POL00039916

MEMORANDUM

TO: Board Members **FROM:** John Roberts

cc: Richard Dykes
Kevin Williams
Stuart Sweetman

DATE: 21 May 1999

SUBJECT: HORIZON

I have managed to brief the Non Executive Directors today on the background to the current Horizon situation. I mentioned to them that we had produced a draft Board paper while all this was going on, a copy is enclosed.

It's not fully up-to-date as events continue to move very quickly but it probably gives the best background briefing that is currently available.

Neville, who is currently in America, has said that if a direction is given to the Board by the Government, he would want to have a Board meeting to consider it before responding. I have asked our Secretary's office to contact your offices to see when you might be available in person or on the phone at any time on Monday.

If we do need to meet, we will confirm this as soon as we possibly can.

GRO

AJR2105994

IN STRICTEST CONFIDENCE

DRAFT

POB (99) o/s

POST OFFICE BOARD
THE FUTURE FOR HORIZON

Purpose and Background

1. The purpose of this paper is to

- update the Board on the progress of negotiations on the future of the Horizon programme since the last Board meeting on 27 April 1999
- decide the Post Office's view of the way forward as Ministers are meeting imminently, following HMT meetings with ICL, and as a consequence there is a real possibility that the Post Office will be given direction by the Secretary of State for DTI to enter into new contracts with ICL.

2. The timetable for the discussions has been driven by Fujitsu's insistence to the Prime Minister (7 April 1999) and other Ministers since, for new legally binding Heads of Agreement (the "Agreement") given the imminence of publishing their report and accounts and the consequences of declaring a massive provision for sunk costs (c300 million) could have in these.

Situation Report

3. At the beginning of March 1999 Ministers agreed that, under the leadership of Steve Robson, HMT, a solution (Option B) should be sought that would meet a number of conditions set out at Annex I.

4. Intensive negotiations have continued with ICL on this solution. The original front runner to meet these claims was an option known as 'B1', which would have done so by creating new POCL bank accounts, with a PO Smartcard, for all beneficiaries. Terms were negotiated with ICL by POCL. together with a POCL proposal to Government for the necessary matching funding and revenue. However this option has been rejected by Government as "not providing value-for-money", and ICL were advised of this by the Chief Secretary of HMT last week.

5. Since then, HMT (backed by DSS) have driven forward a new option (known as "B3") as a way of salvaging something from ICL's work to date as an alternative to termination. We were not involved in developing this option. Its key characteristics are:

- all contracts are between POCL and ICL up to 2005/06 on a turnkey basis rather than PFI
- Benefits Agency would withdraw the payment card and replace it with bar-coded order books nationally (OBCS) instead (rather than by a smartcard, for example)
- there would also be an early move by DSS to force customers to have benefits paid through the banking system (but no universal method to withdraw cash at post offices)
- settling ICL past claims would be wrapped up in ICL's future charges to POCL

- a public/private sector partnership between POCL/ICL to be incorporated

6. HMT on 19 May 1999 put a variant of this deal to ICL to also include ICL having a right to the £150m settlement or cancellation figure from the public sector if final contracts around this option could not be completed within three months (there are a number of important conditions and risks still left open which need proper completion in final agreements).

The Parties' Positions

7. From the outset, the Post Office has made it clear that to enter into any agreement it would need to be commercially and strategically acceptable to the Board. The Chairman wrote to the Secretary of State reminding him of this (27 April 1999) and has this week (18 May 1999) set out our position on 'B3' to him, including meeting the commercial tests by which the Board would judge options. This letter is at Annex II. So far no reply (or any verbal assurances) from Government has been given to the fundamental issues he raises.

8. The Board's fundamental position is that it has agreed to support Option A (our approved way forward), and until another acceptable option is agreed the Post Office will continue to honour its existing contracts on Horizon, and will expect others to do so too (both BA and ICL). This is also in line with our agreed contingent litigation strategy in line with our best legal advice.

9. All Ministers seem to have removed both 'Option A' and Option 'B1' from the table (despite Option A clearly being best value for money even by HMT's own analysis), and would seem to prefer to avoid termination. Funding of the Post Office, within the public sector, around options seems to be a second order issue for them.

10. DSS and Benefits Agency's drivers continue to be withdrawal from ICL contracts and the payment card, avoided costs of settling the past with ICL, and an ACT timetable as fast as possible.

11. Fujitsu and ICL appeared to have given up hope that any deal involving future contracts with DSS/BA (even on a migrated basis such as Option A) will work. They remain determined to claw back their sunk costs to date, as well as having guaranteed income streams for the future (in order to avoid a large accounting provision), or they will sue under termination.

