POL00104333

Electronic *memo*

To: Dawn Howe/e/POSTOFFICE GRO
cc:
Hard Copy To:
Hard Copy cc:

Date: 02/04/2001 10:18
From: Keith K Baines

Subject: Horizon post 2005

Please print and pass to me

---------------------- Forwarded by Keith K Baines/e/POSTOFFICE on 02/04/2001 10:30 ---------------------------

To: David W Miller/e/POSTOFFICE GRO, Stuart Sweetman/e/POSTOFFICE
cc: Alan Barrie/e/POSTOFFICE GRO Clive Read/e/POSTOFFICE GRO Keith K Baines/e/POSTOFFICE GRO
Hard Copy To:
Hard Copy cc:

Date: 25/03/2001 21:04
From: David X Smith

RECEIVED 25 MAR 2001

Subject: Horizon post 2005

Stuart, Dave,

Have now added the Appendices horizon2005.ZIF

Dave

POL00104333

IN STRICTEST CONFIDENCE

Annex A

CONSIGNIA EXECUTIVE BOARD **PAPER NO:**

EXECUTIVE SUMMARY

The current contract with ICL for the Horizon system runs through to 2005. The timescales for procurement and system design, build, test and implementation are such that a decision on the future of the relationship with ICL is called for now if PO Ltd is to realistically choose between all available options. This paper addressees the way forward in the light of input from an independent review on the financial status and direction of ICL and its parent Fujitsu, a review of IS Strategy and legal/procurement advice.

The diversion of significant and scarce resource in the procurement process at a time of unprecedented business change leads to the conclusion that on balance an extension with renegotiation is the preferred option.

STRATEGIC IMPLICATIONS

The preferred option means that PO Ltd's capability to deliver major initiatives such as Banking, GGP and ERA will not be diluted by a lengthy and resource hungry procurement and system replacement project. The option "protects" business strategy. Additionally negotiation objectives include the funding of significant elements of ERA c£65M by ICL and a smoothing of existing costs to create headroom which will support other strategic programmes.

COSTS/BENEFITS

Negotiation will be supported by a "business as usual team". Additional legal fees will be incurred.

SPONSOR
Stuart Sweetman

AUTHOR
David Smith

Annex B

POL00104333

IN STRICTEST CONFIDENCE

POST OFFICE EXECUTIVE BOARD

HORIZON BEYOND 2005

1. Introduction

Horizon contract ends in 2005. Time needs to procure and replace Horizon means we need a business decision now

The Horizon system, provided under contract as a managed service by ICL Pathway, is a major component of Post Office Limited's operating process and is also a large element of its fixed costs. The current contract runs to the end of March 2005. Further significant developments are planned which will barely be completed within this timescale let alone cost in. This paper analyses options for obtaining similar services after the current contract and recommends a way forward that takes account of the wider business context.

In carrying out this analysis three other recent studies have been take into account. These are:

a) Review of the IS strategy for post offices by Group IS
b) An analysis of the legal/regulatory position carried out by Post Office Procurement;
c) A review of the financial and commercial status and direction of ICL and Fujitsu carried out by KPMG.

The background to the current contract is attached as Appendix A.

2. New Developments

There are a number of business critical new developments required on the Horizon platform

Extensive changes will be required to the Horizon service over the remainder of the current contract and subsequently in order to support PO Ltd and Government strategies for restoring network profitability. Key elements of this are as follows:-

- Costs for the development of Network and Universal Banking are likely to fall within the range £30-50m.
- Costs for GGP are likely to be of the order of £10m excluding kiosks (if these are procured from ICL)
- ERA will require a major redevelopment of Horizon functionality. Initial estimates suggest costs in the order of £60m

Thus development costs over the period are likely to amount to in excess of £100m. The costs of ERA are not currently fully funded within the PO' s strategic plan and it has been assumed that the "gap" will be met through a funding arrangement with ICL

3. ICL/Fujitsu Status and Direction

Can PO Ltd get better value from its relationship with ICL ?

