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PRIME MINISTER

BA/POCL

*The Fujitsu Board met this morning. They have decided not to walk away from the contract at this stage. This is on the basis that we would write to ICL giving an assurance to take a decision by 10 May; and that we would provide a contribution towards their (audited) cash costs over this period. Fujitsu has included a provision of £300 mn in its accounts to reflect the sums they have so far spent on the project, but have stood down the planned announcement of their results to analysts in Japan. The provision can only be removed if legally binding heads of agreement are reached on a way forward by 10 May. We must now pursue urgently with all the parties the large affordability gap associated with Option B1.*

Background

My minute of yesterday recorded where matters stood in advance of the Fujitsu Board meeting this morning to sign off their end year accounts. Ministers - Alistair Darling, Steven Byers, Charlie Falconer and myself - had agreed that we wanted to do everything possible to keep Option B1 in play. However the very significant affordability gap meant that further scrutiny of POCL's business case was required before a decision could be taken. This would take a further period of two weeks. This message was communicated to ICL, and through them, to Fujitsu.

2. This was significantly short of what Fujitsu required to avoid a provision in their accounts. On our instruction Steve Robson had offered ICL two further

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concessions - an assurance that the Government would take a decision before 12 May when ICL are legally required to file their accounts; and a contribution towards ICL's on-going costs of continuing with the project pending that decision (of up to £8 million). ICL interpreted this as a sign of our goodwill.

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Next steps

4. The next steps are therefore:

- that Steve Robson is in the process of sending a letter to ICL giving them an assurance that we will take a final decision by 10 May. Legal advisers have cleared the draft, in particular our offer to make a contribution towards ICL's costs over the period, in order to protect our legal position;
- I have spoken to Steve Byers who will be working with the Post Office to see whether there is any further scope to find a more affordable way of delivering Option B1 - either by reducing the costs or by firming up the

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potential revenues;

the Post Office and ICL will continue to work up the draft heads of agreement for Option B1. It is very important the DSS/BA are involved in these discussions to ensure that Alistair Darling's interests are protected.

5. At the same time my officials will continue to explore with DSS and DTI our fall-back position.

6. We will need to be in a position by the end of next week to begin making a final decision about whether the affordability gap on Option B1 can be closed. I will report back with further advice on the basis of this further work in advance of the 10 May deadline.

7. I am copying this minute to Alistair Darling, Stephen Byers, Charlie Falconer and to Sir Richard Wilson, Geoff Mulgan and Geoffrey Norris.

*Yours sincerely*

**GRO**

ALAN MILBURN

*[approved by the Chief Secretary  
and signed in his absence]*

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**Line to Take: ONLY IF FUJITSU/ICL WITHDRAW**

The Government is committed to post office automation, and to a secure, cost effective and convenient way of delivering benefits. The Horizon contract, which was designed to achieve this, was awarded by the last administration in May 1996 to a consortium led by ICL under the PFI.

But ICL have failed to deliver, and have been in breach of contract since 1997. They have asked the Benefits Agency and the Post Office for more time and more money, and have consistently failed to meet deadlines. The system should have been fully operational by the end of last year, but is now running 3 years late.

The Government has done all it can to find a way through the current difficulties with the project, and to salvage the time and effort all parties have devoted to it. But it cannot do this at any price. It would be wrong for the taxpayer to bail out ICL; and unfair to other suppliers who originally bid for the contracts.

Even now, the Government would be willing to continue discussions with ICL. But ICL/Fujitsu have now chosen to walk away.

The Government remains committed to the automation of post offices and will support the Post Office in seeking an alternative system to meet this objective.

In the meantime, the Government will continue existing arrangements for paying benefits, including over the counter at post offices.

**Background**

1. The Horizon project was set up under the last administration with the twin objectives of providing an automation platform for the Post Office

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and an electronic means of paying benefits at post offices which would cut out around £100 million of encashment fraud. This Government remains committed to these objectives.

