NATIONAL AUDIT OFFICE

PPP in practice

National Savings and Investments' deal with Siemens Business Services, four years on

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

HC 626 Session 2002-2003: 8 May 2003

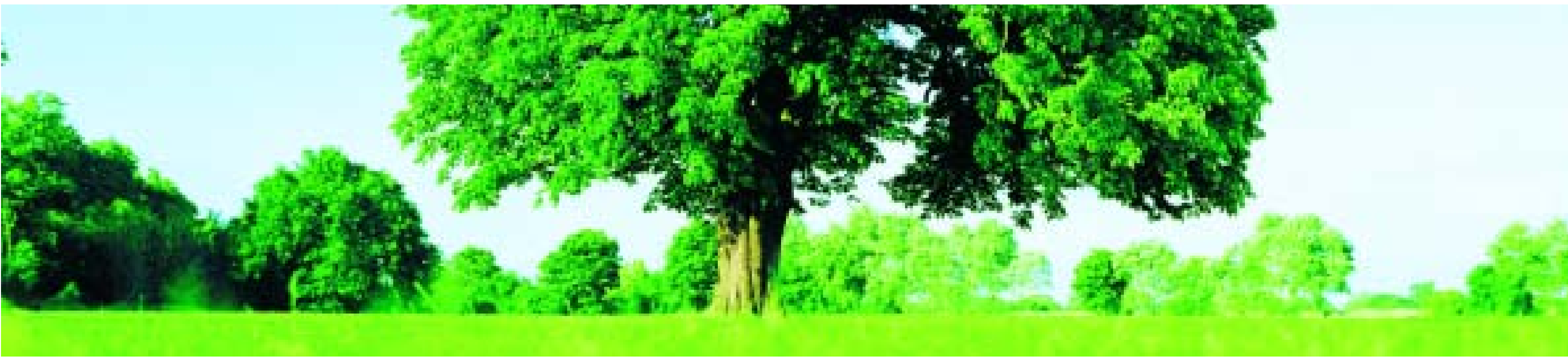
The National Audit Office scrutinises public spending on behalf of Parliament.

The Comptroller and Auditor General, Sir John Bourn, is an Officer of the House of Commons. He is the head of the National Audit Office, which employs some 750 staff. He, and the National Audit Office, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.

Our work saves the taxpayer millions of pounds every year. At least £8 for every £1 spent running the Office.

PPP in practice:

National Savings and Investments' deal with Siemens Business Services, four years on



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 626 Session 2002-2003: 8 May 2003

Ordered by the
House of Commons
to be printed on 6 May 2003

LONDON: The Stationery Office
£9.25

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn	National Audit Office
Comptroller and Auditor General	1 April 2003

The National Audit Office study team consisted of Linda Mills and Doug Neal.

This report can be found on the National Audit Office web site at www.nao.gov.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Contents

executive summary

1 In April 1999, National Savings & Investments (NS&I) transferred its operations to Siemens Business Services (SBS)[1], in one of the largest outsourcing operations ever undertaken by a UK Government Department. In May 2000 we published a report[2], "National Savings Public-Private Partnership with Siemens Business Services", which concluded that NS&I had secured a very good deal with SBS and that the partnership was capable of delivering significant benefits. The Committee of Public Accounts'[3] conclusions on the deal are shown in **Figure 1**.

1 Conclusions of Committee of Public Accounts on the deal

"**The partnership appears to be good value for money**. NS&I estimated that the cost of the partnership would be £158 million[4] less, over the life of a 15-year contract, than retaining the operational service in-house. The entire operational service had been transferred to SBS, which planned to invest in new technology leading to new ways of working and a substantial reduction in staff numbers. As part of SBS's wider strategy to expand its operations, 500 former NS&I staff have so far been re-deployed on third party work allowing continuity of employment at the three sites, though a similar number of staff had accepted voluntary redundancy. This outcome resulted from a well-managed procurement process that took account of the interests of customers, employees and the Treasury. At 8.7 per cent before tax, the return SBS expects to make over the life of this contract is significantly lower than the average return on other PFI deals.

Nevertheless, **this remains a high-risk project for SBS and NS&I**. In modernising the operational service, SBS is dependent on the gradual introduction of a relatively small but crucial amount of new technology. If SBS fails to deliver, the significant improvements in quality of service for customers envisaged by NS&I will be delayed. SBS considers that the risk of failure is reduced because it has more control over this project than over past public sector projects in which it has been involved.

NS&I must therefore remain vigilant. To ensure that the partnership works as intended, NS&I and SBS have put in place a joint governance structure. Within this structure there are two key elements which need to be managed with particular care. First, NS&I should continue to ensure that the operation of the performance management regime, and in particular the penalties for poor performance, is transparent and promotes continuous improvements in performance by SBS. Second, successful implementation of a process to benchmark SBS's performance and costs against the market will be essential if good value for money is to be maintained throughout the life of this long-term contract."

Source: Committee of Public Accounts Report. HC 566 1999/00

2 The contract is into its fourth year and this report examines its progress, with particular reference to the Committee of Public Accounts' previous recommendations. The methodology we used is set out in Appendix 1.

1 A division of Siemens AG, the German parent company of the Siemens group.
2 HC 493 1999/00.
3 HC 566 1999/00.
4 Net Present Cost Value.

The deal has delivered much (Part 1 of the Report)

3 SBS is modernising the business to focus on customers and improving customer service by streamlining processes across the business at its three sites, Blackpool, Durham and Glasgow. SBS's work on identifying the holdings of each customer, a single customer view, will allow NS&I to better understand and target its customers and thus improve its cost effectiveness. The measure of NS&I's cost effectiveness is demonstrated by how much it adds value for the taxpayer. In 2001/02 NS&I saved the taxpayer £176 million, meeting its annual target of at least £120 million. Value Added will also be increased in the future as a consequence of cost reductions being delivered by SBS today.

4 NS&I could not have achieved as much without SBS. The latter's bid offered savings to the taxpayer of £158 million (net present cost) compared to NS&I's Public Sector Comparator. SBS has benchmarked aspects of NS&I's operations, such as its call centre and its automated processes, which compared favourably to leading edge organisations in similar areas of service provision. But SBS will need to continue to benchmark NS&I's operations and take action to ensure benchmarking provides the potential for a reduction in SBS's and NS&I's costs and improvements in service delivery despite those reductions in cost.

5 SBS has significantly increased productivity without compulsory redundancies through reducing the number of staff transferred to it from 4,100 to some 2,000, although the volume of work has remained the same. It has reduced the level of absenteeism to close to the national average of 3.1 per cent, compared to eight per cent when it took over the business. SBS has re-deployed 650 of the 2,100 staff, no longer required for NS&I work, on third party work. Of the remainder no longer employed on NS&I work, 1,200 took Voluntary Early Release and 250 were released through natural wastage.

6 Despite SBS not reducing the costs of running NS&I's operations as much and as quickly as it planned, for example through not achieving the early launch of low cost sales channels, there has been no or little short term impact on NS&I or its customers. The earlier launch of low cost sales channels could have benefited NS&I by increasing its ability to add value and save the taxpayer money and benefited its customers by enhancing their options, but late delivery has otherwise had little or no impact.

Many of the risks have crystallised (Part 2 of the Report)

7 Although SBS's bid was eight per cent lower than the other final bidder's, it expected to make a return of 8.7 per cent on the contract. It was prepared to accept more risks and take on the critical risk of re-engineering NS&I's business processes. To introduce NS&I's Individual Savings Account product to a very tight timescale, SBS chose Thaler, a commercially available banking IT platform. After it discovered that NS&I's in-house programme would not deliver a re-engineered IT system and the Individual Savings Account product was successfully introduced, SBS selected Thaler as the IT element to re-engineer NS&I's operational processes.

8 Key risks accepted by SBS under the contract have crystallised. SBS is unlikely to make its projected returns on the project as it was unable to deliver the full business transformation as soon as it had planned. It has incurred more capital expenditure than planned and although it has increased productivity, it has failed to reduce staff numbers in line with its original plans and has not created as many third party jobs as planned, only 650 against an expectation of 1,200. It is also spending more than planned on the upkeep of the three sites at Blackpool, Durham and Glasgow.

9 SBS underestimated the challenge of transforming NS&I's old business and found existing processes were complex and difficult to change. It encountered a number of problems when it began to transfer NS&I products from legacy systems to Thaler, and as it took a long time to find solutions, weaknesses in the migration process continued. NS&I expressed its concern at the situation and SBS is now developing solutions before it transfers the remainder of NS&I products, including Premium Bonds, to Thaler.

10 NS&I requires SBS's operational performance to meet high and increasingly challenging standards. Although SBS had not completed the business transformation by the target date, it continued to bear the risk of delivering services to the required standards. In the first three years of the contract, SBS achieved 98 per cent of the targets NS&I set and incurred performance deductions of £2.1 million.

All parties have learnt valuable lessons (Part 3 of the Report)

11 NS&I, SBS and Siemens AG have all learnt lessons from their experiences on this deal. NS&I chose the best partner, but at the start of the contract it and SBS had not moved sufficiently away from a traditional customer and supplier relationship. Both parties failed to recognise the influence NS&I could have on SBS's operational costs and each failed to adequately challenge the other's actions and behaviour.

12 They learnt that parties to a PFI contract need to adopt a whole business approach, where decisions are based on what is best for the business as a whole rather than what is best for NS&I or for SBS, if each is to achieve its respective objectives. NS&I revised governance arrangements for the contract accordingly to achieve the modernisation of its operations.

13 Siemens AG and SBS discovered that this contract was more challenging than they originally thought. They did not employ sufficient management resources, nor make sufficient use of existing knowledge within the business. Siemens AG rectified this through bringing in new managers, predominately from its own organisation, who were known deliverers of change. Despite the problems SBS has faced, Siemens AG remains committed to the deal. In case of any failure of delivery NS&I has detailed contingency plans in place.

The deal has been modified without increasing the unitary charge (Part 4 of the Report)

14 To ensure continuation of service and achievement of the partnership's objectives, NS&I, with SBS, has developed a programme to support SBS's actions to improve its financial position. As part of this programme, NS&I has realigned contract terms to ensure the contract is clearer, less ambiguous, fairer and is a driver for a low cost operation through discouraging non-partnership behaviour by NS&I and SBS. In particular, NS&I has refined the Key Performance Indicators regime and it will share in the costs of developing new products and channels whilst both parties are incentivised to minimise development costs. A new set of milestones have been agreed which SBS is now delivering against on schedule. The contract realignment does not materially change the allocation of risk as the key risks of costs of operation, modernising the business and delivering the service remain with SBS.

15 Despite SBS's financial position, NS&I has not increased the unitary charge agreed in the contract and SBS has continued to deliver. Siemens AG is acting as a guarantor for SBS's obligations under the contract and has liability to pay NS&I up to £250 million in the event of default.

