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CONFIDENTIAL

From: Geoff Mulgan
Date: 20 April 1999

Lord Falconer

cc: Steve Robson
Peter Scofield
Alan Milburn/PS
Jeremy Heywood
David Miliband

BA/POCL

1. You and other Ministers are meeting tomorrow to agree a final decision on Horizon. Since I will be abroad on Wednesday and Thursday, I thought it would be useful to set out some considerations in a note, in particular so as to ensure that some additional issues (set out in para 9) are taken account of in any ministerial discussions.

2. The desired outcome is that the meeting on Wednesday will confirm the route agreed at the meeting on Monday, namely to:

- send ICL/Fujitsu a letter on Thursday with sufficient legal force in committing the government to pursuing the revised smart card-based Horizon to avoid them having to make provision for losses in their consolidated accounts

- set in train a radical overhaul of POCL to introduce new management, and to incentivise them to maximise the returns from Horizon

3. From the perspective of government as a whole, there is agreement that pursuing B1 is the preferable option if it is affordable and deliverable. Neither cancellation, nor continuing with Option A, is seen as credible either in policy terms or politically.

4. DTI and HMT will therefore provide the meeting with some further clarification on affordability and deliverability of B1.

5. On costs and benefits, the most recent figures suggested an NPV relative additional cost of £700m, and additional potential revenues of about the same order of magnitude.

6. These revenues would come *primarily* from new services for government. ICL and POCL, working with CITU, have prepared a long list of new

services including such things as a one stop shop for change of address/personal circumstances, and voter registration. None is a big income generator on its own. But 10 services each contributing up to £35m revenue by 2005 add up to the £675 NPV.

7. In addition there are some estimates for additional commercial revenues, with network banking and services for utilities about equal in terms of potential, but both significantly less than the public sector revenues.

8. Clearly realising both the public sector and private sector revenues will depend on new personnel and structures in POCL.

9. However, there are two other key issues to bear in mind which have not been factored into the discussions so far:

- First, the provision of more government services is estimated by CITU to deliver potential savings to government of £2.5bn to £4bn. These figures may be doubtful. But they suggest the order of magnitude of potential savings *if* POCL can quickly become an automated front-end. These figures have not been included in any of the NPV calculations because they accrue to government departments, not to POCL.

- Second, delivering these savings, and the new demands for POCL, will depend on a more concerted action by government in developing electronic government. There are good intentions in the Modernising Government White Paper, and some changes underway in the Cabinet Office. But there is a long way to go before government policy on IT planning and purchasing is a coherent and dynamic as it should be. If we go ahead with B1, it will be as important to sharpen up the organisation of demand from POCL as it will be to sharpen up POCL's ability to meet that demand.

10. Taking all of the different dimensions of the issue into account, for what its worth, my view is that even if some of the numbers change and appear to demonstrate higher costs, and even if DTI/PO are resistant to structural changes, the case for pursuing B1, and driving through parallel changes, will remain significantly stronger than any of the alternatives.

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CHIEF SECRETARY

BA/POCL: HORIZON

We are now facing an immovable deadline of 23 April. If by that date we cannot make a decision, one will be made for us by Fujitsu and ICL's auditors which will make ICL insolvent. I thought it might be helpful if I wrote in advance of our meeting with Alastair Darling on Monday to set out my view of the present situation. The need for an automated platform for the Post Office is well known and I will not repeat the familiar arguments, but essentially we have three options remaining:

Option B "The Smart Card" - Until recently, this has appeared to offer the best option for a successful outcome. The Smart Card would retain the Post Office's customer base and open the way to achieve many other government aims such as social inclusion in the banking system. However, it now seems that there may be significant additional costs for HMG attached to this option (which our officials and KPMG are currently scoping) which may rule it out. It is, however, my preferred option if we can iron out the financial question. In particular, I believe that once an assessment of the income POCL might earn from commercial exploitation of the platform, including early deployment of the Smart Card, is available to us early next week the funding implications for Government of this option may look more manageable.

Termination Quite rightly, for negotiating purposes, we have always retained the "nuclear option" of termination. However, we must accept that this would have immediate and serious consequences. ICL would be insolvent and would begin legal action against HMG. Presentationally, fairly or unfairly, we would be accused of ruining a highly successful UK company. It would also put us in conflict with a major UK investor (Fujitsu) who, with its affiliates, employs around 22,000 people in the UK. This could even impact more widely on Japanese investment here. It would also be a high profile failure for PFI. At the very least the loss of the long awaited Horizon project would seriously damage sub postmaster confidence and lead to a rapid contraction of the Post Office network. This would have a wider effect on the Post Office, on which we are, of course, about to publish a long-awaited White Paper.

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Option A (The Benefit Payment Card) Option A remains the Post Office's preferred option. However, in the light of BA reservations, ICL has all but given it up, even though most of the technology is available. It is probably the cheapest of the options and could still be a gateway to Option B. If we were to decide on this route we would need to make clear that we would not tolerate obstructive behaviour by any of the parties, and devise some form of oversight to minimise it.

I do not believe there are any other options. Obviously, this is a serious position, but I am quite certain we must be the ones to take a decision, not Fujitsu ICL by default, and that of the three options termination would be the most damaging to the Government.

I am copying this minute to the Prime Minister, Alistair Darling and Charlie Falconer.

GRO

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16 April 1999

DEPARTMENT OF TRADE AND INDUSTRY

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10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

12 April 1999

Dear Ros,

HORIZON BA/POCL

The Prime Minister was grateful for the Chief Secretary's useful minute of 9 April.