2. The Horizon project is worth over £1 billion of Government/tax payer's money; has the potential to affect the 15 million people who currently collect their benefit payments at Post Offices; the 28 million who use the network of 19,000 Post Offices; and the subpostmasters whose livelihoods are involved. **It is crucially important that the system works.**

#### Brief history

3. A consortium led by ICL won the contract in 1996. Under PFI arrangements, they undertook to meet the development cost of the project, in the expectation that they would reap a substantial return on that investment once the project was up and running.
4. It soon became apparent ICL had overstretched themselves: they underestimated the technical requirements and despite backing from Fujitsu did not have sufficient financial cover.
5. ICL were placed in breach of contract by the public sector parties in November 1997 for failure to meet a key milestone. Since then, far from improving their performance there have been further delays and missed milestones, with the end date for getting the system in place stretching ever further into the future.
6. Under the original contracts the system should have been operational by the end of 1998 and fully up and running throughout the Post Office network. On current plans, it may be completed three years late at the end of 2001; but the problems with current testing make even this look unlikely.

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Key points

- 7. ICL did not have to sign the original contracts. They took on the project willingly, in the hope of substantial profit. Government and the taxpayer should not be expected to bail them out, if they have made an error of judgment.
- 8. And it would be unfair to others who competed for the contracts if we do.

What was the project?

Project is large and complex. The Government was in a difficult position which was the result of ICL's failure to deliver. The project is now running 3 years late. Government's position fully reflected in the structure of the project, and the complexity, they had to find a way to resolve the difficulties.

What is the Government going to do instead?

Government is fully committed to the delivery of the project. It will provide an alternative platform for the project and it will be a single point of contact for the project. The Government will support the ICL office in setting up alternative arrangements for the project. It will be a single point of contact for the project. ICL will be working on the project. It will be a single point of contact for the project. It will be a single point of contact for the project.

What was the impact on ICL's reputation? Was it a result of widespread concern?

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What about other project offices?

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## **Q&A: ONLY IF ICL/FUJITSU DECIDE TO WITHDRAW**

### **General**

Regret that ICL has felt unable to continue with the project despite the public sector parties' best efforts to agree revised terms with them. But must remember they are in breach of contract.

Even now, Government would be willing to continue discussions with ICL to find a way forward. But not at any price. It would be wrong for the taxpayer to bail out ICL; and unfair to other suppliers who originally bid for the contracts.

### **What went wrong?**

Project is large and complex, has been subject to significant delays which are the result of ICL's failure to deliver. The project is now running 3 years late. Government remains fully committed to the objectives of the project, and has been trying very hard to find a way to resolve the difficulties.

### **What is the Government going to do instead?**

Government is fully committed to the objectives of the Horizon project to provide an automated platform for post offices; and to provide a simple, fraud-resistant way of paying benefits. The Government will support the Post Office in seeking an alternative automation platform. Benefits will continue to be paid over post office counters in the usual way. DSS will be seeking alternative ways of reducing fraud, building on the wider programme it has in place.

### **What will be the impact on PO Counters? Won't it result in widespread closures?**

Government remains fully committed to maintaining a nationwide network of post offices, and recognises vital role that post offices play in communities.

Government will support the Post Office in seeking an alternative automation platform, but in the meantime it will be business as usual for post offices. Benefits will continue to be paid over post office counters as they are now.

### **What about rural post offices?**

Government remains fully committed to maintaining a nationwide network of post offices, and recognises vital importance of post offices in rural

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communities. Will support the Post Office in seeking an alternative supplier for an automation platform.

**What will be the impact on benefit customers?**

Vast majority of 20 million benefit customers will be unaffected. Existing arrangements will continue, including over the post office counter as now. Those currently using the benefit payment card - around 30,000 people - will see no interruption of their payments.

**Is the Government going to introduce compulsory payment of benefits into bank accounts?**

Government will be exploring alternative ways of achieving their aim to secure a convenient, cost-effective and fraud-free way of paying benefits.

Benefit recipients can currently opt to receive their benefits through their bank accounts. But Government wants to ensure that all benefit recipients who wish to do so can continue to collect their benefits in cash at post offices - and it will be exploring alternative solutions that achieves this.

**What about the White Paper on the Post Office?**

It clearly remains our intention to publish the White Paper on Post Office reform. We need to consider with interested parties, not least the Post Office itself, the implications of these events for our modernising programme before the White Paper issues. But the Government remains committed to providing the Post Office with greater commercial freedom and to a more competitive postal market and independent regulation, as set out in our policy statement on the future of the Post Office (Mandelson, 7 December 1998).