Lessons learned

16 In our first report, we concluded that NS&I had secured a very good deal with SBS and that NS&I's experience underscored some important lessons which should be borne in mind in negotiating public-private partnerships. This study shows that NS&I and SBS have learnt valuable lessons in the operation of the project, which are again pertinent to other public and private sector partnerships.

a) Adoption of a whole business approach

The public and private sector partners should not enter a customer/supplier relationship, but need to take a whole business approach, if they are to achieve current and future strategic objectives. Such a relationship is evidenced by the public sector partner:

- recognising its requirements may lead to its private sector partner not adopting the most appropriate method of delivery that is best for the business;
- recognising its actions can have an unwarranted impact on its private sector partner's costs; and
- having access to the private sector partner's income and expenditure forecasts and not just actuals.

And by the public and private sector partners:

- challenging the actions of each other to establish that proposals are in the best interest of the whole business; and
- demonstrating their willingness to change the contract as it is a dynamic document and their interaction through governance procedures.

b) The private sector needs to recognise the management challenge that PFI represents

Private sector contractors need to recognise the management challenge that complex PFI projects with tight timescales represent and employ and manage appropriate resources effectively to achieve the public sector partner's and their own objectives.

c) Parent company guarantees are essential

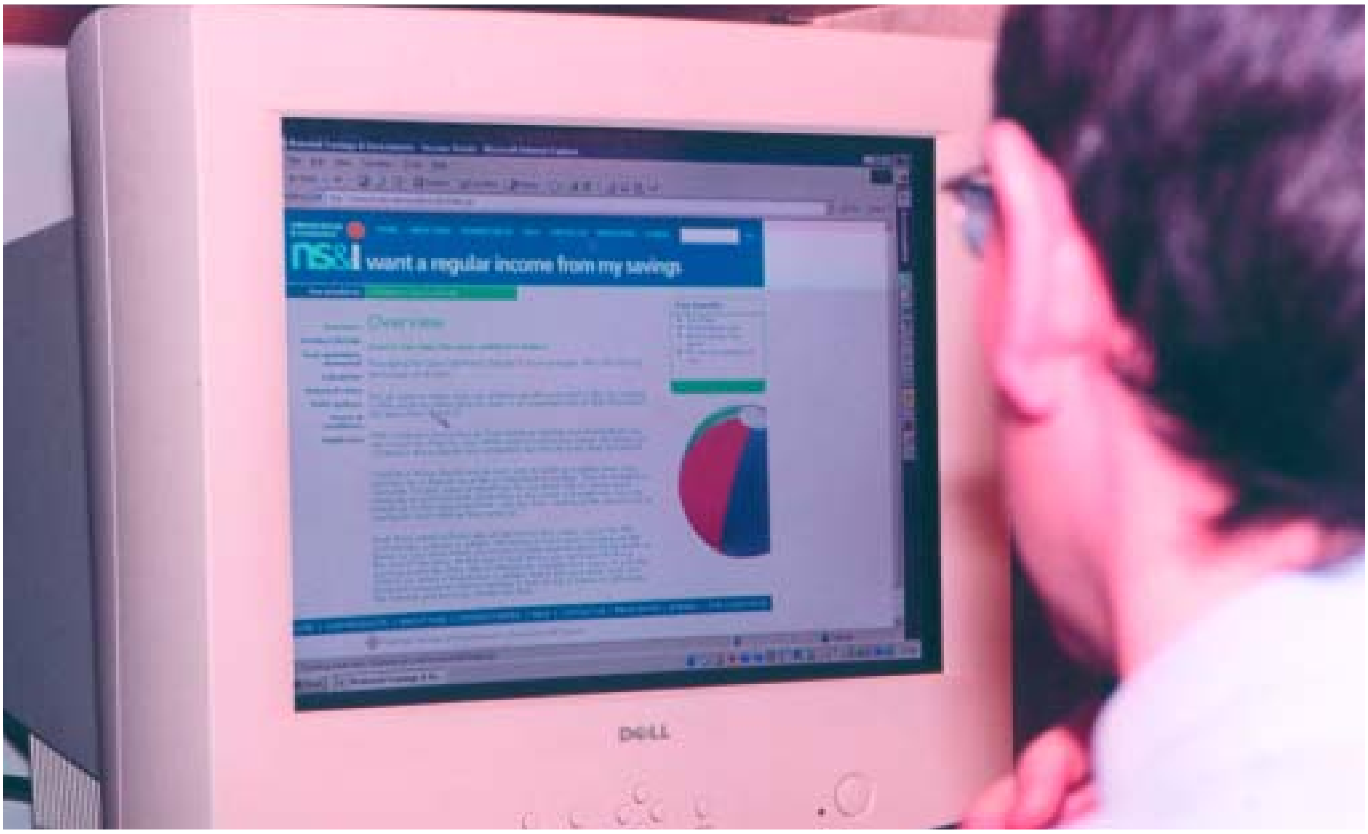
The existence of a substantial parent company guarantee has been instrumental in ensuring that SBS has stayed with the project as it places the onus on the private sector partner to take action to improve a poor financial position. Such a guarantee ought to incentivise the parent company to recognise the management challenge its subsidiary faces and to take sufficient due diligence.

d) There are alternatives to bailing out the private sector

The public and private sector partners can consider other actions which preserve the original allocation of risk, besides increasing the unitary charge, which will assist the private sector partner to improve a loss making position. Such action can also lead the private sector partner to seek improvements in the business. If public sector partners do provide additional work for their private sector partners, they must demonstrate that variations to the contract represent value for money through, for example, benchmarking of prices, and ensure their decisions are fully auditable.

e) Contingency plans should be in place

Public sector partners should have contingency plans in place ready and up to date to use if their private sector partners default. Such plans should be drawn up and maintained even where default is unlikely.



Customer phone access 24 hours a day, 365 days a year

Part 1

The deal has delivered much

1.1 This part of the report examines how much of the deal SBS has delivered. We found that SBS has delivered much of what was required enabling NS&I to increase the value of its business and that NS&I would not have achieved the same results within the public sector.

Value has been added to the business

1.2 The outsourcing was a critical part of NS&I's modernisation strategy. This was developed in 1996-97 following a review to clarify NS&I's role and purpose. The review concluded that NS&I created significant added value for the taxpayer, but it warned that this would be seriously eroded unless operational delivery was modernised to compete more effectively within the UK retail savings market. The main objectives of the strategy were therefore to improve NS&I's efficiency, capability and customer service to protect its value to the taxpayer.

NS&I has increased the options open to it

1.3 A significant amount has been delivered during the first phase of the strategy in partnership with SBS. The partnership has delivered new products and channels, including a single point of contact for customers, a data-warehouse (a database of customer records) and a more skilled workforce. This has provided NS&I with a number of options for the future through increasing the flexibility and capability of its business. In particular, the partnership has enhanced NS&I's ability to deal with customers directly. NS&I has consequently revised its strategy to ensure that it remains relevant and delivers NS&I's objectives optimally. Before the partnership NS&I's in-house capabilities and its annual budget limited its future options.

The value of NS&I's business has been enhanced

1.4 SBS has invested heavily in the modernisation of NS&I's operations and increased the value of the whole NS&I business. NS&I plans to enhance the value of its business even further and forecasts that implementation of its new strategy will add £10 billion to the amount invested with it by mid-2007. This business growth will increase Value Added. If NS&I's operation had remained in the public sector, the value of its whole business would have been significantly lower and would have been deteriorating.

NS&I is providing added value

1.5 NS&I funds about 20 per cent of net government debt through sales of savings and investments to the retail market. The strategic review of NS&I's role concluded that NS&I provided added value to the taxpayer. This could be measured by the extent to which NS&I raised funds at lower yields than the alternative of the government issuing gilt-edged securities, taking account of the administration costs and tax foregone on some NS&I products. Appendix 2 explains how NS&I measures the value it adds for the taxpayer. In partnership with SBS, NS&I is better placed to achieve added value as its operations become more cost-effective. During 2001/02, NS&I achieved Value Added of £176 million, meeting its annual target of at least £120 million, and expects Value Added in 2002/03 to be some £227 million.

The business has been benchmarked

1.6 The contract requires SBS to undertake a programme of benchmarking. The Committee of Public Accounts' report[5] on the partnership noted that it was important in long-term contracts for performance and costs to be measured regularly against the market to maintain pressure for value for money. As other Government departments had previously told the committee that benchmarking was difficult to implement it asked NS&I to share its experience with other departments.

1.7 SBS, with support from NS&I, has carried out a number of benchmarking projects since the partnership began as detailed in Appendix 3. SBS has compared aspects of NS&I's business, such as its call centre and its automated processes, with organisations considered to be at the leading edge in their areas of service provision. SBS and NS&I fared well against such benchmarks, which also identified further areas for improvement within NS&I's operations.

1.8 For example, the benchmarking of automated processes identified that fewer processes were used in NS&I's operations than in comparator organisations. SBS concluded that more automated processes would increase operational efficiency, and reduce error rates and rectification costs, and is starting to take appropriate action. The contract recognises that benchmarking may result in reductions to the Unitary Payment and/or, increases in the standard of performance required from SBS. To date benchmarking has not allowed NS&I to add value to the business by achieving either of these outcomes. In some instances, however, such as the handling of complaints, the benchmarking findings have resulted in improved customer service. SBS needs to continue with benchmarking activity, which NS&I should closely monitor and support, to ensure it leads to lower operational costs and improvements in service delivery.

The deal has delivered significant change

1.9 The deal transferred all of NS&I's operational staff and assets to SBS. NS&I required SBS to reduce staff numbers, find third party jobs, operate the three former NS&I sites at Blackpool, Durham and Glasgow, complete a business process re-engineering programme and assist in the development and introduction of new products and sales channels.

1.10 SBS has to keep a presence at the former NS&I sites at Blackpool, Durham and Glasgow until 2004. SBS told us that it is sensitive to its position as a major employer at each location and will take this into account in any future location strategy.

1.11 At the start of the contract the three sites operated almost autonomously. Each location administered particular products. As there was no common computer system for all savings products, customers who held a range of investments could only complete transactions or make enquiries about different products by going to separate contact points. In addition, NS&I could not collate and analyse customer information to help market products as effectively as it might. Against a background of fragmented information on its customers, NS&I had in the past been slow to react to changes in the market. Other characteristics of the operation before the deal with SBS are shown in **Figure 2** together with the characteristics NS&I would like to see in place once the business has been modernised. NS&I wants the business transformed such that it will be a low cost operation focused on customers, employing multi-skilled staff at each location capable of dealing with all products, and allowing NS&I to better understand its customers.

