Briefing to Ministers from Treasury.

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BA/POCL: ICL OFFER OF 13 MAY 1999

__Summary__: The price of ICL's offer is considerably higher than we assumed in our modelling of B3, with the payments very heavily front-loaded. The NPV of the offer is significantly worse than termination. In addition, we are concerned at some contractual issues. We have prepared a counter offer which would involve scaling back the NPV for ICL, transferring risk back to ICL and introducing more conditionality to allow further scrutiny of the contracts.

The offer

The offer from ICL takes the form of a draft letter for a Government Minister to send to them, enclosing documentation of what the deal means in contractual terms by reference to the earlier contracts for the benefit payment card and the heads of agreement for B1. Signing the letter as it stands would represent an unconditional commitment.

Is the deal worth doing?

2. If Ministers do this deal, their decision will be scrutinised very carefully by outside commentators and by the NAO. The key questions that Ministers need to consider are: does it make commercial sense for POCL? Is the contract satisfactory? And is the price reasonable?

Does it make commercial sense for POCL?

3. For POCL, the key commercial issue is the funding gap, which for them is around £1.2-1.3 billion NPV compared to Option A (though much of this is accounted for by reduced payments from DSS). This funding gap dwarfs all other commercial issues for POCL. It is similar for termination.

4. POCL believe the Horizon hardware and software is probably sub-optimal as the platform for providing network banking and Modern Government services, but would need several months' work to have a clearer view. They are therefore unable to take a view on whether the Horizon hardware and software is preferable to the system they might procure following termination.

Is the contract satisfactory?

5. ICL are insisting that this contract, involving the commitment of many hundreds of £ millions for five years ahead, be signed within 24 hours of having

To: Stuart Sweetman →Telefax

handed it to us (yesterday evening). We strongly advise that any agreement be made conditional on agreeing detailed contractual terms over (say) the next three months. This would give reasonable time for proper scrutiny of what are complicated documents. It would avoid a situation in which we have an unconditional commitment to proceed when unforeseen and unreasonable requirements might be demanded by ICL in drawing up detailed contracts.

6. There are a number of contractual issues which in any case are not satisfactory. ICL have attempted to shift a number of risks from them back onto the public sector, for example, under this proposal, payments for the hardware would not be dependent on it performing satisfactorily. We will need to ensure that any counter offer (see recommendation below) addresses these points.

<u>Is the price reasonable?</u>

7. There are two ways to consider the price:

- how it compares with what we regarded as a reasonable price for B3 in out modelling;

- how it compares with the termination option.

<u>Compared with B3</u>

8. The attached table illustrates both comparisons.

9. It shows that, compared to our modelled B3, the offer is £320 million worse in NPV terms. This is because:

- under options A and B1, ICL were prepared to accept an overall NPV loss of £126 million. They are now demanding a <u>return</u> of £110 million NPV (ie an improvement of £226 million) compared with the cost numbers they have provided to us previously (under an earlier option called B0);

- and the remaining £80 million flows from the fact that the current offer does not include the provision by ICL of network banking services. The NPV assumes POCL buy these services from someone other than ICL - so ICL do not receive any net contribution (profit) from network banking. They therefore have to increase their prices on the services they <u>are</u> providing to compensate.

Compared with termination

10. Compared to termination, the offer again looks poor value for money.

11. The key issue for Option C is the likely outcome of a termination settlement. This partly depends on the approach we take to any termination. Treasury Solicitor advise (and DSS and POCL lawyers agree) that there is some advantage in taking no immediate steps to terminate the BPC contracts. This means, in formal terms, the existing contracts continue, leaving ICL to "down tools" or otherwise acknowledge that they cannot perform the contracts at the original price. This is the formal background but in practice ICL and the public sector parties would be encouraged to get round a table and consider terms of settlement as well as working out the orderly winding down of the contracts. If ICL purport to carry on performing the contracts, we will not have lost the option of formal termination under the contracts.

12. Under termination, it is difficult to assess the outcome of any litigation or to assess, at this stage, the settlement cost. If ICL successfully claim that the public sector parties have terminated the contracts for their own convenience, the liability on them could be as much as £330 million. At the other extreme BA and POCL could recover damages for ICL's breach up to £200 million. It is likely that the public sector parties would be liable for some damages and the best assumption for present modelling is a damages liability of £150 million. This figure is in line with views of Treasury Solicitor.

13. The table shows that, on this basis, termination, followed by purchase by POCL of a comparable off the shelf automation/network banking technology, and a move to ACT from 2003, has an NPV some £200 million better than the ICL offer. The offer is £400 million worse than termination followed by ACT from 2001.

Conclusion

14. The fundamental drivers for ICL/Fujitsu are to get rid of most if not all of the provision in their accounts. They therefore need a contract that is sufficiently unconditional to satisfy their auditors, and with sufficient up front payment to cover the provision.

15. As indicated above we would not recommend signing the current contract without some changes to the terms and with sufficient conditionality to allow proper scrutiny in the coming months.

16. We also do not believe the current offer represents value for money, compared with what we regarded as a reasonable price for B3, or compared with termination.

17. We are preparing a counter offer, which would have the following features:

- a £270 million improvement in the NPV for the public sector. This could be justified in terms of the extra profit ICL are now demanding, and/or on the grounds that the public sector would be bearing additional risk under this offer. It can also be justified in terms of making the deal better than at least the more costly form of termination;

- reprofiling of the cash flow, so as to spread it more evenly over the life of the contract;

- greater conditionality, to allow change in the light of further scrutiny;

- transferring risk back to ICL.

18. We think it unlikely this would be acceptable to ICL. We might want to fall back a little from this position (particularly on the NPV) in negotiation. But the bottom line should be no worse than the NPV for termination - it would be hard to defend a deal which represents worse value for money than what the public sector could achieve by going elsewhere. We would be exposed by the fact that the counter offer already has an NPV £160 million worse than termination followed by moves to ACT from 2001.

19. Viewed against the Prime Minister's requirements (Jeremy Heywood's letter of 11 May) - see annex B:

- accepting the offer would avoid a row with the sub-postmaster lobby, avoid putting ICL's future in jeopardy, but we do not believe it offers value for money so would be hard to defend with the PAC;

- termination might be difficult to present with the sub-postmasters; depending on the termination settlement, it would have implications for ICL, but is unlikely to put their whole future at risk; but would be defensible on value for money grounds;

- the best approach would be to put a counter offer - if accepted, it would satisfy all the PM's requirements. The vfm test would depend on Ministers

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deciding that, as a matter of policy, they were not prepared to start a move to ACT before 2003.

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COMPARING THE FIGURES

Annex A

£m NPV at 6%	NPV	cash cost in CSR years	10 yr cashflows	NPV to ICL?
ICL offer	363	538/236/176	-980	+110
recommended counter offer	629	47/336/212	-740	-126
termination: option Cv* (ACT from 2003-06)	577	182/136/316	-775	
termination option C* (ACT from 2001-04	791	196/150/310	-459	
option B3**	684	203/149/199	-640	-126

*assumes public sector has to pay ICL -£150m.
**as modelled previously i.e. assuming ICL bear a -£126m NPV loss

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Annex B

Conditions in Jeremy Heywood's letter of 11 May

"Any solution should meet three key political requirements:

- we did not want a huge political row, with the Post Office or the sub-postmasters' lobby claiming that the entire rural network had been put in danger by the Government;

- we should not put ICL's whole future at risk;

- it would be important to ensure that the Government had a fully defensible position vis a vis the PAC."