**Isn't this just another example, in a growing list, of failed PFI projects in the IT sector?**

There is nothing fundamentally wrong with PFI procurements nor are there any fundamental flaws with taking IT projects forward under PFI — others are being delivered successfully: providing good value and service to the public-sector and attractive return to the private sector investors. For example:

- the OSIRIS project supplied by Siemens Business Service for the Welsh Office
- ArmyMail Project supplied by Bull for the Ministry of Defence



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• **Employment Partnership Project supplied by EDS for the Department for Education and Employment**

In contrast a number of conventionally procured IT projects have run into difficulties - for example the delays to the National Air Traffic Services New Enroute Centre (NERC).

We have been working with the supplier to address their problems with the Project and we find it unfortunate that they have needed to take this action.

**What will be the impact on ICL? What about their plans for flotation?**

Decisions concerning the future of ICL are a matter for ICL and its parent company, Fujitsu.

**Government has destroyed ICL?**

ICL remains a major player in the UK's IT sector, as well as a valued supplier to the Government. This is only one of a significant number of contracts - e.g. the ELGAR contract for DTI. ICL and Fujitsu are private sector companies who make their own commercial decisions. It is for them to decide future plans.

**ICL says that its the fault of the Benefits Agency/PO Counters?**

ICL were placed in breach of contract in 1997 and since then have consistently failed to meet deadlines. Whole series of independent reports which confirm that fault lies at ICL's feet. Public sector has met all its commitments under the contracts.

ICL did not have to sign the original contracts. They took on the project willingly, in the hope of substantial profit. Government and the taxpayer should not be expected to bail them out, if they have made an error of judgment.

**ICL say Ministers have been too slow to take decisions?**

Government is committed to the objectives of the project, and wanted to find a way of resolving the difficulties. Large and complex project, significant amount of public money at stake. Only right that it should consider very carefully how to move forward.

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**ICL say that the Government has allowed the termination of the contracts because they did not want to continue with the benefit payment card. The Government terminated for convenience?**

Not true. It is only because ICL are in breach of contract for failure to deliver, and are seeking more money and time to complete the contracts, that we had to review the project at all. If they had delivered to time and to contract, the benefit payment card would be up and running, to the benefit of Post Office Counters and taxpayers. Against the background of a 3 year delay, however, and for a project of this size, it is standard practice to make contingency plans.

**Surely a project failure on this scale will result in serious difficulties for ICL. In view of the Government's role in these difficulties won't it be under pressure to bail out ICL as it has in the past and has recently done with Rover?**

ICL's commercial position is a matter for ICL and its parent group Fujitsu.

**What are the implications for inward investment by ICL's parent company, Fujitsu?**

Fujitsu is one of the largest overseas investors in the UK. Government has made it clear at the highest levels how much this investment is valued. It is clearly for Fujitsu to decide on the future of its investments in the UK but the Government will do all it can to ensure the UK remains an attractive investment location for the company.

**What are the implications for the future investment from Japan generally?**

The issues here are not about Japanese investment in the UK. There are a wide range of factors which have led to the UK being Europe's number one investment location for Japanese companies with over 40% of Japanese investment here. These factors have not changed.

**Is termination of the project a reaction to Fujitsu closing its semiconductor plant in the North East?**

There is absolutely no connection whatsoever between these two events. The Government continues to work closely with Fujitsu and its Response Group to try and find a buyer for the Newton Aycliffe plant and together we have succeeded in placing 80% of the 570 strong workforce in alternative employment, full time training or higher education.

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**ICL Pathway: list of failures**

Independent reviews of the Horizon project by external IT experts have all concluded (most recently this week) that ICL Pathway have failed and are failing to meet good industry practice in taking this project forward, both in their software development work and in their management of the process.