A detailed review of ICL Pathway and Fujitsu's financial status and future business direction has been carried out by KPMG. The headline conclusions are

- ICL's financial performance is poor whilst that of Fujitsu remains strong.
- ICL's strategy is prudent but will restrict growth/innovation whilst Fujitsu has strong capability to expand albeit it is over dependent on Asia/Pacific
- ICL remains well positioned within its core markets, has a trusted brand, not cutting edge but with some innovative capability
- Fujitsu strongly loyal to ICL but taking greater interest due poor performance. Analyst view if they'd wanted to sell would have done so by now. ICL as Fujitsu's bridgehead into Europe ?
- Horizon key contract now part of Large Contracts Division focused on delivery and tight cost control which might be at the expense of future capability and innovation

Fujitsu clearly has the resources to deliver another "Horizon" , ICL have an increased focus on delivery and whilst they have innovated for other clients they have a mixed record of delivery, may not have sufficient resource of the right kind and need to change culture.

The implications for Post Office Ltd. are that it must get better value from the relationship. The challenge is whether through a stronger partnership approach PO Ltd. can draw out the best of ICL's capability.

4. Legal/Regulatory Constraints

We can extend the contract for 3 years without having to go through a procurement process

Procurement advice is that non-competitive award of a new contract of similar length to the original one would breach public sector procurement rules which PO Ltd. is required to follow. However, a non-competitive extension of the contract of up to 3 years would be allowable provided that there were sound reasons for doing this.

5. IS Strategy

Horizon will be at the core of our architecture beyond 2005

The review of the IS Strategy concluded that Horizon would continue to form the core of the retail infrastructure through 2005 and beyond. It proposes, where commercially viable, to use the developments of other channels e.g. kiosks as the basis of developing alternatives to ICL.

6. Options

The business priority is to change the business not to change suppliers

The options considered were as follows

- Do Nothing (yet) -The current contract still has 4 years to run. PO Ltd. could simply allow it to continue for the time being, on the basis that a procurement to obtain a replacement could be carried out nearer to the end of the contract.
- New competition - We could start planning now for a full competition to award a replacement contract in or before April 2005.
- Truncate current contract - We could plan to terminate the existing contract early. This would involve a significant termination fee.
- Extend current contract - An extension of up to 3 years could be made. This would take the current contract to 2008.
- Renegotiate and extend - As above, but seek significant improvements in the terms and conditions applying to the contract now in return for the extension including financing for major projects such as ERA

Detailed analysis, description and comparison of the options is at Appendix b.

All of the options which imply replacing ICL or at least testing the market create a significant risk. ICL could if they so chose paralyse further developments. Any delays beyond 2005 would almost certainly require short term extensions which could be at significant cost. If this was done with serious intent to change partners then all of the technology based PIU business cases would be difficult if not impossible to cost in. But above all else at a time when PO Ltd faces change on an unprecedented scale large amounts of scarce resource would have to be diverted into changing supplier. This would undoubtedly be at the expense of some of the fundamental business change necessary for the businesses survival.

An extension on existing terms has little benefit for PO Ltd other than stability. An extension with renegotiation does provide the business the opportunity to strengthen its position with ICL, provide the opportunity to fund ERA which has significant business benefits and provides an opportunity to develop new ways of working with ICL including a more innovative approach to development. Negotiations will not divert scarce resource on anything like the scale that competition would.

Extension with renegotiation, is therefore, the preferred option.

7. Negotiation Objectives

Proposal to grant an extension in return for significant benefits to PO Ltd

The objectives for negotiations are as follows :-

- Extension of current contract by up to 3 years.
- Spreading of the remaining £120m capital payments over a longer period to create headroom for funding new development.

POL00104333

- Annual cost including banking and ERA developments over the extended contract to be no greater than the costs of the core services under the current one.
- funding of ERA development in 2001/2 to be paid for through the operating charge
- PON to have greater control of the system design; once the ERA design is implemented PON should control this at system design level as well as business requirements level
- ICL to partner with other technology companies to ensure that all new developments are innovative
- Market pricing
- Incentivisation through some sharing of benefits and risks

8. Negotiation Plan

Negotiation will be based around a plan

Negotiations would be lead by Dave Miller. However, the negotiation objectives would be agreed by the Executive Board and the negotiating brief by Stuart Sweetman to ensure that this conformed to the agreed objectives. The outurn of negotiations to be agreed by the EB if this falls utside the negotiation objectives.