2 The changes NS&I expects in its organisation

	Organisational characteristics before 1999	Organisational characteristics at the completion of the modernisation programme
	50 million transactions a year requiring 4,100 staff	50 million transactions a year requiring fewer than 2,000 staff
Functionality	13 products with 11 IT systems	Many products on one common IT platform
	No data warehouse	Data warehouse
Customer	Minimal channel choice to make transactions	Choice of channels to make transactions
	Difficult for customers to access NS&I	Easier for customers to access NS&I
	Disparate customer offerings	Refreshed and competitive products
Processes	Largely paper based, labour intensive processes	Streamlined, automated, efficient and consistent processes
	High cost operation	Low cost operation
People	Only capable of working on products at one location	Multi skilled and capable of working on all products

Source: NS&I

5 *HC 566 1999/00.*

SBS has increased productivity and created third party jobs

1.12 SBS has significantly increased productivity and reduced costs within the NS&I business. It has reduced the number of staff transferred to it in April 1999 from 4,100 to some 2,000 although the volume of work, some 50 million transactions a year, has remained the same. These transactions have been delivered with improved service levels, increased speed of response, high accuracy levels with improved access and choice of products which are now more aligned to customer needs.

1.13 SBS has re-deployed 650 of the 2,100 staff, no longer required for NS&I work, on third party work. Five hundred and fifty are employed on work for a retail bank, fifty on work for Siemens Accounting Services and fifty on work for the Passport Service. Of the remainder no longer employed on NS&I work, 1,200 took voluntary early release and 250 were released through natural wastage. In transferring staff from the public to the private sector, SBS needed to manage the expectations of staff carefully as failure to have done so could have affected staff morale and even led to resistance to change. Staff have adapted to the new ways of working, and SBS's success in achieving this is demonstrated by the fall in levels of absenteeism to between three and four per cent[6], compared to eight per cent at the start of the deal. A survey published by the CBI and PPP Healthcare in 2002 found that 3.1 per cent of total working time was lost in the UK in 2001 indicating SBS has brought NS&I's operations in line with average performance nationally.

SBS is modernising the business to focus on customers

1.14 SBS has modernised many areas of NS&I's operations and changed the culture of the business. Most significantly it has transferred the majority of products, core to NS&I's future strategy, from a number of different IT systems to a common IT platform, Thaler[7], and has redesigned some business processes. By streamlining clerical processes across the business, SBS intends to effectively bring the three sites closer together and make them more customer focused.

Service to NS&I's customers has improved

1.15 NS&I has up to 30 million customers, more than any other UK retail financial provider. Before the contract with SBS, NS&I's target time to respond to customer requests was nine days. SBS has reduced the response time from seven days to three days while maintaining the standard of accuracy required by NS&I. As customer service is critical to NS&I, it has appointed a dedicated Customer Services Manager to act as a "Consumer Champion" and Intelligent Customer to monitor SBS delivery to customers. As **Figure 3** shows, customers now have direct access to NS&I 24 hours a day. NS&I has launched new products and developed the website and capability for customers to purchase products via the website.

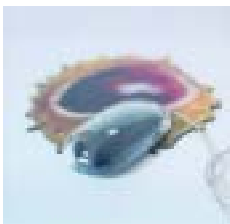
3 New products and channels have been established

In 1999 NS&I launched ISAs, Tessas and Fixed Rate Savings Bonds. Although NS&I was well on the way to launching ISAs when SBS took over, it considers that the product would not have been launched in time for the April 1999 deadline, without the partnership. Similarly, the launch of Fixed Rate Savings Bonds in October 1999 would have been delayed.

In 2002 NS&I launched the Guaranteed Equity Bond, its first equity-linked investment product offering returns linked to the stockmarket and 100 per cent security of the customer's original investment. Total sales of the first two issues of the bond exceeded expectations at more than £160 million.

NS&I has enhanced existing products. For example, Savings Certificates and Pensioners Guaranteed Income Bonds are now available over shorter terms. Customers have greater choice and the business benefits as the demand for repayments on fixed term products is spread more evenly over time.

Originally established as a contact and service centre, NS&I's call centre also became a sales centre in January 2002. Customers can call NS&I on a single number 24 hours a day, 365 days a year. Customers can buy many products over the phone using a debit card or request repayments directly into their bank or building society accounts. Telephony is proving to be a popular and successful channel. The call centre received 1.7 million calls from customers in 2001-02, 57 per cent more than received in the previous year. Currently, around 10 per cent of calls result in sales. This year the call centre is on target to receive over two million calls with the number of transactions carried out by phone forecast to rise significantly.



NS&I introduced a new website in July 2002. It allows customers to purchase products on-line, and check Premium Bond prizes, among other functions, with more planned in the future. Customers can still contact NS&I or buy its products at the Post Office's 17,000 branches, by post, or through financial intermediaries.

Source: NS&I

6 *The percentage of total working time lost.*

7 *Thaler is a specialised banking platform. It has components for managing sales and repayments of financial products and for accounting, customer management and central administration.*

1.16 In April 2001, for the first time, NS&I published a Customer Code, setting out the standards of good practice customers can expect when dealing with it. This will be subsumed into the Banking Code[8], which NS&I subscribed to on 1 March 2003. The implementation of this code is a huge project for SBS given the size of NS&I's customer base. NS&I is paying the costs of meeting the terms of the codes as SBS was not required by the contract to deliver these codes. NS&I anticipates costs of the Customer Code will be some £3 million during the first year, following a one-off data capture exercise covering more than 11 million customer records costing £4 million. NS&I estimates that subscription to the Banking Code will cost £20 million over seven years. Much of the cost relates to the need for SBS to mail a significant number of customers on an annual basis.

1.17 On 11 February 2002, National Savings relaunched as National Savings & Investments to reflect the modernisation of the business through its partnership with SBS and its new focus on customers. The launch attracted media attention and some quarters criticised the £2 million cost of the exercise, although the cost of the new image was absorbed in NS&I's existing marketing and running costs budgets. NS&I is assessing and will continue to assess the impact of its new image with Market and Opinion Research International (MORI). Research conducted to date suggests a positive customer response.

NS&I will gain a better understanding of its customers

1.18 Before April 1999, NS&I had limited information on its customers and their accounts. Each office held customer records for the products it serviced. These records were stored on different computer systems or as manual records and had inconsistent levels of detail and completeness of data.

1.19 SBS has constructed a data warehouse in line with the contract to enable NS&I to gain a better understanding of its customers. For each customer within the data warehouse SBS is providing NS&I with a single customer view. This is a unique record of each customer and all their NS&I product holdings as recorded on Thaler. Although details of some customers remain to be added, the data warehouse is proving to be a useful tool. NS&I has started to segment its customer base and to identify those most valuable to the business. This will enable it to target its customers more effectively, thus increasing its cost effectiveness and its ability to add value for the taxpayer.

NS&I could not have achieved as much without SBS

1.20 As part of its value for money appraisal of outsourcing its operations, NS&I prepared a public sector comparator. The Public Sector Comparator estimated the net present cost of continuing to manage the operational service in-house would be £793 million to NS&I over 15 years. NS&I would not have had the resources to modernise its operations. The estimated net present cost of the proposed deal with SBS was £635 million.

SBS's bid was £158 million less than the Public Sector Comparator

1.21 SBS's bid offered savings of £158 million in net present costs to the taxpayer. There were a number of reasons why SBS could run the operations at a lower cost than NS&I. Compared to NS&I, SBS expected to employ fewer staff through the increased use of technology and to minimise redundancies through the creation of new jobs on third party business. SBS also had the capability to release staff more easily than NS&I as it was not as constrained by annual budgets and could release surplus staff through redundancy or early retirement.

1.22 Although SBS was subject to budgetary constraints, it could invest where a strong business case existed and hence incur financial losses on the deal in the early years. Investment in the short term was seen as the means to delivering a lower cost business to NS&I and a financial return for SBS in the longer term.

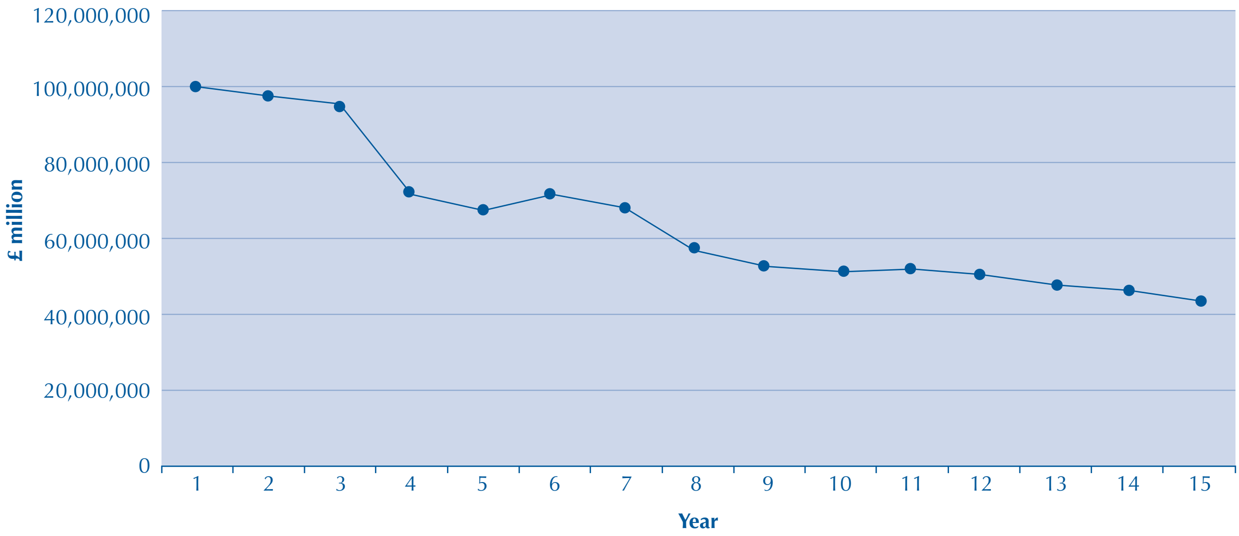
NS&I would not have had the resources

1.23 NS&I would not have been able to afford the business transformation proposed by SBS. The contract delivers everything that was included in NS&I's operations budget before April 1999 plus many new activities such as the call centre and the data warehouse. The annual NS&I operations budget was about £100 million in cash costs before the partnership. During the first three years of the contract, NS&I paid unitary charges of £102.2 million, £101.6 million and £100.9 million respectively. The unitary charge decreases to £72 million in the fourth year, with further decreases over the remaining contract term as shown in **Figure 4**.