To date, in the development stages of the project:

- all planned release dates have been missed - including the key contractual milestone for completion of the operational trial for which ICL Pathway were placed in breach in November 1997
- on current working plans, updated as recently as September 1998, the first milestone thereafter - Model Office Testing - was delayed by 2 months
- every release has been subject to reductions in the originally planned functionality
- and even when each release has gone live, there have been faults and problems which have resulted in the need for Pathway to reimburse DSS
- in the current trials the known problems have risen from 46 in November 1998 to 139 at the end of March 1999; and currently 146 have not been resolved
- nearly 16 million people should by now be paid by the benefit payment card. In fact only 30,000+ people are currently being paid by the benefit payment card - for one benefit only
- roll out of the system to 19,000 post offices should have been completed at the end of 1998. But only limited functionality is available currently in 204 post offices
- delays to the programme have already cost the Government over £200m in savings they would otherwise have expected to make

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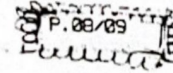
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**Restricted - Policy and Commercial**

**ICL ASSERTIONS THAT SPONSORS ARE RESPONSIBLE FOR DELAYS TO THE PROJECT**

**Sponsors changed technical specifications**

- Assertion unsupported; no significant changes in sponsors' requirements.
- Volume of changes to technical specifications sought by both ICL Pathway and sponsors is no more than expected for project of this size and complexity.
- Decision to award contracts to ICL Pathway was based on solution tendered by ICL Pathway in response to sponsors' requirements.
- Sponsors have been concerned to ensure compliance with contracted solution, subject to any agreed changes.

**Project Delivery Authority (PDA - joint BA/POCL project management team) interfered and added to delays/costs**

- PDA established to manage relationship between ICL Pathway and sponsors; and it played invaluable role in management of project and provided essential single point of contact between ICL Pathway and sponsor organisations.
- Was inevitable that organisation would evolve as project moved from procurement phase to implementation. This resulted in sponsors' proposal that PDA should be reformed as Horizon project.
- No documentary evidence of ICL Pathway complaining to sponsors about role of PDA. ICL Pathway, by contrast, found it necessary to bolster own organisation, particularly in management, planning and testing areas, in recognition of its serious underestimation of task to which it was committed.

**Alleged failures of the Benefits Agency**

- Suggestion that BA failed to meet its obligations under contract in supply of data to ICL Pathway and that this added to ICL Pathway's delays and costs is unsupported.
- In February 1997 all parties, including ICL Pathway, entered into negotiations to revise project plans in recognition that all parties, including ICL Pathway, would have difficulty in meeting their obligations under terms of original contract. The resulting plan was agreed on no-fault basis.
- Since that time, BA has met all its obligations under revised contract to time except where there were dependencies on ICL Pathway and ICL Pathway was unable to meet its own commitments.

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**ICL requested establishment of Treasury Review**

- No. Review proposed by BA to provide independent assessment of project and provide impetus to finding acceptable way forward.
- Public sector parties very pleased that after some discussion ICL felt able to take part.

**Benefit Agency a reluctant partner to project and may not be negotiating in good faith**

- No. Whilst BA sees clear advantages in paying benefits via automated credit transfers into bank accounts, it also recognises many of its customers want to collect their money in cash at the post office. That is why BA fully supported this project by meeting all of its contractual obligations and giving project very highest priority within its own work programme.
- Sponsors have every interest in seeing project objectives secured, not least to avoid adding to costs already incurred as result of ICL Pathway's delays.

**Increased costs to ICL Pathway as a result of delays (wrongly) attributed to sponsors and the need secure commercial terms which will enable it to recoup its investment**

- Sponsors believe ICL Pathway is responsible for the delays and any additional costs arising.
- This is a PFI contract under which service provider agrees to bear substantial risks associated with design, development and implementation.
- Sponsors believe ICL Pathway has been in breach of contract since November 1997 for failing to complete an operational trial required under terms of contracts. As consequence of this and other delays caused by ICL Pathway, both sponsors have incurred very significant additional costs.
- Any proposal to transfer risk or costs back to public sector therefore unacceptable in view of ICL's responsibility for delays.

DBS

22 April 1999.

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PRIME MINISTER

BA/POCL

*At a meeting... Steve Robson's view is that we may need to seek the POCL agreement to get in some form new deal if we are to bridge the affordability gap during the period of the project. It goes to the successful potential of the project.*  
**The Fujitsu Board met this morning. They have decided not to walk away from the contract at this stage. This is on the basis that we would write to ICL giving an assurance to take a decision by 10 May; and that we would provide a contribution towards their (audited) cash costs over this period. Fujitsu has included a provision of £300 mn in its accounts to reflect the sums they have so far spent on the project, but have stood down the planned announcement of their results to analysts in Japan. The provision can only be removed if legally binding heads of agreement are reached on a way forward by 10 May. We must now pursue urgently with all the parties the large affordability gap associated with Option B1.**

