FACSIMILE

TO: Paul Rich

FAX NO. GRO

DATE: 13|10|98

FROM: Richard Christou,
ICL
26 Finsbury Square
London EC2A !DS
Tel: GRO
Fax:

MESSAGE:

Please see the attached

No. of pages including cover 7

13th October 1998

Mr. Graham Corbett,
HM Treasury,
Parliament Street,
London.
SW1P 3AG

ICL

Dear Graham,

<u>Proposed May Forward for the BA/POCL Programme</u>

I enclose ICL's proposals on the way forward for the BA/POCL Programme. This is based upon the discussions and presentation we made to you last week, and continues to be our position in resolving the commercial and programme issues faced by the programme.

Yours sincerely,

GRO

R. Christou

Cc: Graham Corbett, BA
P Rich, POCL

R Christou
Director

Commercial & Legal Affairs
26 Finsbury Square
London EC2A 1DS
Tel +4 GRO
Direct
Fax +4

ICL PATHWAY

Proposed Way Forward for the BA/POCL Programme

1. Introduction

Due to the way in which the contract has been handled by the sponsors, especially the Benefits Agency, ICL is faced with ever increasing costs, declining volume in full operation, no certainty about when full operation will begin and the consequent impossibility of financing the completion of the programme without a thorough restructuring of the original contract. It is completely inconsistent with the PFI concept to argue, as Graham Corbett has done, that ICL should write off its past costs and look only to the future. Under PFI the contractor's expenditure on the design, build and finance phases should be remunerated during the operational phase. In the discussions with Graham Corbett, ICL has put forward a number of proposals for solving the problems. This paper sets out the ICL position.

In parallel with the HM Treasury review, ICL has engaged in confidential discussions with the Post Office to explore proposals in which the Post Office would take a 50% (less one share) equity stake in ICL Pathway. Athough such a proposal has merits in its own right, it could also provide the key to making possible the next stage of funding for the programme provided that an acceptable commercial deal can be agreed. The essential points for the equity proposal are described in the attached note by Sir Michael Butler dated 9 October.

2. Proposal Objectives

ICL believes any settlement must provide a fair way forward for all parties, and must provide ICL Pathway with a fair chance to at least break-even over the contract. The committed funding by ICL to date stands at some £250m, with the expectation that a further £250m of funds will be needed to complete the programme. Whereas originally it would have been reasonable to expect to put non-recourse funding in place after full acceptance in July 1997, we are still a very long way from reaching a position where this would be possible. In all the circumstances, ICL does not consider it reasonable to try to make a distinction between the past and the future, as Graham Corbett has sought to do.

3. Components of the Solution

In addition to the equity proposition there are four key components for an acceptable solution; contract term, contingency arrangements for known and future risks, achievement of contractual acceptance, and appropriate pricing arrangements. Each component has elements of flexibility, which taken together can provide an acceptable resolution for ICL Pathway. This paper describes one such combination.

4. Contract Term

The sponsors have indicated that they may be prepared to consider a contract extension with ICL Pathway to end March 2007 for BA and to end March 2009 for POCL. BA state that they would migrate all non- ACT benefit payments to full ACT by the end of their contract, on a 20%, 40%, 40% basis, starting in fiscal year 2004/5. This amounts to maintaining the period of full operation in which ICL receives revenues at five years but delivers a sharp decline in volumes within that period.

POCL's offer to extend the contract to 2009 is much more helpful, especially if POCL and ICL Pathway form a dynamic partnership to open up new streams of revenue.

Furthermore POCL have indicated that they may be prepared to fund the essential equipment upgrades and replacements required in the post office network in 2006.

5. Contingencies for known and future risks

Discussions between the parties have highlighted and helped define the outstanding differences on the implementation plan and its detailed timetable for project completion. The major areas requiring contingency arrangements are:

- programme risks leading to delay
- contractual acceptance including process and sign off
- BA and POCL business volumes
- fraud risk
- service level agreement penalties
- programme costs

Although the above contingencies are being further refined between the parties ICL Pathway has included a contingency of £100m (£60m in NPV terms) in its business case to cover the likely outcome on these risks. This figure could double if the acceptance issue referred to below is not resolved.

We recognize, however, that all parties share a mutual interest in mitigating and preventing such risks materializing. ICL Pathway has offered the sponsors the principles of an incentive plan whereby if specified contingencies can be avoided, the associated cost savings can be shared on a 50/50 basis. This would offer the sponsors the prospect of cost reductions, and ICL Pathway the opportunity for a modest return on its investment in the programme. The main intent, however, is to incentivise all parties to work together to effect a prompt delivery of the benefits arising from the programme. This has not worked well in the past.