An outline of the draft timetable is shown below. This would have to be agreed up front with ICL

Agree negotiation objectives in PO	April 2001
Agree negotiation brief	April 2001
Approach ICL to initiate negotiations	May 2001
Negotiation of heads of agreement	June 2001
(If fails, then switch to contingency plan)	
Negotiate full agreement	October 2001
Draft and agree new contract	January 2002

9. Conclusion

Extension and renegotiation is recommended on the basis that this will deliver worthwhile benefits and allow major change to proceed

The Executive Board is invited to agree that negotiations be opened with ICL with the objectives as outlined above.

Appendix a

Background to the Horizon contract

POL00104333

1. History

Following various studies into options for payment of social security benefits through post offices, a decision was taken by Government in 1994 to proceed with a major project that would both modernise benefit payment and provide counter automation in all post offices.

Following an extensive procurement exercise, contracts were awarded to ICL Pathway in May 1996. Known as the Related Agreements, there were three contract with ICL Pathway - Contract 2 for the payment card, held by the Department of Social Security; Contract 3 for Post Office automation held by Post Office Counters Ltd.; and the master Contract 1 defining the overall framework and terms and conditions held by DSS and POCL jointly.

These contracts were awarded in accordance with the principles of the Private Finance Initiative. This meant that significant areas of risk associated with the project and with benefit fraud prevention were transferred to ICL Pathway; and that payment for the service was based on transaction volumes. Once the service was live, the payments to ICL Pathway were underpinned by guaranteed minimum amounts (which equated to the payments that would be due at around 70% of forecast volumes) and there were discounted prices for volume growth. However, no payments were due to ICL Pathway until the service was accepted and in live service.

There were associated contracts between POCL and the DSS. Contract A covered transaction services - that is, analogous services to those previously provided in the manual environment, but updated to take account of the payment card. This contract was on normal commercial terms. Contract B covered transmission services, and in effect allowed POCL to recharge those elements of the Contract 3 services that related to benefit payment to the DSS, without any mark-up other than a fee to cover contract management costs.
In addition, POCL had similar contracts with the Social Security Agency for Northern Ireland.

There were repeated delays to the development and deployment of the services under the Related Agreements. This resulted in a re-plan of the project on 1997, and then to a series of reviews as timescales continued to be failed.

This culminated in a review of the project led by HM Treasury and involving the DSS and the DTI (as the Post Office's sponsor in Government) and a decision by ministers in early 1999 that they no longer had confidence in the project's ability to deliver services in time to support government policy, that the payment card element of the project should be cancelled, but that automation of post offices should continue.

Terms with ICL to implement this were negotiated by representatives of HM Treasury, and a proposal put to the PO Board for endorsement in May 1999. On the basis of undertakings from DTI that would enable the Post Office to draw on reserves (not otherwise available to it) to fund the up-front costs of the new contract, a letter agreement was signed between Post Office Counters and ICL Pathway in May 1999, and following detailed negotiations this was turned into a new contract in July 1999.

POL00104333

2. Current Contract

The new contract between POCL and ICL Pathway, signed in July 1999 and known as the "Codified Agreement" (because it codified the terms of the May 1999 letter agreement) was largely derived from those parts of the Related Agreements that were not concerned with the benefit payment card. However there were significant changes to the pricing and other terms and conditions.
Payments to ICL Pathway are no longer volume-related (except to a very limited extent as explained below.) Instead, there are a series of payments related to Acceptance and physical roll-out that are intended to remunerate ICL Pathway for the development of the service, and further regular payments to cover operation of the live service. Incremental development and change is chargeable separately, on a time and materials basis, agreed case by case through a defined change control process.