Background

*without saying that there are all kinds of ways also showing front account POCL to enter into a PPP with private partner to deliver this.*  
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*Your sincerely*

**GRO**

*per* ALAN MILBURN

*[approved by the Chief Secretary  
and signed in his absence]*

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*Yours sincerely*

**GRO**

*AM* ALAN MILBURN

*[approved by the Chief Secretary  
and signed in his absence]*

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**PRIME MINISTER**

**BA/POCL**

option C seems to have a  
considerable risk but the P.O. network  
will shrink by next year I might  
see a big objective. Is there an agreed  
"option C" spec? **GRO**

*The Fujitsu Board meet tomorrow morning to decide whether to continue with the Horizon project. The large affordability gap on the alternative option means that we were unable to provide the assurances which Fujitsu were hoping for by now. We have done and will continue to do everything we can, short of this, to keep Fujitsu in play. But we have also prepared a handling strategy in the event that Fujitsu walk away from the project.*

Last night I met Alistair Darling, Stephen Byers and Charlie Falconer to discuss the way forward on the Horizon project.

Assessment of options

2. We agreed that option A (the Benefit Payments Card or BPC option) was unviable in view of ICL's failure to deliver and the breakdown in relations between the parties. Although option A currently looks like the cheapest option it is already three years delayed, and every six months additional delay adds a further £100 million to the costs. In addition, ICL appear increasingly disinclined to cooperate on option A.

3. We agreed that option B1 (the alternative option) has many attractions over



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PRIME MINISTER

BA/POCL

*The Fujitsu Board meet tomorrow morning to decide whether to continue with the Horizon project. The large affordability gap on the alternative option means that we were unable to provide the assurances which Fujitsu were hoping for by now. We have done and will continue to do everything we can, short of this, to keep Fujitsu in play. But we have also prepared a handling strategy in the event that Fujitsu walk away from the project.*

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Option A. However it looks currently unaffordable with a net present value (NPV) estimated at £870 million more than Option A which was the basis on which public expenditure provision was made for the project. Steve Byers reported on his discussions with the Post Office and with POCL about securing commitments to option B1 to make it affordable by narrowing the NPV gap. In short, thus far, the Post Office cannot give any financial commitment to bridge the £870 million NPV gap through the prospect of generating higher revenue or finding ways to reduce costs. However, Steve Byers believed that given a bit more time, it might be possible to persuade the Post Office to make some progress on this.

**Discussions with ICL**

4. In view of the undeliverability of option A and the fact that option B1, although attractive, remained unaffordable, but with the prospect that further work might bridge the funding gap, we decided that Steve Robson should speak to ICL today to communicate the following points:

- Ministers remained attracted to option B1 and the potential scope for modernising government, provided it could be made affordable;
- it was currently unaffordable;
- Ministers would therefore like to explore further in the first instance with the Post Office whether there were options that would bridge the affordability gap under option B1 by delivering additional revenues or reducing the costs. This process is likely to take 2-3 weeks.



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5. This was clearly much less than Fujitsu were hoping for ahead of the Board meeting tomorrow. ICL reacted calmly at the meeting with Steve. However, we subsequently received indications that this might not be sufficient to persuade ICL to recommend to Fujitsu that they continue the project.

6. In an effort to keep Fujitsu on board, Charlie and I therefore instructed Steve to have a further conversation with ICL, and to offer two further concessions:

- a cast iron guarantee that the Government would take a final decision before 12 May when ICL are legally required to file their accounts with Companies House;

- an offer to contribute towards ICL's ongoing costs of continuing the project pending a final decision by Ministers.

7. ICL indicated that they took this as a clear sign of goodwill from the Government, but emphasised that the final decision would be a matter for the Fujitsu Board at their meeting tomorrow morning (UK time). We should know their response soon after that.

8. We need to recognise that Fujitsu may decide these concessions are not enough. In the event that Fujitsu decide to terminate - an eventuality which we will do everything we reasonably can to prevent - the public sector parties would need to respond robustly, not least to protect their legal position. I attach draft lines to take, including a complete list of ICL/Fujitsu's failures to meet their contractual obligations on the Horizon project. All inquiries would be handled centrally by the Treasury press office.