In Strictest Confidence

POB(99)7th
PO99/71 to 86

POST OFFICE BOARD

Minutes of the meeting held at Charingworth Manor, Gloucestershire, on 20 July 1999

Dr Neville Bain	Chairman
John Roberts	Chief Executive
Richard Close	Managing Director Finance
Jerry Cope	Managing Director Strategy & Personnel
Mike Kinski	Non-Executive Member
Dr John Lloyd	Non-Executive Member
Rosemary Thorne	Non-Executive Member
Richard Adams	Secretary
Scott Childes	Notes

Richard Dykes, Managing Director Royal Mail
Stuart Sweetman, Managing Director Post Office Counters Limited.
Kevin Williams, Managing Director Parcelforce Worldwide

Others attending: Barrie Stephens, Director Royal Mail Delivery Review, for PO99/77
David Miller, Horizon Programme Director, for PO99/78 & 79

APOLOGIES **PO99/71**

Miles Templeman was unable to attend.

MINUTES OF PREVIOUS MEETING **PO99/72**

The Board approved the minutes and separate record of proceedings of its meetings of 7/8 June 1999.

Irrelevant

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Irrelevant

CHAIRMAN'S BUSINESS

PO99/74

(i) The Chairman had wanted to discuss two key issues:

- White Paper, and
- Horizon.

Irrelevant

CHIEF EXECUTIVE'S REPORT POB(99)45

PO99/75

(i) Select Committee. Since the previous meeting The Post Office had made two appearances before the Trade & Industry Select Committee on Horizon and on the White Paper. Both had gone well, the Committee appearing to be supportive of The Post Office position. The unprecedented appearance of three cabinet Ministers (DTI, Treasury and Social Security) at the hearing on Horizon had been uneventful with each Minister presenting a consistent position.

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ACCOUNTING, FUNDING & TAX IMPLICATIONS OF THE 24 MAY 1999 HORIZON AGREEMENT POB(99)48

PO99/78

(i) The Board paper only reflected the impact on POCL.

(ii) Under the Horizon contract POCL would have to make payments to ICL for services and assets. Ernst & Young had advised The Post Office that the contract could be regarded as a Hire Purchase agreement and as such the Horizon system would be recognised as an asset on POCL's balance sheet. The asset would be purchased for £550m. It was possible that the full value of the asset could be allowed for capital allowance purposes, which would provide a tax benefit of up to £165m over the life of the contract. Additionally, future cash flow projections suggested that the contract would not sustain an expected rate of return and that therefore the £550m should be written off at the half year.

(iii) Under the terms of the agreement, POCL could make use of £480m of gilt investments to fund payments to ICL. However, without Government intervention, this would have to go through the balance sheet and would not be recognised as income in the profit and loss account. The £480m might also be viewed as a Government grant and as such taxed and the write-off significantly reduced although this would improve the adverse impact on the profit and loss account.

(iv) Careful management of the accounting, tax and funding position could affect The Post Office's ongoing profit and loss position by as much as £100m p.a.

(v) With regard to accounting, the use of the £480m of current investments could be treated in four different scenarios although one of these, scenario 3 had, following discussions with Government, been discarded. Under scenario 1 the transaction remained as set out in the 24 May Heads of Agreement and would be accounted for under conventional UK GAAP. The Corporation funding of POCL is treated as an investment and impaired to the extent the POCL asset is impaired. The Post Office's advisors, Ernst & Young and Slaughter & May, [redacted] Scenario 1 was the preferred option.

(vi) In scenario 2(a) Government appropriates surplus EFL reserves by way of a quasi-dividend from the Corporation and makes a Government grant to POCL for investment in an automated infrastructure. Under UK GAAP the Corporation's reserves are reduced and POCL recognises the net cost of acquiring the asset from ICL Pathway. This cost is depreciated over the contract term. It was unclear whether Government had power to take a quasi-dividend.

(vii) Scenario 2(b) mirrored the arrangement for 2(a) but Government did not take a dividend but rather awaited the restructuring of The Post Office's balance sheet prior to a change of status. It was highly likely that under scenarios 2(a) and (b) the £480m funding payment would be taxable and that this could be as high as £150m.

It was noted that

(viii) DTI and Treasury officials were aware of the factual basis behind the accounting, funding and tax implications but not of The Post Office's preferred way forward.

(ix) Reporting the impact of Horizon within the half year accounts and taking this 'hit' over the short term as opposed to a five year period was considered the best way forward for The Post Office, although politically it might be unpopular. The timing of any declaration was within The Post Office's control and would not be made whilst negotiations continued with the Benefits Agency.

Agreed that

(x) Based on advice from Ernst & Young, POCL could impair the Horizon asset by as much as £550m at the half year.

(xi) POCL should attempt to improve the chances and amount of capital allowances.

(xii) Unless Government guaranteed that the grant to POCL was £480m (net of tax), and was free from any additional conditions on network size, The Post Office's preferred way of treating the £480m funding was under scenario 1.

IMPLICATION ON THE POST OFFICE OF THE 24 MAY 1999 HORIZON AGREEMENT POB(99)47

PO99/79

(i) The Board had considered the Horizon contract in detail at its 'Awayday' discussion on 19 July. In particular the discussion had identified four work streams to be progressed:

- Influencing the timing of ACT
- Getting the most out of Horizon
- Reviewing channel strategy across The Post Office
- Defining options for the counters network, including subsidy issues

An action plan to progress these issues with milestone reporting to the Executive Board would be undertaken.