6. Contractual acceptance

The speed of the acceptance process has been highlighted as probably the most critical programme risk. Given our experience since 1996, any revised programme must give us assurance that the contract will not be terminated at some date in the second half of 1999 on a relatively minor technical point.

ICL proposes that programme acceptance must be managed in a staged approach, with each stage having its own, self contained, acceptance arrangements. Deferred, or conditional acceptance, with termination rights preserved for later stages is unreasonable.

We recommend that acceptance of the first stage scheduled to go forward for national roll-out in July 1999 is handled as part of the HM Treasury review process and is completed by the end of December 1998.

The BA components of this first stage, covering use of the Payment Card for Child Benefit, and the Order Book Control Service have been subjected to extensive joint testing and have had operational exposure in over 200 post offices for very many months and are known to work well for staff and customers alike. There is no reason to delay acceptance.

The sooner full acceptance is achieved the better since non-recourse funding depends on it.

7. Pricing Arrangements

Given the BA's desire to get away from the use of the Payment Card as soon as possible, and the need for prices to bear some of the burden of the increased costs. ICL have proposed that the contracted prices set in May 1996 should rise in line with inflation throughout the contract period. This effectively offers the sponsors a fixed price contract in real terms.

It would be possible to construct a payment mechanism for BA based upon an annual fee structure, agreed in advance, and based upon BA's best view of volumes and their ACT migration plan. This would provide some flexibility to the BA in the speed and choice of benefits to migrate to the Payment Card, prior to the final migration to ACT. It would also provide ICL Pathway with a predictable revenue stream.

We see the arrangements for POCL continuing as at present with the only key change being that the banking volumes are underwritten at 90% of best forecast volumes. This reflects the fact that achievement of such business rests exclusively with the business drive within POCL.

8. Summary and next steps

So far Graham Corbett and the sponsors have based their positions on ICL's acceptance of writing off its past expenditure as a loss. Moreover, given the risks, the prospects of profits in the future appear dim. This is unacceptable in principle for a PFI contract and it would make it impossible to secure the financing necessary to complete the programme. We submit that ministers now need to agree a framework which would make restructuring of this PFI contract a reasonable deal for ICL and give Graham Corbett or some senior government representative a mandate to settle the problems fast on a fair basis.

Richard Christou
13th October 1998

ICL PATHWAY

- ICL have no wish to cut across Graham Corbett's efforts to promote a solution to the problems in the BA/POCL programme. We will therefore concentrate exclusively on the ICL proposal for the Post Office to take an equity stake in ICL Pathway. Though it could provide the key to unlock the programme's problems, the proposal has merits in its own right.

- ICL is not aware of the Secretary of State's thinking on the future of the Post Office. But whatever the outcome of his review, it seems to us that the Post Office and Post Office Counters Ltd (POCL) in particular, will need to be enabled to operate as a modern, entrepreneurial, commercial business if its long-term future is to be assured.

- Because the ICL Pathway system has been designed with Smart Cards in mind, it can be developed to serve the Government's needs for more user-friendly and cost-effective dealing with the citizen. If the Post Office has a major equity stake in ICL Pathway, it will be better placed to help in this process as well as being able to increase its earnings, assuring the future of the POCL countrywide network.

- POCL needs a world-class IT system for many of its operations. ICL Pathway could help to re-engineer its business processes to make it more competitive. ICL would be ready to contribute its own skills in this field, into the joint venture.

- POCL and ICL working together would make a powerful team which could exploit other new commercial opportunities, including retail banking and export initiatives for postal systems.

- ICL believes that during the duration of the contract (as agreed in the current negotiations) the present ICL Pathway management should remain in place. But ICL would hope that the Post Office would but 50% (less one) of the shares; and would, of course, welcome Post Office representation on its board; and would be open to proposals for changes in management structure or ownership thereafter.

- ICL wishes to take it as an assumption that the present negotiations will succeed. But it needs to point out that the consequences of failure would leave POCL very exposed, without a modern IT infrastructure.

Sir Michael Butler
9th October 1998

POL00028688

DSS/BA/POCL OBJECTIVES

- Fair way forward for all parties
- Provides ICL Pathway with:
  - a fair chance to make a modest return on future investment required to complete the project;
  - a fundable solution
- Secure safe delivery of the project, to agreed milestones

1538