8 *The Banking Code is a voluntary code which sets standards of good banking practice for banks and building societies to follow when dealing with personal customers in the UK.*

4 Reduction in unitary charge over 15 years

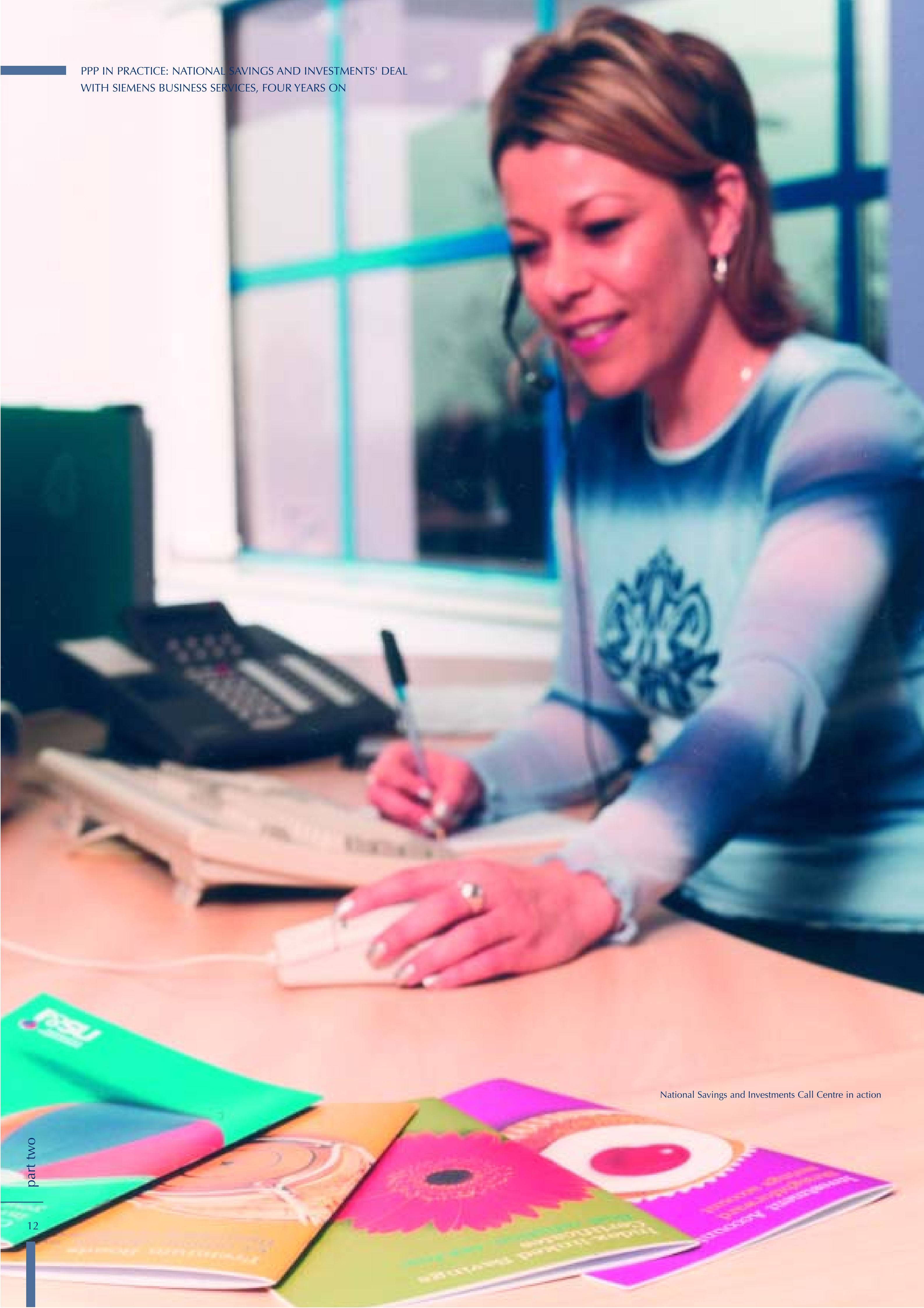
The original contract was for ten years with the option to extend it for a further five years. The unitary charge in years 11 to 15 will remain the same as that in SBS's original bid.



Source: NS&I

1.24 When the deal was signed, SBS's price showed savings of £158 million in net present cost terms over 15 years compared to the cost of keeping the business within the public sector. During the first three years of the contract the costs to SBS of transforming the business were substantially higher than planned. This suggests that at the time of the outsourcing, NS&I also significantly underestimated the costs of modernising the business within the public sector. NS&I now estimates that the net present costs of running the business without the partnership would have been £336 million higher over 15 years.

1.25 Despite SBS not reducing the costs of running NS&I's operations as much and as quickly as it planned, for example, through not achieving the early launch of low cost sales channels, there has been limited short term impact on NS&I or its customers. The earlier launch of low cost sales channels, however, would have benefited both parties, by increasing NS&I's ability to add value through the pace of the delivery of change and by enhancing the options for its customers.



National Savings and Investments Call Centre in action

Part 2

Many of the risks have crystallised

2.1 Our report on the original deal showed that this was a high-risk project. In this part of the report we show that many of the risks transferred to SBS have crystallised. Through failing to meet the target date for modernising NS&I's business, SBS is unlikely to make its projected return on the deal.

SBS expected to make a profit on the deal

2.2 SBS told the Committee of Public Accounts that the acquisition of the NS&I business was a strategic purchase, on which it was seeking a rate of return of 8.7 per cent. SBS won the contract in competition with Electronic Data Systems (EDS). Our report on the original deal found that the final bids were close, as were the estimates of the number of employees each bidder would need to run NS&I's operational service. The main difference between the bids was that SBS was prepared to accept more risk than EDS and planned to reduce staff numbers more quickly.

Financial bids for the deal were similar, as were the assumptions behind the bids

2.3 SBS's final bid of £635 million was £57 million lower than EDS' of £692 million. Both bidders estimated a similar number of staff would be required to run the operational business. SBS proposed to underwrite 1,200 jobs through the creation of third party business compared to the 1,900 jobs EDS planned to underwrite.

SBS was prepared to accept more risk

2.4 SBS was prepared to accept more risk than EDS. The major risks transferred to SBS are shown in Appendix 4. The major difference between the two bids centred on the Post Office Counters Automation Project eventually aborted by the Post Office, which would have had a positive impact on NS&I's operations. SBS bore the risk of the Post Office Counters Automation Project being aborted whereas EDS had included an additional charge of £60 million at most to cover the same risk. SBS was also prepared to accept a higher level of risk in other areas.

SBS is unlikely to make its projected returns

2.5 The deal, under a fixed price regime, transferred appropriate risks, as shown at Appendix 4, to SBS who considered that it had more control over this project than its previous public sector projects, as NS&I transferred all of its staff and assets to the private sector. The Committee of Public Accounts in its report on the partnership expressed concern about SBS's ability to achieve the business transformation by the target date of December 2000. By May 2002, SBS had delivered 87 per cent of NS&I's total requirements. As a result, SBS has incurred greater capital expenditure. This and the crystallisation of other risks – employing more staff, creation of fewer third party jobs, and maintenance of the three sites – have had a significant impact on SBS's ability to make its projected return of 8.7 per cent, and it is more likely to make a loss.

5 The number of forms used pre-April 1999 and today in NS&I's operations

	Pre-April 1999	Today	Per cent reduction
Customer Facing Forms	2915	636	78
Internal Forms	1945	418	79

Source: Siemens Business Services

SBS has incurred greater capital expenditure than it planned

2.6 During the first three years of the contract SBS spent significantly more than planned on transforming NS&I's operations. Both NS&I and SBS underestimated the scale of the business transformation.

2.7 SBS's introduction of technology has not always had the significant impact on reducing staff numbers it expected. Imaging technology, for example, is not always reliable and can produce poor quality images which can lead to errors. SBS argues that standard application forms for products would significantly improve the use of imaging technology and NS&I and SBS are working together to address this issue. They have reduced the number of forms, both internal and external, significantly as shown in **Figure 5** and they intend to make further reductions.

SBS has not been able to reduce staff numbers by as much and create as many third party jobs as expected

2.8 As SBS did not complete the business transformation programme to plan, it is employing more staff than expected at this stage in the contract. At the end of 2002, SBS was employing some 2,000 people in NS&I's operations. NS&I remains SBS's largest Business Process Outsourcing (BPO)[9] account, of its kind, in the UK, but it has only redeployed 650 former NS&I staff when its original bid was based on the assumption that it would now be employing 1,200 such staff on third party business. Both NS&I and SBS told us they were disappointed with this out-turn, but SBS is continuing to seek re-deployment opportunities for NS&I staff.

SBS is spending more than it planned on the three sites

2.9 SBS is spending more than planned to meet health and safety regulations and to maintain the three sites. SBS is operating its third party contracts at the Durham and Glasgow sites, but with less third party business than forecast, and with a reduction in staff numbers in the NS&I operations, large areas of the offices are now lying vacant. SBS is actively marketing these sites for third parties to rent.

Post Office errors effect SBS's efficiency

2.10 NS&I has a separate contract with the Post Office for processing its transactions, some 18 million in 2001/02, which it has restructured to ensure that the Post Office is appropriately rewarded for the services it provides. There is a cap on how much NS&I can reclaim for the Post Office's failure to meet performance targets, but during 2001/02 the Post Office reached the cap before the contract year-end. This suggests that the cap should be set at a higher level. NS&I told us that it intends to continue to strengthen the link between payment and quality of service although SBS bears the risk of errors made at Post Offices.

2.11 The Post Office uses 58 forms to transact NS&I business and this figure has not changed despite efforts by NS&I and SBS to cut down the number of forms since 1999. Errors on Post Office forms can affect the efficiency and quality of imaging systems used by SBS. NS&I and SBS are reviewing the Post Office work stream because they believe there is still much more they can do to reduce errors.

SBS bears the cost of dealing with death claims

2.12 SBS has a significant number of customers to service. For example, under the terms of the contract SBS is responsible for processing general correspondence and death claims relating to NS&I products, which can involve significant resources. NS&I receives over 400,000 death claims each year, equivalent to two thirds of deaths in the UK annually. Dealing with these claims costs SBS some £11 million a year. SBS intends to continue to seek ways of cutting costs by simplifying operational processes in the business further, by reducing manual processes and by increasing opportunities for automation.

9 *Outsourcing of an organisation's business functions such as personnel or IT to a contractor.*

The contract has been amended to increase SBS's liability on fraud

2.13 The contract requires NS&I to share the risk of customer and staff fraud with SBS. Originally, NS&I's annual exposure to fraud was £250,000 with SBS bearing the risk of fraud above this amount. The Committee of Public Accounts' report[10] on the original deal said it was essential that NS&I continued to ensure that fraud was minimised. NS&I subsequently negotiated an amendment to the original contract, reducing its annual liability from £250,000 to £90,750 over the life of the contract. In the two years before the partnership, NS&I experienced customer fraud averaging £388,000 a year, In the first three years of the partnership, the average fell slightly to £375,000 a year. Around 85 per cent of fraud relates to the Ordinary Account resulting in NS&I reviewing the account products with the aim of decreasing the level of fraudulent activity with particular focus on the payment on demand facility available at Post Offices. The remainder of fraud mostly stems from repayment warrants. Changes to the way in which fraud is accounted for may have artificially inflated the fraud figures since contract inception.