12. HMT seem to be driving towards some sort of deal with ICL to avoid a potentially messy termination situation to meet Ministers' wishes, and would see termination taking the course of a negotiated settlement at a risky and early stage (despite our best legal advice to the contrary). They have neither included us in many of their approaches to ICL and have ignored our comments when they have requested them, nor have dealt with our considered requests around the consequences of these approaches on the Post Office.

IN STRICTEST CONFIDENCE

DRAFT

Analysis of Option B3

13. It is clear that, unless the relevant key issues are assured by Government this option, as it now stands, fails the Chairman's tests of commercial acceptability to us.

14. The Chairman's letter (at Annex II) sets out the key issues and the scale of the cash funding and income POCL would need (in excess of £2.5 billion) to get us back to what the Board thought was acceptable under Option A (which itself produced a marginally positive NPV). If these finances were not made available, the Post Office could find itself consuming much of its balance sheet reserves, and/or effectively having to give priority to this investment ahead of our other strategic programme to an extent that could badly undermine the Post Office's overall commercial direction. There are clearly fundamental White Paper issues associated with this too. That is already delayed chiefly because of Government indecision on Horizon, and it is possible that some of Governments promises around investment freedoms, EFL regime, and balance sheet restructuring may fall too depending on Horizon's outcome.

15. The impact is even more severe on POCL. The turnkey nature of 'B3' would bring new immediate significant liabilities onto its balance sheet that will exceed its net assets. POCL's strategy, and vision, recently agreed by the Board, would probably be irreparably damaged by the sudden and severe loss of benefits business, a severe reduction in its wholesale cash business, the lack of a new card base to develop its new markets and services (eg 'Government Gateway' and 'Network Banking'). In addition, it would be contracted to having an IT infrastructure that will not be optimal as its business requirements are likely to change following the BA Payment card service being stripped out from the design. POCL will also be faced with a loss of confidence in its marketplace and the consequential need to re-shape its network much more rapidly than envisaged. It will need to review its strategy, including facing the real prospect of managed decline.

16. There will also be an increased risk of procurement challenge from other IT supplier because of the extent of the change in scope, and the non PFI nature, of the new deal.

17. There will be a flow-through adverse impact on other POCL stakeholders. The CWU and NFSP (both of whom have been very active to date in lobbying Ministers against termination or "salvage" solutions such as B3) would no doubt work hard against an option that destroyed Post Office value or create great uncertainty about the network. Some POCL clients would also be badly damaged by BA-related business loss, either through less footfall (eg Camelot, or the Utilities) or less cash provisioning (eg Girobank).

Comparison with Other Options

18. Annex III shows the comparison of options, as we understand them, including Option A and termination.

It is very difficult to be firm about these, given the lack of complete understanding we have been given, the softness of the costings, the absence of revenue streams, and the range of the risks.

19. There are various scenarios, of course, that could flow from either 'B3' or termination, given the uncertainty that either represents. Under 'B3' the loss of prospective new business, alongside the certainty of losing core business, has wide ranges, as do the network consequences. Under termination, there is both the outcome of the litigation risk with ICL to consider (ranging from £+200m to -£334m for the public sector as a whole), as well as the strategic choices the Board would face for POCL. These include whether or not to automate at all and "cash cow" the business or whether to reduce the network and automate to a much smaller scale, or whether to continue to try to find alternative automation for the whole network which would be transacting significantly less business in the medium term. Either option will require another strategic review for POCL, taking some months, whilst interim operational contingency arrangements (already planned) are put into effect. Nonetheless, best estimates have been made for comparison purposes. The scale of additional funding required under termination scenarios requested of POCL to HMT for modelling purposes is not very different from that for 'B3' (but would exceed it if the ACT timetable was to start even earlier then B3 as HMT have suggested as a variant - say in 2001).

Choices facing the PO Board

20. Unless the assurances sought by the Chairman are immediately met, the option being vigorously and urgently pursued by HMT with ICL, does not look acceptable. Under these circumstances, the Secretary of State has a general power to "direct" the Post Office Board.

21. In essence the Secretary of State would have to direct us by meeting two tests:

- that there is a general "defect" in the way the Post Office has reached its decision on how the Post Office or POCL in particular should be run
- and that the "remedy" he is directing is the right one to put right that defect.

22. In this case, it is likely that he will be implying that the PO Board has failed to manage the social needs the network represents and that the B3 deal, by entering into ICL contracts to do that, will "save" the network.