The Prime Minister duly met Mr Naruto this afternoon. Naruto was accompanied by Keith Todd and George Hall (ICL) and an interpreter. Lord Falconer, Steve Robson, Geoff Mulgan, Jonathan Powell and I were also present.

The Prime Minister opened by thanking Naruto for the sensitive way in which Fujitsu had handled the closure of their semi-conductor plant in his constituency. Naruto in turn thanked the Prime Minister for the help that Fujitsu had been given by local agencies in the North East – 479 out of 550 employees had now found new jobs.

Turning to the Horizon project, Naruto said that he was very grateful for the work Steve Robson had done in recent weeks. He understood that ICL were now close to agreement with the DSS and POCL on a new way forward. ICL were fully committed to supporting the UK Government. He wanted to ask the Prime Minister to give Steve Robson complete authority to bring the current discussions to a successful resolution. On 23 April the Fujitsu Board would meet to decide whether to support the new project. He personally looked forward to securing a positive outcome. But he sincerely wished to get a legally binding agreement before the 23 April meeting. Fujitsu was spending £5-10m a month on the existing project. Nearly £300m had been invested so far. Sums of this magnitude could not simply be ignored.

Keith Todd added that more progress had been made in the last 6 weeks than in the previous 9-12 months. The project now in prospect was fully

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deliverable. Any assistance the Prime Minister could provide in bringing matters to a successful conclusion would be extremely welcome.

The Prime Minister said that he too was very keen to make progress over the next 3-4 days. His only concern was to get a viable system agreed that would actually deliver what the Government wanted both now and in the future. Steve Robson agreed – he was working towards the 23 April date and hoped the remaining issues could be resolved.

I am copying this to Rod Clark (Department of Social Security), Antony Phillipson (Department of Trade and Industry), Mark Langdale and Sebastian Wood (Cabinet Office).

Tom, GRO

JEREMY HEYWOOD

Ros Roughton Esq
HM Treasury

WITHOUT PREJUDICE

Top: JM
cc: OB
PJ

13 May 1999

Mr Sibbick CGBPS
IW
SMS
Mr Macdonald
Mr Baker CGBPS
Mr Sheehan Com
SpAds
CW

The Rt. Hon. Stephen Byers MP
Secretary of State
Department of Trade and Industry
1 Victoria Street
London
SW1H OET

By fax (2 pages) GRO

ICL

Dear Secretary of State,

BA/POCL AUTOMATION PROJECT ("HORIZON")

Thank you for seeing me yesterday.

I now understand that the Government has reconsidered its position with regard to Horizon and that, instead of wanting us to proceed with the national roll-out of the computerised network based on the Payment Card – which we have been planning to do this summer – the Government wishes us to contract simply for the supply of the core Horizon platform as a turnkey contract (with on-going operational support) rather than a PFI. Furthermore, it has been suggested that the existing PPP between ICL and The Post Office might be developed to look at the business case (and downstream opportunities) for network banking and Modern Government services.

I cannot pretend that I am not disappointed that you were unable to proceed with Option B1. However, as a businessman, I have to accept that my customers' requirement has changed. As Chief Executive of ICL, I have a duty to my Board, my shareholder (Fujitsu Limited) and to my people to try to work out a solution with the Government to protect ICL's (and Fujitsu's) interests.

However, I am not prepared to be party to living a lie. I cannot pretend any longer that it is "business as usual" with regard to this project; not least to the one thousand or so people in ICL, and our subcontractors, who have been working flat out to deliver Horizon.

Therefore, I am setting out a timetable with the intention of resolving this once and for all. I have discussed this with Steve Robson at the Treasury, but it is important that Ministers give him the support and authority necessary to reach a conclusion in the time-scale. I am also recommending this timetable of action to my Board this afternoon:-

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- Richard Christou (ICL) and Stuart Sweetman (POCL) are meeting today to work out a joint ICL/PO position.
- Richard Christou and I are meeting Steve Robson later today to consider the terms of a legally binding Heads of Agreement to settle the current and future financial conditions which must be in place by Friday (tomorrow).
- I am seeking a meeting with the Prime Minister tomorrow so that the Chairman and Vice-Chairman of Fujitsu can confirm the arrangements for proceeding with the revised project and for them to understand at first hand the rationale behind the Government's decision to scrap the Payment Card. I think it would be appropriate if you and Mr Robson could also be at this meeting.
- If, as I hope, it is possible to reach an acceptable legally binding Heads of Agreement, there should be a joint ICL/PO/DTI press briefing on Monday 17 May (at which you, John Roberts and I will be present) to counter-act the negative publicity which has been generated to date.
- If negotiations are not successful within this time-frame, then the activity related to the Payment Card aspect of Horizon should cease to avoid further wasted costs for all parties, and the taxpayer, in continuing with something which the Government no longer requires. Inevitably, this will become public knowledge, so we shall need to issue a press statement and briefing to set the record straight.

I trust that you and your colleagues will ensure that Steve Robson is fully empowered to work with ICL to find a solution in the time-scale. The time-scale is tight, but all of the basic elements, including the costs, have been known to the Treasury for some time. Furthermore, it seems to me that the Government has known for months that the project – in particular the future use of the Payment Card – was going to be changed. We, meanwhile, were left to rack up heavy costs in Pathway (some £50 million since I wrote to you as Chief Secretary on 18 December 1998) and a heavy further investment in senior management opportunity costs across the ICL Group. It is now time to bring matters to a conclusion.

Yours sincerely

GRO

Keith Todd

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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

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.

Is the price reasonable?

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.

Compared with B3

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.

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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.

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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.