2.14 In 2002, after conducting a Fraud Management Review to identify and assess the risks of internal and external fraud for each product and each delivery channel, SBS introduced enhanced fraud mitigation procedures designed to effectively counter fraud.

NS&I's Business Process Re-engineering was flawed and SBS had to seek an alternative

2.15 NS&I required SBS to deliver its Individual Savings Account (ISA) product by 6 April 1999, six days after NS&I transferred all of its operational staff and assets to SBS. To meet that target date, SBS started work on the ISA after being selected as preferred bidder in December 1998. Following a benchmarking exercise, SBS selected Thaler, a commercially available banking platform on which to run the ISA product. In April 1999 SBS took on the risk of operating NS&I's products. In IT terms each product ran on separate customised software. Before procuring the deal, NS&I had commenced a Business Process Re-engineering programme (BPR) which SBS planned to use. SBS's due diligence, however, before contract signature indicated that NS&I's BPR was unlikely to deliver in line with the plans. After the contract started SBS discovered the technology behind NS&I's BPR was unable to deliver a re-engineered IT system.

SBS is introducing a more modern IT system

2.16 As the introduction of Thaler for the ISA product was successful, SBS selected the software as the IT element to re-engineer NS&I's operational processes. SBS engaged Thaler's developers as external IT consultants to configure the package for each product to be transferred onto the new IT platform. NS&I and SBS do not plan to migrate products which are no longer on sale to Thaler. Instead, they are reviewing how to manage remaining liabilities to investors. NS&I and SBS are also reviewing how Ordinary Accounts and Investment Accounts will develop, including the possible IT solutions. NS&I's legacy systems are known to contain many inherent weaknesses, which gave rise to product accounting problems considered by the Committee of Public Accounts in 1996 and 1998. While products remain accounted for by the legacy systems, which is likely to be for several more years, the weaknesses need to be addressed. SBS told us that product accounting has been a prime focus for itself and NS&I and it has been significantly improved to address migration issues. SBS also told us that it is committed to continuous performance improvement of the area and that it had reviewed the product accounting arrangements and the IT systems which support remaining legacy products and has developed a programme of change to address the weaknesses.

2.17 By and large the terms and conditions of products were not changed before migration although NS&I did enhance a number of products, in terms of interest payable and term, before migration. SBS told us that its strategy on migrations represented a low risk approach. It considers fundamental changes to the products before migration would have been riskier and would have extended the time required to migrate beyond that allowed in the contract.

SBS's strategy for process re-engineering significantly underestimated the challenge of transforming the old business

2.18 SBS's migration strategy sought to recreate the existing business processes for each product on Thaler and then use the features of Thaler to rationalise the processes, improve their efficiency and achieve the desired staff reductions. With up to 30 million NS&I customers, the migration of products onto Thaler was huge by any world-wide standards and clearly required a well-defined strategy to ensure success. In practice however, SBS encountered difficulties in adequately specifying for its IT consultants the complex processes supporting each product.

10 HC 566 1999/00.

2.19 SBS migrated First Option Bonds and Fixed Rate Savings Bonds, two of the smaller products, onto Thaler first in November 1999. Internal audit's review of the migration identified a number of failures in key reconciliations between customer and financial records and recommended actions to address these. Savings Certificates were migrated to Thaler in December 2000 but post-implementation reviews identified a continuing backlog in key reconciliations. A lack of skills transfer from SBS' external IT consultants to internal SBS staff meant that tracing the precise cause of the problems was very slow and rectification of problems even slower. SBS's pressure on its IT consultants to migrate products as quickly as possible led them to implement system fixes without full testing which generated additional functionality problems.

2.20 Although SBS took steps to develop permanent fixes to the configuration problems similar weaknesses emerged again following the migration to Thaler of Income Bonds and Pensioners' Guaranteed Income Bonds in June 2001. SBS' internal Risk Management Committee, although aware of the migration issues, failed to identify and adequately address their significance largely because SBS managers at the time were over-optimistic when reporting on the implementation of internal audit's recommendations.

2.21 In accordance with PFI principles, SBS bears the risk of authorising migrations, but NS&I has the opportunity to review SBS's proposed strategy. As the problems with the migrations became more apparent, NS&I decided that the situation could not continue and expressed concern about migrations continuing until SBS could demonstrate that the fixes were in place. SBS is unlikely to complete its rectification plan for Thaler before March 2003 and is preparing revised testing.

2.22 SBS introduced new sales of Capital Bonds on to Thaler in February 2003 because the legacy system was running out of Bond numbers to allocate, and this was completed in accordance with the new approach to migration. SBS then plan to migrate Children's Bonus Bonds onto Thaler in the Autumn of 2003. The final migration, Premium Bonds, which represents a significantly higher risk to NS&I's business than previous migrations, is planned to go live in Spring 2004. SBS says it will mitigate the risk through six months of parallel running before the go-live date. This migration will not only transfer sales and repayments to Thaler, but also offer increased functionality for administering the prize draw. NS&I needs to remain vigilant as SBS transfers the final products to Thaler.

6 Key Performance Indicator (KPI) targets have become more challenging performance targets

KPI Targets	1999/00	2000/01	2001/02
Despatch of Customer Documentation for Direct Sales Channels - 97% of documentation must be despatched, depending on product, within:	1 to 12 days	1 to 11 days	1 to 6 days
Despatch of Customer Documentation for Agent Sales - 97% of documentation must be despatched, depending on product, within:	4 to 9 days	3 to 10 days	3 to 6 days
Despatch of Customer Documentation for Telephone Sales - 97% of documentation must be despatched, depending on product, within:	4 to 12 days	3 days	2 days
Sales Queries - 97% of query resolution must be in hand and customer advised of query by target, depending on product, within:	1 to 12 days	1 to 10 days	1 to 7 days
Death claims and general correspondence - 97% of full or interim replies must be despatched respectively for death claims and general correspondence within:	15 and 10 days	12 and 9 days	11 and 6 days
Miscellaneous processes e.g. valuations or change of customer details - 97% of replies must be despatched or customer instructions complied with, depending on the process, within:	2 to 10 days	2 to 9 days	2 to 7 days
Acknowledgement despatched for Notice Payments - 97% must be despatched, depending on product, within:	3 to 8 days	3 to 5 days	2 days
Payments despatched for Non-Notice Payments - 97% must be despatched, depending on the product, within:	1 to 8 days	1 to 6 days	1 to 4 days
Payment Queries on Non-Notice Payments - 97% of query resolution must be in hand and customer advised of query, depending on product, within:	1 to 8 days	1 to 6 days	1 to 4 days

Source: NS&I

As the contract has progressed SBS has faced more challenging performance targets

2.23 NS&I set more challenging performance targets, shown in **Figure 6**, for SBS as the contract progressed on the assumption that SBS delivered the full business transformation by December 2000. The failure to achieve this has had serious implications for SBS. In Part 4 of the report we show how NS&I and SBS are addressing this issue.

2.24 In the first four years of the contract, SBS achieved 98 per cent of the performance targets NS&I set. In the fourth year of the contract SBS paid performance deductions of £454,900 compared to £1.3 million in the third, £0.7 million in the second and £0.1 million in the first **(Figure 7)**.

The time to agree deductions has sometimes taken too long

2.25 SBS has paid performance deductions and annual rebates to NS&I as agreed under the contract. NS&I receives an annual rebate from SBS for lower transaction volumes, unused new products and shares in third party rent. Appendix 6 shows how this rebate is calculated.

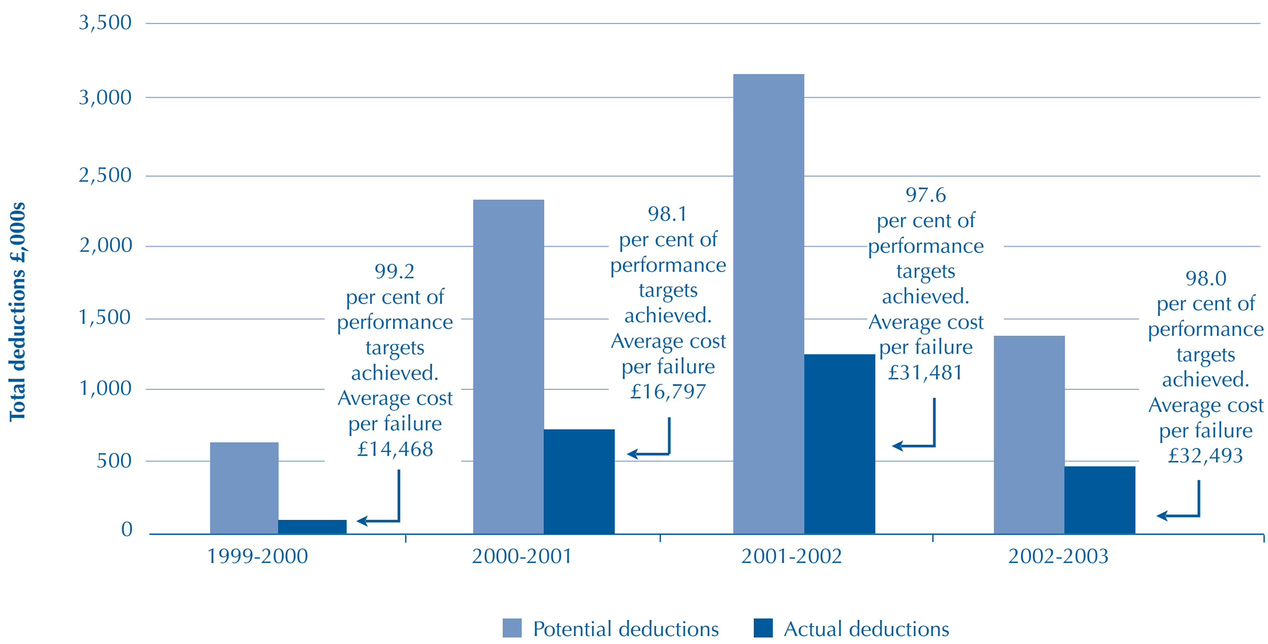
2.26 The rebate due for the second year of the contract, 2000/2001, was £2.9 million, mainly because NS&I did not launch any new products during the year. SBS did not pay this rebate until the end of March 2002 because it did not make provision for it and sought to reduce the financial impact of the payment by balancing it against costs incurred on other areas of NS&I work for which payment was due.

2.27 Up to October 2002 a significant number of performance deductions were outstanding. Deductions for failing treasury management KPIs were outstanding from October 2000 and SBS was also formally disputing a number of deductions for failed KPIs on after-sales and payments that resulted from the Savings Certificates rollover incident **(Figure 8)**. NS&I and SBS have now agreed all outstanding deductions to July 2002 and SBS has cleared these for payment.