23. We know that DTI lawyers have been working on the format of the direction based upon these arguments and the powers given under the Post Office Act. We have tested our own legal advice with Queen's Counsel. Annex IV is a summary of Counsel's opinion. Counsel has unequivocally stated that the legal basis of the direction is invalid and would be "susceptible to judicial review proceedings". Essentially, the Secretary of State only has a power to direct us generally, rather than direct us to enter into specific arrangements. Moreover, it is not at all clear that entering into this contract with ICL would be a "remedy" to the network issue at the heart of why he wants to direct us in this instance. We have advised DTI of the legal difficulties they face in

going down this route. We should also note Counsel's view that the Post Office, as a public sector body, may itself be open to challenge for taking into account a factor that may be invalid in reaching a decision on this matter.

24. Besides, we are asked to run the Post Office on a commercial basis, and not essentially for social needs. The commercial consequences of entering into these new ICL contracts, with their certain costs long term, without any contracts or final commitment of equal status, about the necessary revenue steams is clearly wholly uncommercial. Moreover, that is against the background both of an existing set of contracts we are prepared to honour (but others, including DSS, are not), or another option ('A) which we were prepared to back.

25. If a direction is proven to be legally justifiable, and given to us, the Board has no option but to comply. The direction must then be published in the Report and Accounts to indicate that this was a Government and not a Board decision.

26. In such circumstances, the Post Office would need to give POCL Directors indemnity in some way against the financial or other consequences that could bring.

Next Steps Under B3

27. If B3 was to proceed the key next steps would be:

- operationally wind down the benefit payment card service, contractually with DSS, and operationally in the trialed post offices
- attempt to complete the relevant contracts in three months with ICL
- turn the (hopefully) commitments if given, from Government about POCL's income and funding into a set of contracts
- POCL to review its business strategy and plan in the light of the above
- decide a communication plan (internally and externally) taking into account the Board's stance about direction.

Summary

28. The Board is invited to:

(a) agree that B3, as matters stand, is unacceptable commercially and we should refuse to enter into contracts with ICL until terms to the Post Office are made acceptable as set out in the Chairman's letter annexed.
(b) note the position on possible "direction" by the Secretary of State
(c) note that Option A remains our preferred way forward (and is the best value for money for Government)
(d) note that we require both ICL and BA to honour existing contracts until another option is agreed.

21 May 1999

POL00039916

IN STRICTEST CONFIDENCE

ANNEXES

I	Original aims of Option B from Ministers
II	Chairman's letter of 18 May 1999 to Secretary of State outlining current Post Office Position on options
III	Financial analysis of comparison of options
IV	Counsel's opinion and draft DTI wording of the direction

POL00039916

IN STRICTEST CONFIDENCE

ANNEX 1

Original 'Option B' aims agreed by Ministers.

A commercial arrangement between ICL and POCL, backed by DSS/BA that would

- enable electronic payments of benefits at Post Offices using a smartcard;
- involve mass conversion of order book holders, to this method;
- build a system capable of developing other new services and, in line with HMT's drivers, should be cost effective for the public sector as a whole;
- should not destabilise Option A (Horizon with the benefit card), or prejudice termination rights against ICL

POL00039916

S. Russ...

PRIVATE & CONFIDENTIAL

ANNEX II (1)

THE POST OFFICE

DR NEVILLE BAIN
Chairman

148 Old Street
LONDON
EC1V 9HQ

GRO

URGENT - BY FAX & BY HAND

18 May 1999

The Rt Hon Stephen Byers MP
Secretary of State
Department Trade & Industry
1 Victoria Street
LONDON
SW1H 0ET

Dear Stephen,

Horizon

Since we last met, discussions have continued on Option B3 with your officials and the Treasury as you requested.

We have now reached a point where I think it is important that I restate The Post Office position on the various options available. First of all, we continue to believe that Option A is the right way forward, are still prepared to honour all current contracts, and believe that it is the only option that meets the Prime Minister's requirements as set out by Jeremy Heywood on 11 May 1999.

It is a matter of considerable regret to us that this option, we are told, is now off the table, as is Option B1, which is not seen by Ministers as value for money.

Our team has continued therefore to work on B3 against the background of the tests required by the Post Office Board and which I set out to you in my letter of 27 April 1999. For ease of reference they are appended at Annex A.

POL00039916

Annex I (2)

PRIVATE & CONFIDENTIAL

We still have not had from Government a precise definition of B3 as it affects The Post Office. However, our understanding is that under this option we would effectively be buying assets and an operating service from ICL under a schedule of fixed payments but without either the vital underpinning commitments associated with continued and automated benefit payments at post offices (at least, to anything like the levels of business and timescale under our existing agreements, or even Option A). Nor would the fundamental components for developing our new markets, for example, a card issued widely to many millions of our customers, be available.

