They then say (again probably correctly) that OBCS will represent, at least in the early years, about one-third of the total business conducted over the Horizon platform. They conclude from this that BA should pay them in excess of £300 million (ie one-third of £1 billion). I regard POCL's position on this as unreasonable and indefensible. I have argued with them that the Government is contributing £480 million towards the capital cost of the project, and that the most they can look to recover from BA is £173 million (i.e. one-third of £520 million). POCL have argued that the £480 million was already their money (it was not) and that, in any case, it is needed to help bridge the funding gap once the payments from BA begin to reduce in 2003. We have told them that this longer term funding gap is to be addressed separately by Ministers and will first be the subject of an interdepartmental study, probably conducted by the PIU. BA have offered to pay £111 million for OBCS, which leaves a gap of £62 million from the £173 million which, as noted above, might be a reasonable share for OBCS to carry (this is, of course, £63 million over the life of the project whilst the announced expected savings from OBCS amount to £100 million each year).

DAVID SIBBICK

RESTRICTED - POLICY & COMMERCIAL**SPEAKING NOTE**

- Grateful that you have agreed to see me. The ICL/POCL negotiations are now virtually complete. The Post Office Board appear content with outcome, and the agreement should be ready for signature by end of week. However, the PO Board have made it clear that they will not sign the agreement with ICL until the back-to back agreement between POCL and BA is also ready for signature. If the agreement with ICL is not signed by end July, the project automatically terminates and ICL are to be paid a termination fee of £150 million. I appreciate the constraints on DSS/BA budgets, but we need urgently to find a way through this impasse.
- Despite several rounds of negotiation, BA and POCL appear a long way apart. There are three outstanding issues on which I hope we can make progress today:
- First, acceptance testing. I fully understand BA's desire not to enter into a contract with POCL costing in excess of £100 million without the right to verify for themselves that the system actually works. However, two separate sets of acceptance testing would inevitably delay progress with the programme, and the projected timetable is extremely tight if national rollout of the platform is to be achieved by end March 2001. POCL are apparently willing to share fully with BA the results of all their acceptance testing, but cannot accept - and I have sympathy with this view - that BA should be able to carry out their own acceptance testing when they no longer have a contractual relationship with ICL. Provided that POCL can convince BA that they will carry out acceptance testing and the evaluation of it with sufficient rigour, could not BA accept POCL's offer to share fully with them the results of all acceptance testing?.

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- **Second, guaranteed minimum payments.** I understand that BA would like to withdraw all provision for minimum guaranteed payment from the contract. POCL, on the other hand, want the existing provisions to continue unchanged right through to 2005. Both positions seem unreasonable. Against the background of the assurances that we have collectively given that there will be no change in the existing means of paying benefits at post offices before 2003, it is surely not unreasonable for POCL to expect that the existing provision for minimum guaranteed payment will continue unchanged until that point in time. This would not be a costly concession for BA to make, whilst offering POCL some degree of reassurance of a continuing revenue stream during those years. Similarly, I fully understand BA's wish not to continue with that level of minimum payment between 2003-2005 as though nothing had changed, when the reality is that we have taken a clear policy decision to phase out paper-based payments at post offices during that period. I suggest that a reasonable compromise might therefore be to leave the floor unchanged in the years up to 2003, but to put in place for 2004 and 2005 revised floors which reflect realistically the expected rate of migration to ACT during that period.
- **Third, payment for OBCS.** I understand that POCL have been looking for a level of payment for OBCS which seeks to recover one-third - the expected percentage of total transactions through Horizon that OBCS is expected to represent in the early years - of the total cost of the platform of around £1 billion. We have made it clear to POCL that we regard this claim as unjustifiable. It ignores the £480 million that we have agreed to contribute to the capital costs of the project. I do, however, suggest that it would be reasonable for OBCS to bear one third of the costs of the platform less our contribution of £480 million. This would require BA to contribute £173 million over the life of the project as against the £111

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million which I understand they have already offered. There is, therefore, a gap of some £62 million over the life of the project. In the interests of reaching the agreement which is essential if the Post Office are to sign with ICL, would it not be possible for BA to agree to meet this additional £62 million spread over five or six years, recognising that OBCS will produce savings for the Benefits Agency of around £100 million each year?

A deal on the outstanding issues on the basis I have described would clearly fall some way short of POCL's ambitions. If you could accept it, I would be willing to do my best to persuade the Post Office Board to sign up to it, and in turn to sign the ICL agreement.