Customer satisfaction measures did not measure SBS performance accurately

2.28 SBS measures customer satisfaction through postal surveys of a sample of NS&I customers, some 750,000 a year, and customer satisfaction Key Performance Indicators (KPIs) are based on the results. From the start, SBS often failed to achieve the KPIs and considered the delivery of its service to NS&I customers was not being

7 SBS has achieved 98 per cent of performance targets set



Source: NS&I

8 The Savings Certificate Rollover Incident

In October 2001, NS&I introduced "automatic rollover" on Savings Certificates. Customers no longer had to inform NS&I if they wished to rollover their investment for a further term of the same length. Following the change, a small number of customers contacted NS&I to query or complain about the rollover procedure. In addition delays began to develop on payments and after-sales work. This reached a critical state at the end of February 2002. The average time taken to turn around customer payments increased from 2 days to 12 days and responses to general correspondence were taking over 30 days in some cases against a target of 6 days. The problems attracted national media attention and the number of customer complaints rose significantly. This posed a potential threat to NS&I's image. SBS met the costs of a jointly agreed recovery plan and NS&I paid compensation to those customers most seriously affected by the delays. Both parties learnt that it was vital to work together to ensure all potential risks are identified, mitigated and impacts monitored and addressed. It demonstrated the need for NS&I to carefully manage its relationship with SBS and remain vigilant within the partnership, to avert any residual risk. The introduction of rollover did have positive benefits for the business. The retention of matured funds in Savings Certificates more than doubled, operational costs of the product reduced and research indicated that 98 per cent of customers are satisfied with the changes.

measured accurately. It thought that many other factors, outside SBS's control, such as the interest rates paid on products or service delivery at the Post Office, were having an impact on levels of satisfaction. Customer research indicated this view was correct and as a result NS&I and SBS agreed to suspend any deductions relating to the KPIs measuring customer satisfaction from 2001.

2.29 Following a review of customer satisfaction measurement, NS&I designed new postal and telephone surveys to provide a better measure of SBS's service to NS&I's customers. NS&I piloted the surveys in September 2002 and will use them from 2003/04 to give it greater feedback on customer service by product and by channel. SBS will continue to administer the postal surveys. NS&I is employing another company to conduct telephone surveys as the requirement is outside the original contract, and SBS lacks the resources to undertake such work.

2.30 NS&I told us that it considers customers are very satisfied with the service they receive. Research by MORI in July 2002 showed that customers' net satisfaction with NS&I's service increased by 9 per cent on the previous year to 85 per cent, which is above ratings achieved by NS&I's major competitors. SBS handles 50 million transactions a year and only 0.02 per cent result in complaints, which equates to one complaint for every 4,200 transactions. The Key Performance Indicator for Customer Complaints requires upheld customer complaints to be equivalent to less than 0.1 per cent of transactions. NS&I and SBS are working on a joint project to examine the current complaints process as it is thought that many issues could be addressed through devising and publishing a comprehensive series of "Frequently Asked Questions" for the NS&I product range.

Premium Bond Draw

Part 3

All parties have learnt valuable lessons

3.1 This was a pioneering deal for both the public and private sector. Consequently both sides have learnt many lessons over the past four years. This part of our report sets out the lessons learnt and shows that although SBS has had to face many risks it remains committed to the deal.

The parties to a PFI contract need a single business focus

3.2 In our report, "Managing the relationship to secure a successful partnership in PFI projects"[11], we said that the parties to a PFI contract needed a single business focus so that each could achieve its respective objectives. This required both parties to understand their respective objectives, to assess the prospects for a partnership, and to have made efforts to understand each other's business. In this case NS&I and SBS have needed to make a number of changes to achieve such a single focus.

NS&I chose the best partner although the relationship was initially one of customer and supplier

3.3 NS&I recognised synergies between its culture and strategy and those of SBS during contract negotiations. Despite the difficulties faced by SBS in delivering some aspects of the contract, NS&I acknowledges that its partner has worked hard to find solutions and is committed to achieving an acceptable outcome for NS&I, for itself and its stakeholders.

3.4 Both NS&I and SBS now recognise that they seriously underestimated the influence NS&I could have on SBS's operational costs. At the start of the contract, NS&I and SBS had not moved sufficiently away from a traditional customer/supplier relationship: NS&I, did not fully consider the impact its demands could have on SBS's costs, specified what it wanted and SBS delivered it. For example, NS&I does not now require all the management information reports specified in the contract. NS&I and SBS have worked together to redesign the format of management information reports since the start of the contract and although NS&I is demanding less management information than originally specified, it considers the data it receives to be more strategic and useful.

3.5 NS&I's approach to the relationship changed because it realised that there was a need to take responsibility for the costs of the business, issues with transferring products to Thaler and a real risk of qualified audit opinions on its product accounts. It also recognised that, if at the end of the contract the operation is to be low cost, sleeker and more efficient, it must change its behaviour and share this responsibility with SBS.

NS&I and SBS have now adopted a whole business approach

3.6 NS&I and SBS are now much more focused on the whole business. Partnership decisions are now based on what is best for the business as a whole rather than what is best for either NS&I or SBS. In the areas of transaction accounting and business process re-engineering NS&I now has strong involvement although it does not seek to transfer risk back to itself through approving SBS's solutions to its requirements.

NS&I and SBS should have challenged each other more

3.7 NS&I negotiated a contract, which only considered the investment needs of the business over the first 3-4 years. It had not fully considered how it could gain a low cost, sleeker and more efficient operation through the contract. It did recognise, however, that its objectives could change and incorporated change mechanisms in the contract.

3.8 The whole business approach requires each partner to challenge the requirements and actions of the other because of the impact they might have on the business

11 HC 375 2001/02.

as well as each other's objectives and how the contract is delivered. As this was initially a customer/supplier relationship neither party challenged the other sufficiently. In line with PFI principles, NS&I transferred appropriate risks to SBS but although NS&I, rightly, did not seek to approve SBS's actions, it failed to challenge sufficiently SBS's solutions for transforming the business. Neither did SBS challenge NS&I's requirements around product, channel and customers. And both partners failed to fully identify the longer term changes required to deliver the future vision. SBS did not do so because it was new to the BPO business and the retail financial market and considered it lacked sufficient ability to challenge NS&I's requirements.

3.9 As the contract required business transformation through the migration of all NS&I products to a new common IT platform to be completed by an early date, December 2000, SBS transferred complex products onto Thaler without adequately reviewing the processes and testing the application before implementation. NS&I now recognises that putting all products onto Thaler may not benefit the business as a whole.

Early challenge and review would have been beneficial

3.10 Early challenge and review of NS&I's strategy for the business and of SBS's strategy to deliver the contract would have been beneficial. NS&I would have recognised earlier that full migration of products to a single common IT platform may not have been necessary. With hindsight, NS&I and SBS consider that a review may not have delivered outputs any quicker. Nevertheless, what was delivered could have been planned better. For example, SBS, to achieve headcount reductions, invested heavily in imaging technology, when NS&I's strategy and its joint future with SBS will be better served through the development of new cheaper sales channels such as the Internet and telephony which would allow SBS to make less use of imaging technology.

3.11 Furthermore the approach to risk management was not sufficiently co-ordinated at all levels across the business and NS&I should have sought more reassurance, particularly on SBS's future income and expenditure projections.

NS&I now has access to SBS's financial forecasts

3.12 NS&I was aware of SBS's expenditure on the deal through open book accounting. Although it was apparent that SBS's costs during the first two years were rising faster than forecast, SBS continued to forecast a profit assuming it could achieve compensating efficiency savings. By February 2001, it became clear that this would not be the case and by the end of the year NS&I was aware that its partner faced potentially significant losses on the deal.

3.13 NS&I knew SBS's historical performance through open book accounting but it did not provide NS&I with evidence of SBS's future assumptions. NS&I now has access to those assumptions through open book forecasting which NS&I and SBS employ to assess the financial impact on the whole business of each other's actions.

Governance of the contract has changed

3.14 If a partnership is to continue to deliver the services required, then the arrangements for monitoring the long-term contract and agreeing changes to it will be crucial. To achieve this, NS&I and SBS established a joint governance structure for the contract. The Committee of Public Accounts recognised in its report on the deal[12] that it was important that the structure was used and developed to ensure that all the benefits expected would be delivered on time. In the light of the whole business approach now adopted and the need to consider future corporate as well as operational strategy, NS&I and SBS have agreed a new governance structure. **Figure 9** shows the changes. The changes are still bedding in, but both sides are optimistic that the new governance structure will deliver its potential.

The private sector should recognise the management challenge that PFI represents

3.15 In taking on complex PFI projects with tight timescales for change, the private sector needs to assess the challenge such that it employs appropriate and sufficient management skills to deliver the public sector's and its own objectives.

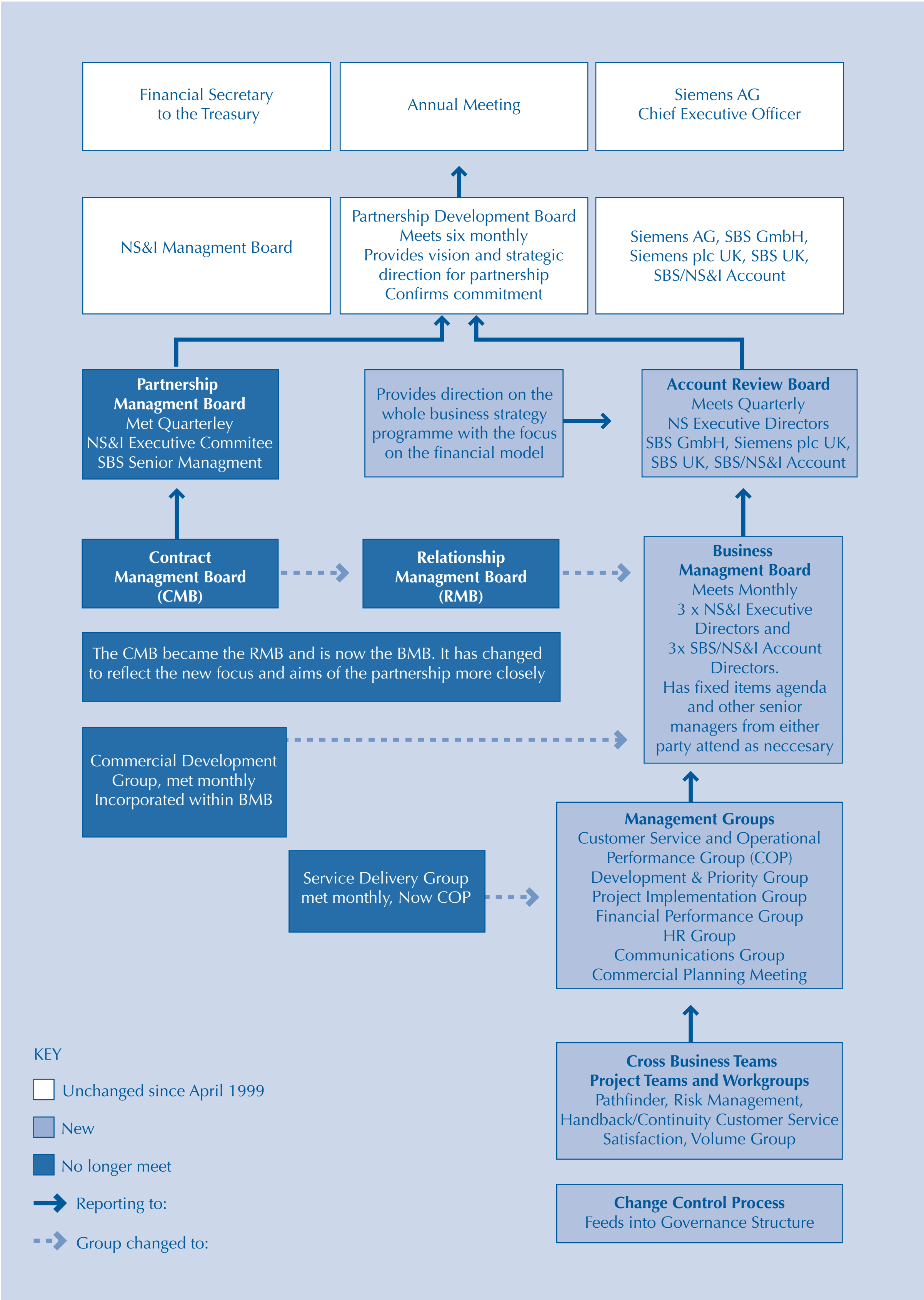
Siemens AG should have challenged local management