We have now been asked to set out the terms under which B3 might become acceptable to us and in order to consider this, we have attempted to estimate the minimum income and cash funding profiles the Post Office would need from Government. These are shown at Annex B. In the light of them, we would therefore require the following:

- A guarantee that Government would provide this minimum income and cash funding additional to that envisaged under the proposed White Paper (without such a guarantee we would face serious balance sheet issues, including immediate liabilities to ICL that could exceed POCL's assets).

- An ACT timetable which would start in 2005.

- A firm commitment by Government to use the new B3 infrastructure extensively for existing and new services, including the possible use of a new smartcard for such services.

- Even if the 3 points above are met, there are a number of other significant issues outstanding which would require around 3 months work before any unconditional agreement could be signed with ICL.

Without these commitments, a large part of our core business, e.g. benefit payments, would be removed without the certainty of means to replace it with significant new business. In such circumstances it would be impossible for us to sustain the current nationwide network.

As a result, B3 does not appear to The Post Office to meet the tests I set out and thus provide an acceptable commercial case to which the Post Office Board could agree.

ANNEX II
(3)

PRIVATE & CONFIDENTIAL

Termination of the contracts and an honouring of commitments to automate post offices produce a similar set of direct and indirect consequences for The Post Office. Again we would need very significant funding similar to that described for B3, and the other financial and customer issues would also apply, together with payment for alternative automation of post offices. Compared to Option A, as matters stand, termination does not meet my commercial tests.

In addition as I said to you at our meeting on 6 May, we must also consider in the event of termination:

- impact of litigation including who holds the ring;
- communication;
- honouring both Government's and our commitment to automating the Counters network;
- the approach to be taken to sub-postmasters.

I hope this letter gives you a very clear statement of where The Post Office stands.

Yours sincerely,

GRO

DR NEVILLE BAIN

POL00039916

PRIVATE & CONFIDENTIAL

Annex E (4)

Annex A

COMMERCIAL TESTS

1 Is the case a commercial one with fairly balanced risks? In other words one that gives a positive NPV at an appropriate discount rate.

2 Can the funds be generated in such a way that they do not prejudice other planned Post Office activities (which may have a much better return)?

3 What is the impact and timing of the costs on The Post Office and POCL Profit & Loss accounts? In particular the Board will need to consider if the proposal can be accommodated by Post Office Counters Ltd without technically bankrupting this business.

Annex. II (III) (5)

PRIVATE & CONFIDENTIAL

Annex B

P&L AND FUNDING REQUIREMENTS

P&L:

POCL require the following additional income stream:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
£m	66	21	131	96	128	382	530	412	241	159

Cashflow:

Additional to the above (and excluding interest), POCL require the following funding from Government:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
£m	101	244								

The repayment profile of such funding (net of interest) will be as follows:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09
£m			61	62	65	66	56	20		

These numbers are at outturn prices and are indicative only, and will need to be revised in the light of final agreements. They reflect the terms of the "counter offer" being put by HMT to ICL on the evening of 17 May 1999.

Note for Board: also see Annex III (2) for revised numbers to reflect latest HMT deal with ICL of 19 May 99.

POL00039916

IN STRICTEST CONFIDENCE

Annex III

These numbers are indicative and will need to be revised in the light of final agreements

Financial Summary

In NPV terms the current options have the following NPVs when compared to Option A (including POCL's latest view of Network Banking and Government Gateway):

	Absolute (Outturn) £m	NPV (at 12%) £m	
Option B3 as at 17 May 1999:	(2,485)	(1,112)	worse than A
Option B3 as at 20 May 1999:	(2,516)	(1,139)	worse than A
Option C termination (first cut):			
• automation (ACT 01/02 to 02/03):	(2,698)	(1,153)	worse than A
• automation (ACT 03/04 to 04/05):	(2,102)	(849)	worse than A

None of these options include the consequences on network size, costs and pace of change.

Other options yet to be evaluated fully would include understanding the impact of not automating post office at all (with different ACT timescales). Early scoping of these would suggest that such options, none of which are better than A, are an improvement on the above. However, there is still a great deal of uncertainty around the impact that such a plan would have on both income and footfall, and hence network size and shape.

NB: Option A worse than Business Plan:	(567)	(203)

NB: These numbers are indicative only and can be used for comparative purposes only.