The contract runs to 31 March 2005 unless terminated earlier. POCL has the right to terminate the contract at any time by giving 12 months notice, but this would result in significant termination payment to ICL Pathway equating to their unrecovered costs plus estimated future profits. There are circumstances in which the contract can be terminated earlier without such a long notice period, and without a termination payment; these include termination as a result of uncorrected ICL Pathway defaults.

At the end of the contract, or on its earlier termination, POCL has the right to acquire the assets used by ICL Pathway to provide the contracted services for a nominal payment of £1. (A higher transfer payment would have applied in the roll-out phase of the contract, but this is no longer relevant now that ICL Pathway have received all of the roll-out payments.)

3. Service Levels

The Codified Agreement specifies a range of service levels that Pathway are to meet in providing the contracted services. These fall into the following main groups:
a) Training
b) Roll-Out
c) Transaction times
d) Data transfer
e) Help desk performance
f) Time to fix (field maintenance)
g) Reconciliation
h) System stability

Groups (a) and (b) are relevant only to the roll-out period. The remainder are relevant throughout the contract.

Groups (g) and (h) were added as a result of rectification plans for faults found during the Acceptance of the Core Services Release (CSR). The remainder were included in the original contract.

Generally, service levels are reported monthly in a report prepared by Pathway and discussed at the Service Review Board. Some service levels have Minimum Acceptable Thresholds (MATs) and/or Termination Review Thresholds (TRTs), and most of these also have mechanisms for calculating liquidated damages to compensate POCL for losses incurred as a result of performance below the Minimum Acceptable Threshold level.

If service falls below a TRT during any quarterly reporting period, or below the MAT for any 3 quarters out of 24, then POCL has the right to terminate the contract. An alternative course of action in these circumstances is to require Pathway to devise a rectification plan to correct the sub-standard performance; in that case the right to terminate would still apply if no satisfactory plan could be agreed.

The right to terminate would not arise if the sub-standard performance by Pathway was a result of force majeur, or if it had been caused by POCL failing to carry out our obligations to Pathway.

4..Current Status of Horizon

Roll-Out

Over 95% of the roll-out has now been completed. This is ahead of schedule. There are around 600 post offices still to be automated; around 400 of these are expected to be completed within the next 2-3 months, with the remainder taking longer because there are issues (such as moving to new premises) that will take time to resolve.

Update

Pathway have now achieved all of the roll-out milestones to which payments are linked; an element of the operating payment is linked to the number of automated post offices, so there is a limited price incentive for them to complete the rest (around £100 per post office per month with effect from April 2001); but this is probably less significant than the savings that they will make by closing down their implementation operation and saving the management overhead they are incurring on it. There are some indications that completion of the roll-out has been getting reduced management attention in Pathway recently, and that as a result the "headroom" that has been created by previous over-performance relative to the contractual schedule will be used up over the next few weeks.

Development of the Core Services

The contract with Pathway includes defined services (the "Core Services") to be provided at the contracted price. These services are being provided within 2 main releases - CSR and CSR+. Both of these have now been delivered; however there are a number of "hang-outs" from the Core Services that have not yet been completed.

Automated Payment Service client connections have not yet been established for all the clients; this is scheduled to be completed around June 2001.
There are known problems in the CSR+ release as implements; these are due to be rectified, mainly in a maintenance release, "M1", due for roll-out in April/May 2001.

Service Performance

POL00104333

There have been problems with performance against service levels in relation to:
time to fix
data transfer
help desk performance

In the first two cases, a number of MATs were failed in each of the first three quarters following Acceptance of the service. (There are no MATs for help desk performance; various targets were failed over the same timescale, but with less contractual significance.)

As a result of this, POCL required Pathway to develop rectification plans to bring performance up to the required standard. Pathway's response is still being discussed; their proposals in relation to data transfer service levels would change the contracted service levels and are not currently acceptable; the proposals on the other failed service seem likely to lead to acceptable improvement plans.

Financials

ICL Pathway have achieved the major roll-out milestones for the roll-out payments. They have received approximately £440m (ex VAT) from the contract to date, and will receive approximately £115m (ex VAT) per annum from April 2001 for the core services; this excludes cost of change (see following section).