3.16 The Siemens business culture is based on trust and delegated authority to its senior management. Local management is empowered to run its accounts or areas of business with a degree of autonomy. Local managers were committed to delivering a successful outcome at NS&I and invested heavily in the project with a view to achieving this result in the long term but Siemens' financial oversight failed to alert it to the escalating costs of the project at an early stage.

12 *HC 566 1999/00.*

9 Governance of the contract has changed

This figure shows how membership of the groups governing the contract has changed since April 1999



Source: NS&I

3.17 By April 2001, Siemens AG was concerned by the continuing fall in profit forecasts and sent its internal audit team to assess the project. The team concluded that unless management acted, SBS was going to make a significant loss on the deal. Siemens AG has now changed its management practices by introducing more robust sign off procedures at all management levels and setting SBS financial targets for each year of the project.

SBS should have deployed appropriate management resources

3.18 Although SBS has achieved many successes it underestimated the scale and complexity of the task and the management resources needed to transform NS&I's business. SBS brought in external people to manage the NS&I account from the start. Its new managers, however, were not experienced in managing a business similar to NS&I, and their number was less than EDS had planned to employ on managing the business. At the end of 2001 after discovering major problems on the project, Siemens AG addressed this risk to its business by bringing in new senior management at SBS. These changes were designed to address resourcing issues on the project, the new managers being proven deliverers of change and experienced "Siemens" people.

3.19 In 1999, NS&I was SBS's biggest contract in the BPO sector, not just in the UK, but globally. It lacked sufficient internal resources to manage emerging risks and problems on the project. SBS employed a large number of consultants early in the project when former NS&I employees could have contributed, although SBS told us it had good reasons for not adopting this approach. SBS has learnt many lessons from its experience but considers that its competitors have also faced similar issues. This learning should not be lost and SBS will benefit from setting down the experience as a model for managing future BPO business. Working in partnership with NS&I, SBS has gained experience of working with a public sector partner on a scale never before undertaken.

High level commitment to make the deal work is essential

3.20 Although SBS is unlikely to make its expected return on this deal, it retains the support of Siemens AG and its shareholders. This commitment is partly driven by the terms of the contract which required Siemens AG to guarantee SBS's delivery or risk financial liability of up to £250 million. Also, Siemens regards itself as an organisation which will deliver to its commitments.

Siemens AG shareholders are backing the deal

3.21 The contract does not give SBS the right to withdraw despite the return on the deal being very poor to date. SBS appears more likely to make a return on its investment by remaining in the partnership for the full 15 years of the deal, if it can achieve its target operational cost savings and increase revenue through third party business and additional work for NS&I. SBS's latest financial figures show that that the project is performing in line with, if not better than, current forecasts so there is now a more positive outlook.

But there has been tension in the relationship

3.22 SBS's financial position and the change in management had a negative impact on the partnership for a while as it operated more at arm's length. Both sides have since worked together to recover the relationship quickly. SBS continues to work under intense pressure to cut costs and meet financial targets, which can sometimes place temporary stress on the relationship, but we have observed a close and co-operative approach to meet the partners' different, but related, objectives.

NS&I has contingency plans for a number of scenarios in place

3.23 NS&I is committed to managing risk within its organisation. In line with good governance arrangements and in response to the Committee of Public Accounts' report[13] on the NS&I and SBS partnership, NS&I has developed a Partnership Continuity Plan which identifies the risk of early termination of the contract. NS&I appointed a Business and Partnership Continuity Manager to be responsible for keeping the plan up to date.

3.24 The plan is based on a number of scenarios described in **Figure 10.** The plan covers in detail:

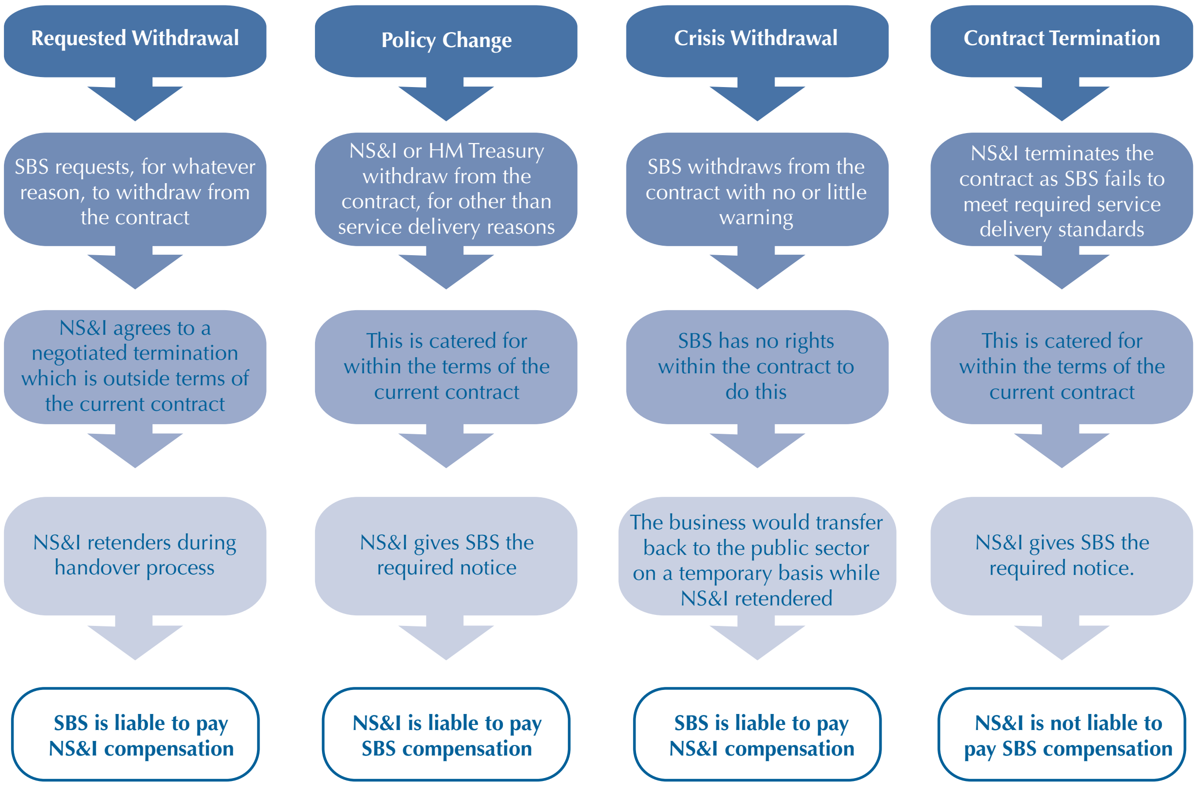
- Stabilisation of the business
- Re-tendering process
- Handover to new provider
- Call-off contract details
- Cost of invocation
- Monitoring of risk and management of the escalation process
- Potential alternative providers
- Potential legal issues
- Roles and responsibilities
- Project Plans

13 *HC 566 1999/00.*

3.25 The work on the plan is productive in supporting the longer-term needs of handback requirements. A joint working group has been set up to facilitate handback arrangements and it is, for example, involved in drawing up an asset register for the business.

3.26 As part of the Partnership Continuity Plan a range of consultants are on standby to support NS&I in crisis and interim management, project management, tendering, legal advice and communications. NS&I can send out an Invitation to Negotiate very quickly if required and has allocated contingency roles to key NS&I managers if its operations had to return to the public sector for a temporary or prolonged period.

10 NS&I's Partnership Continuity Plan is based on Four Scenarios



Source: NS&I


Fixed Rate Savings Bonds
Fixed Interest
Savings Certificates
Investment Account
Straightforward
savings account
ns&i

Part 4

The deal has been modified without increasing the unitary charge

4.1 An important characteristic of PFI contracts is that they transfer the risks of delivering public services to the private sector. During the life of the contract departments need to ensure that their behaviour does not lead to these risks returning to the public sector. This part of our report shows that in partnership NS&I and SBS have acted to improve SBS's financial position and to achieve NS&I's objectives without increasing the unitary charge.

A Whole Business Strategy will benefit NS&I and SBS

4.2 NS&I recognised that to ensure the deal delivers its original aims and objectives the partnership had to take remedial action. It acknowledged that not only did SBS have to review its financial forecasts and take necessary action to improve its position, but NS&I also had to review its behaviour to support SBS. NS&I, with SBS, developed an Operational Strategy Programme to address these issues.

NS&I can expect to gain a sleeker and more efficient business

4.3 NS&I's ultimate objective is to have a modern, efficient and customer focused operation, which is cheaper to run than at the start of the contract, delivers improved customer service and provides additional opportunities to increase Value Added. Although NS&I recognises it needs to take a whole business approach to addressing the costs of running its operations, it also recognises that it must make a real and conscious effort to reduce operational costs in line with its own long term business needs. During the first two to three years of the contract NS&I acknowledges that the partnership failed to effectively control costs. The contract provides for NS&I to share in SBS's annual profits and therefore NS&I has the opportunity to gain through reducing the cost base.

SBS 's financial position can be expected to improve

4.4 The E-Commerce and Banking Code[14] projects offer SBS additional revenue opportunities outside the original contract. NS&I and SBS agreed these variations through their joint control process and NS&I audits the costs of the changes on an annual basis. SBS will have further opportunities, through the experience it has gained on the projects and the associated development of skilled resources, for example in the provision of print facilities and the call centre, to develop third party business. Such additional business will reduce SBS's need to cut staff numbers and hence save SBS the costs of further redundancies.