A revised view of Annex B to the Chairman's letter which explains the income and cash funding requirements POCL would need based upon our best understanding of HMT's latest offer to ICL of 20 May 1999 follows:

POL00039916

IN STRICTEST CONFIDENCE

P&L AND FUNDING REQUIREMENTS
P&L: POCL require the following additional income stream:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10
Original	66	21	131	96	128	382	530	412	241	159	163
Amended following reconciliation to KPMG model:											
Revised:	89	68	177	140	136	219	557	589	260	147	162
View based on latest Treasury "offer" (20 May 99)											
Revised:	121	68	177	140	136	219	557	589	260	147	162

Cashflow: Additional to the above (and excluding interest), POCL require the following funding from Government:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10
Original	101	244									
Amended following reconciliation to KPMG model:											
Revised:	56	217						5			
View based on latest Treasury "offer" (20 May 99)											
Revised:	56	217						5			

The repayment profile of such funding (net of interest) will be as follows:

Year	99/00	00/01	01/02	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10
Original			61	62	65	66	56	20			
Amended following reconciliation to KPMG model:											
Revised:			59	60	60	15	21	0	36	27	0
View based on latest Treasury "offer" (20 May 99)											
Revised:			59	60	60	15	21	0	36	27	0

POL00039916

IN STRICTEST CONFIDENCE

DRAFT

Notes:

1. These income and cashflows represent the necessary payments and funding required by POCL to return it to the same position as under option A.
2. Main amendments included:
   - changed replacement assumptions,
   - ICL prices already outturned,
   - latest assumptions on volume.
3. To be consistent with KPMG we have included an additional year.
4. These numbers exclude risks.
5. Possible accounting consequences:
   - POCL would need to capitalise some £480m (plus irrecoverable VAT),
   - assuming no impairment of assets and without funding, POCL would have a deficiency in assets in the financial year 2004-5,
   - under FRS 11 and without funding, POCL would need to write down the assets to a value on which the return was acceptable. Given no return this would mean that we would write them down to zero. In addition, there could be an argument that all the business assets are permanently impaired and the remaining POCL assets should be written down as well. In this case, POCL could have a deficiency of assets within months of the new contract. If POCL's property assets have a market value independent of POCL business, then this could delay deficiency for up to two years.

SLAUGHTER AND MAY

35 Basinghall Street, London EC2V 5DB • Telephone +44 (0)171 600 1200 • Fax +44 (0)171 600 0289
Telex 883486 and 888926 • LDE and CDE Box No 11

John Roberts, CBE,
The Post Office,
148 Old Street,
London EC1V 1HQ.

Document number CA991410103
Your reference
In reply please quote JRT
Writer's direct line 0171 710 3162

21st May, 1999

Dear John,

<u>Horizon</u>

Catherine and I have been for a consultation with James Goudie QC on the question of whether a direction under Section 11 of the Post Office Act in the form of DTI Solicitor's draft would be valid.

His advice was unequivocal. Any direction under Section 11 has to be of a general character. The direction to conclude a particular agreement is of a specific and not a general character. Furthermore, Counsel could not conceive of any alternative way of wording the direction which would make it general.

Any direction to sign the agreement would therefore be invalid. The Secretary of State's decision to issue the direction would be susceptible to judicial review proceedings. In addition, the Post Office would be open to challenge as a public body for taking into account a factor (i.e. the invalid direction) which it should not have taken into account in reaching a decision which it would not have reached but for that factor.

Lack of generality was the main factor making the direction invalid. There were also other concerns, such as the fact that the Secretary of State would need to have reasonable grounds for concluding that there was a defect in the general plans or arrangements of the Post Office for exercising any of its powers. In addition, the direction would have to be designed to remedy that defect.

POL00039916

SLAUGHTER AND MAY

We will supply an approved written note of Counsel's advice in due course.

Yours sincerely,

GRO

J.R. Triggs

POL00039916

Annex IV

POST OFFICE

Direction of the Secretary of State to the Post Office under section 11 of the Post Office Act 1969

Whereas it appears to me that there is a defect in the general plans or arrangements of the Post Office for exercising its powers insofar as they relate to the future of its wholly-owned subsidiary, Post Office Counters Limited:

Now, therefore, in exercise of the powers conferred on me by section 11(2) of the Post Office Act 1969, after consultation with the Post Office, I hereby direct the Post Office [to exercise its powers in relation to Post Office Counters Limited so as best to secure a network of post offices as a public service in the United Kingdom and in particular] to conclude an agreement in the form attached to this direction, subject only to such amendments as may be agreed by me.

One of Her Majesty's Principal Secretaries of State

May 1999