(ii) The Board had to decide by 31 July 1999 whether it wanted to terminate or sign the revised contract with ICL for the automation of post offices. Key elements of the new contract were:

- Electronic Point of Sale functionality, automated payments, local feeder systems and Order Book Control Systems (OBCS);
- additional functionality, such as Network Banking and Government Gateway to be added at an extra cost of £120m;
- system rollout by March 2001;
- the contract to terminate on 31 March 2005.

In addition the following payments would have to be made:

- Capital of £480m to be paid, less a 25% retention, over the next two years (retention to be paid over subsequent four years);
- a payment of £68m to be made on acceptance;
- following rollout, operating payments of £95m a year to be made;
- operating costs of 61% fixed, 32% variable with number of outlets and 7% variable with volume;
- unrecovered VAT costs borne by POCL; and

Termination for convenience would result in payments in the order of £450m, but if the system failed acceptance, no payments would be made.

(iii) POCL was currently negotiating a deal with BA to cover the existing manual benefit payment and new OBCS. BA was not prepared to move its position from that agreed with its Secretary of State which would reduce POCL's original income projections by £400m.

(iv) Ministers were meeting on 21 July to discuss Horizon and it would be important to ensure that The Post Office's

Minister, Ian McCartney was fully aware of the Board's concerns. This would best be communicated through a letter from the Chief Executive.

(v)

- System roll-out was scheduled for 23 August 1999 with acceptance needed by 18 August. There were three categories of acceptance each with a threshold which would determine whether or not rollout could proceed: high, medium and low.

One incident within the high category, or more than 20 incidents within the medium category, would result in the system not being accepted. Currently there were 270 incidents of which 1 was high and 29 were medium. Of greatest concern was the inadequate training of employees although a new package had been produced and work on the other incidents was underway. At this stage it was expected that there would be no reason for not accepting the system by 18 August.

It was noted that

(vi) Excluding the concerns over training, David Miller considered the system robust and fit for service.

(vii) A number of sub-postmasters were experiencing difficulties operating the system and in particular with balancing. To help overcome this and in addition to the new training package, additional resource (300 managers) had been allocated to 'hand hold' staff as offices came on line. This was a considerable but necessary investment to ensure the human/technology interface worked correctly. It was likely that a small number of sub-postmasters would continue to experience difficulties.

(viii) ICL's ability to develop the system over time was an important issue and the Board was reassured that they had demonstrated an ability to do this in other projects e.g. the An Post package.

(ix) Given that ICL's own future was uncertain POCL had arranged for Fujitsu to provide a written guarantee on future support.

(x) Roll-out to offices would be suspended for a 4-6 week period over Christmas 1999 at which point a review of the process would be conducted.

(xi) The contract provided for 39,750 counter positions to be automated with up to a 35% price variation on annual

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operating costs.

(xii) Members were concerned that a number of technical issues remained unresolved and that the BA contract position was still unclear. These were two critical issues and needed to be progressed further before the Board would be content for the contract with ICL to be signed. An update on the negotiating position with BA would be provided to Members who were content that the final decision on whether or not to sign the contract be remitted to the Chairman and Chief Executive.

<u>Agreed that</u>

(xiii) The decision to sign the revised contract with ICL would be remitted to the Chairman and Chief Executive.

(xiv) Interim funding of £11.03m could continue until the formal MaPEC meeting in September.

(xv) Work should continue on the work streams set out in paragraph (i) above.

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BOARD EFFECTIVENESS

PO99/81

(i) The Chairman had previously circulated to all Members a questionnaire covering the performance and effectiveness of the Board as it currently operated. These responses had been collated and a summary of results circulated.

(ii) With regard to 'Key areas of Governance ' there had been some uncertainty over the establishment of appropriate values. These had now been addressed and all Members were aware of what these were. A concern over matters reserved to the Board had been based on Government's handling of Horizon and the role of the Board in developing a commercial way forward. This 'hands on' approach by Government was typical of their handling of Nationalised Industries and would not easily be changed. With regard to actual matters reserved to the Board, something on strategic acquisitions was thought appropriate. It would be useful to seek advice from Ernst & Young on how these reserved matters compared with other companies.

(iii) On administration of the Board, there had been a general concern over the information provided to Members. This had been addressed and improvements made through the new format of the annex to the Chief Executive's Report.

(iv) Succession planning issues would be covered at the Board in either December 1999 or January 2000.

(v) Meetings would be aligned to the financial reporting schedule.

(vi) Non-Executives were now content that major issues were addressed by way of the Awayday sessions.

It was noted that

(vii) The provision of information to Non-Executives in advance of major announcements/decisions could be improved and action to address this would be taken.

(viii) Meeting managers from across the organisation was extremely beneficial and the establishment of new Business Unit Managing Directors would increase the opportunity for the Board to meet these people as issues related to their area of work were tabled for discussion. Non-Executive Members were also happy to take part in internal conferences/seminars etc.

(ix) The future format for reporting on employee issues would be reviewed.

Actions	
The Secretary	To seek advice from Ernst & Young on how matters reserved to the Board compared with other companies.
The Secretary	Meetings would be aligned to the financial reporting schedule.
John Roberts The Secretary	The provision of information to Non-Executives in advance of major announcements/decisions could be improved and action to address this would be taken.
Jerry Cope	The future format for reporting on employee issues would be reviewed.

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Irrelevant

THE SECRETARY		PO99/85
	(i)	The Board noted that Richard Adams would be retiring in October and agreed that Jonathan Evans should be appointed by resolution at the September meeting.

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DATE OF NEXT MEETING

PO99/86

The next meeting was scheduled for 14 September 1999, at 148 Old Street