Appendix B

Options

1. Do Nothing (yet)

POL00104333

The current contract still has 4 years to run. POCL could simply allow it to continue for the time being, on the basis that a procurement to obtain a replacement could be carried out nearer to the end of the contract.

Pros - defers the potentially disruptive effect of commercial negotiations that may prove difficult and that may make if more, rather than less difficult to achieve rapid delivery of the new developments needed.

Cons - a new procurement may take longer than currently anticipated (PO Purchasing estimate 18 months) and a 12-18 month roll-out for any new supplier would potentially be required in addition to any development time. Thus the minimum lead time from starting the procurement to completing roll-out of replacement services is likely to be 3 years. Also, it will become increasingly difficult to reach agreement on terms for incremental development with Pathway when the future of their contract is in doubt. New developments would be increasingly difficult to justify in the interim, since they would have to be cost justified over the existing contract, and then paid for a second time on the replacement system. The effort required to put in place a new contract and service would be considerable and a diversion from change activity.

2. New competition

We could start planning now for a full competition to award a replacement contract in or before April 2005.

Pros - maximises price competition and opens up the possibility of making a step change in capability and cost. Minimises any risk of challenge on procurement regulation.

Cons - Likely to distract Pathway and the Post Office from current developments to getting their bid together; also likely to be very difficult to manage the Pathway relationship if they believe they are unlikely to win. Also, it may be difficult to specify the service required given the uncertainty about the future shape of the network given that the PIU programme is at an early stage, and that the government guarantee on the social network is due for review in 2006. New developments would be increasingly difficult to justify in the interim, since they would have to be cost justified over the existing contract, and then paid for a second time on the replacement system.

3. Truncate current contract

We could plan to terminate the existing contract early. This would involve a significant termination fee.

Pros - allows benefits of a new contract with a new supplier to be achieved early. Minimises period of dependency on a dissatisfied existing supplier.
Cons - costly. Even if a new supplier was prepared to finance the exit fee, this would in effect be recharged to POCL over the subsequent contract. very difficult to manage Pathway during the notice period, and this is a time in which key business developments are required. Would put delivery of banking and GGP at risk.

POL00104333

4. Extend current contract

An extension of up to 3 years could be made. This would take the current contract to 2008.

Pros - likely to be attractive to ICL, and therefore should maximise their co-operation on new developments during the next few years. Avoids disruption of major procurement exercise during a period in which major business change has to be achieved.

Cons - may not achieve as low a price as would be obtained by competition. Continuation of problems being experienced with the current contract in relation to visibility and control of developments, and high costs of incremental change. Existing hardware may become unreliable if not replaced during the extension period, and that would make a subsequent competition less attractive to other suppliers.

5. Renegotiate and extend

As above, but seek significant improvements in the terms and conditions applying to the contract now in return for the extension.

Pros - as above, plus opportunity to improve PON cash flow in the intermediate period to 2005.

Cons - may prove a difficult negotiation. If unsuccessful, it may be more difficult to manage the relationship with ICL during the remainder of the current contract. ICL may not have the financial headroom to do the kind of deal we need.

6. Comparison of Options

The following table compares the above 5 options in terms of a number of criteria on the following scale:

1 Option meets criterion in full
2 Option meets criterion to a significant extent
3 Option fails to meet criterion to a significant extent
4 Option does not meet the criterion

	8.1	8.2	8.3	8.4	8.5
	Do nothing yet	New competition	Truncate current contract	Extend current contract	Extend and Renegotiate
Supports NB and UB	2	3	3	2	1
Supports ERA	3	3	4	2	1
Supports GGP	2	3	3	2	1
Supports Network Transformation	2	3	2	2	1
PO has adequate control of design and introduction of new developments	3	2	2	3	2

POL00104333

IN STRICTEST CONFIDENCE

	8.1 Do nothing yet	8.2 New competition	8.3 Truncate current contract	8.4 Extend current contract	8.5 Extend and Renegotiate
Creates financial headroom for new developments in 2001-2004	4	4	4	4	2
Reduces PON system costs after 2005	2	1	1	3	2
Provides business continuity at end of current contract	4	3	3	1	1