4.5 Our review of the e-commerce channel project revealed that NS&I has not always fully or clearly documented its decisions to award work outside the contract to SBS or to pay SBS additional money, based on a value for money analysis. NS&I's website became operational in July 2002, although it was due to go live by February 2002. NS&I told us that it was its decision to delay as it required additional testing to ensure risks were properly managed. As no blame for the delay was attributed to SBS, NS&I agreed to pay SBS £1.6 million from March to June 2002 to cover the costs already incurred by SBS. In providing SBS with additional revenue opportunities NS&I must demonstrate that variations to the contract represent value for money and ensure decisions are supported by an adequate audit trail.

14 *The Customer and Banking codes are defined in Paragraph 1.16.*

Contract terms have been realigned while preserving the original allocation of risk

4.6 In December 2001, SBS, Siemens AG and NS&I identified a number of key areas for review within the contract, as part of the Operational Strategy Programme. Following negotiations, an agreement was signed between the parties in September 2002, which reflected a realignment of the contract. The drivers behind the contract re-alignment were:

- to improve clarity and reduce ambiguity;
- to adjust any issues which both parties deemed as intrinsically unfair; and
- to ensure the contract was a driver for a low cost operation.

4.7 NS&I was keen to ensure that the agreement was not a renegotiation and did not change the functionality of the contract, or the transfer of risk. At the same time it wanted to ensure the contract encouraged "best" behaviour by both NS&I and SBS to achieve the objectives of the partnership and whole business working. NS&I and SBS consider they have a "living contract", which should evolve over time, and the realignment is a means of supporting this concept.

The Key Performance Indicator regime is fairer and clearer

4.8 The Key Performance Indicators (KPIs) became tougher after the target date, December 2000, for the completion of business transformation. As SBS did not achieve that target, it has faced difficulties in achieving the required performance standards. To perform better it needs to improve processes further to achieve the full modernisation of NS&I's operations. NS&I recognised this and agreed to temporary changes to KPIs to reflect a fairer performance deduction for SBS in line with NS&I's liability for SBS's performance failures and to assist SBS in re-engineering the operations. **Figure 11** shows the amendments and NS&I's rationale for the changes.

A new joint process of change control offers clarity and reduced costs

4.9 NS&I and SBS considered that change control procedures were not effectively controlled and managed. Under the Operational Strategy Programme, they agreed a new Change Control Procedure, introduced in March 2002, to manage all chargeable changes or specification changes for the remainder of the contract. NS&I and SBS have agreed that any changes must go through the change control process which requires discipline on both sides.

4.10 In line with their whole business focus approach, NS&I and SBS now share a list of required changes whereas before they held separate lists. This allows NS&I and SBS to make the best use of the IT staff available throughout the business. NS&I has also appointed a Business Change Manager to add value to the process.

NS&I could potentially share in the costs of product and channel variations

4.11 NS&I expected to make minor variations to products and channels which would not attract a charge. In the event, many of the changes NS&I considered variations were actually quite complex and required significant work from SBS. NS&I was also designing quite complex products without considering the consequences on SBS's operational costs.

11 Summary of Key Performance Indicator (KPI) review

KPI amendments	Rationale for change
Reduction in the overall number of KPIs from 37 to 23. N.B. In April 1999 there were 42 KPIs but some of these have now ceased.	NS&I has merged a number of KPIs ensuring that overall, SBS is required to meet the same standards. For example there were previously four separate KPIs for sales. Targets for responses to customers a) buying directly, b) through an Agent, c) over the phone, or d) making general sales queries. NS&I has merged these into one sales KPI while ensuring service to customers is maintained.
Extension of the process time for specific processes within KPIs for the period up to 1 January 2004.	NS&I has relaxed some KPIs for a temporary period to allow SBS to manage further process changes required to achieve the full business transformation.
Reduction in the performance deductions of Platinum and Silver KPIs.	Potential performance deductions for some KPIs bear no relation to potential loss incurred by NS&I or HM Treasury or actual deductions made by NS&I during contract period.
Reduction in the escalation of performance deductions for repeat failures.	Escalation for recurring failures particularly on Platinum KPIs deemed out of step. Again changed to reflect real liability faced by NS&I and its stakeholders.

Source: NS&I.

4.12 NS&I felt this was unfair and that they should pay a fair contribution to these development costs. NS&I and SBS, therefore, agreed definitions for product and channel variations, product and channel enhancements and new products and channels to add clarity to the existing contract. They also agreed SBS's cost liability for any variations, enhancements or new products and channels as shown in Appendix 7. The new definitions may result in increased or decreased costs to NS&I depending on actual development costs and the scale of the change. The aim is jointly to develop low cost enhancements costing ideally no more than £300,000. If costs exceed £300,000 NS&I is liable to share the excess. For the development of low cost products, the aim is jointly to develop them within £600,000 and ideally for less than £1 million. If costs exceed £1 million, NS&I will share the liability with SBS. The arrangements incentivise both partners to design products that are less costly to deliver and operate on an ongoing basis.

4.13 The agreement also clarifies contract terms on other product-related issues such as product connectivity, product closure, fundamental product changes and overseas transactions. The agreement allows NS&I to make milestone payments to SBS for the introduction of new products and other services, which can smooth the financing requirements for SBS and decrease the overall costs to NS&I.

The contract extension allows time for SBS to make a return and NS&I to pay the original price

4.14 The original contract was for ten years with the option to extend it for a further five years. NS&I and SBS signed a Letter of Intent in August 2002 indicating both sides' willingness to commit to a further contractual period, potentially making a commitment[15] on 1 April 2004 to last until 31 March 2014. Such an extension, if it were to be mutually agreed would allow SBS to consider it effectively has a 15-year contract with NS&I and to continue to invest in the business with the prospect of improving its financial results.

4.15 NS&I will also benefit from a 15-year contract, as it will pay a lower unitary charge from years 10 to 15, regardless of SBS's costs ensuring that the risks remain with SBS. A longer term should also ensure SBS completes the business transformation in full, before the return of the business to NS&I or transfer to another provider.

The obligation for SBS to deliver the contract has been confirmed

4.16 The contract realignment confirms SBS's obligations to deliver outstanding elements of the contract to an adjusted milestone plan. For example, the single customer view, a unique view of all the NS&I product holdings of each customer, was an implied requirement of NS&I. But as the contract was not specific SBS could have avoided the obligation to deliver. NS&I has confirmed and agreed the single customer view obligation with SBS, but the scope and detail of this is still being discussed.

Allocation of risk has not changed

4.17 The contract realignment does not materially alter the transfer of risk and as generally recognised in PFI deals it would be a mistake to hold SBS firmly to every detail of the contract if this would jeopardise NS&I's overall long term objectives. All the key risks of modernising NS&I's operations, reducing staff numbers, service delivery and the cost of running the business remain with SBS. In the short term, changes to the contract are not likely to have any measurable impact on SBS's projected financial deficit position.

4.18 The contract realignment discourages non-partnership behaviour by either NS&I or SBS. For example, it limits the significant negative impacts NS&I could have, by acting unreasonably on the costs of running NS&I's operations and on SBS's financial position.

NS&I is not paying SBS a higher unitary charge

4.19 One of the principles of PFI is that the private sector bears the financial consequences of the risks transferred to it. In this deal SBS will do so as NS&I and the Treasury are adamant they will not increase the unitary charge. As the contract progresses, the unitary charge reduces. In the first three years, the unitary charge was set to cover SBS's investment in the business transformation programme at some £100 million a year. In the fourth year, the unitary charge fell to £72 million and will reduce further over the contract term as shown earlier in Figure 3.

4.20 Siemens AG agreed to guarantee SBS's obligations under the contract. The parent company's liability was set at up to £250 million by NS&I and this places the onus on SBS to improve its loss making position.

15 *This commitment is subject to a variety of provisions including ministerial consent in 2004, satisfactory service delivery, government policy and the discretion of the Director of Savings.*

Glossary

Benchmarking	The process of comparing the method, time or cost of an operation, service or product against those of other organisations, preferably thought to be the best in the field.
Deliverable	Indication of the possible ways of delivering a service, before contract award. After the contract's award, the agreed service specification.
Governance	System of joint working and responsibility for running the contract.
Key Performance Indicators (KPIs)	The detailed standards of performance the authority requires a contractor to provide.
Net present value of the contract price	The net present value of the contract price represents the amount that would have to be invested at the the start of the contract to fund the expected future cash payments which an authority will be required to make to the contractor.
Open book accounting	A description of arrangements, whereby part or all of a contractor's financial records for a project, can be seen by the authority.
Private Finance Initiative	A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services, while reducing the impact of public borrowing.
Private Finance Initiative principles	The allocation of risk and reward should be clearly defined and private sector returns should be genuinely subject to risk; and the contracts should represent value for money, taking into account the benefits of transferring risk to the private sector and the cost of that transfer.
Public Sector Comparator	A benchmark against which value for money is assessed. It is typically a cost estimate based on the assumption that assets are acquired through conventional funding and that the procurer retains significant managerial responsibility and exposure to risk.
Risk transfer	The passing of risk under the contract between the public sector and the private finance provider.
Unitary payment	The periodic payment that the public sector agrees to pay for the provision of services by the PFI contractor.
Value for Money (VFM)	The achievement of the optimum combination of whole life cost and quality to meet the customer's requirements.

Appendix 1 National Audit Office Methodology

1 The National Audit Office examined the progress achieved by NS&I and SBS, in partnership, in delivering a modernised NS&I business. In particular we assessed whether the deal, which commenced in April 1999 is delivering value for money.

2 We used an issue analysis approach to design the scope and nature of the evidence required to complete this examination. We set a series of high-level audit questions that we considered it would be necessary to answer to assess the success or otherwise of the partnership in delivering its objectives, and collected evidence accordingly. For each of the top-level questions, we identified a subsidiary group of questions, linked logically to the main questions, to direct our detailed work and analysis. Our general report, Examining the value for money of deals under the Private Finance Initiative (HC 739, 1998-99), provides an outline of this general methodology which acts as a starting point for all our PFI examinations.

3 The top-level questions we set were:

- Is the deal delivering as planned?
- Will changes to the deal ensure delivery of its objectives?
- Does the deal still make sense?

4 We derived our main evidence from examining documents held by NS&I at its head office in London and through interviews with relevant staff within NS&I, SBS and Siemens AG.

5 We also visited SBS's offices in Blackpool, Durham and Glasgow to examine NS&I's operations.

Appendix 2 How NS&I measures the value it adds for the taxpayer

1 In 1996, NS&I conducted a strategic review supported by Corporate Value Associates to determine whether its business added value for the taxpayer and how such value might be maximised in the future. The review concluded that NS&I adds value for the taxpayer through being cost effective in raising funds from retail savers compared to the cost of raising funds by issuing gilts to participants on the wholesale capital market. Such added value equates to a pound for pound reduction in public expenditure. This appendix provides a brief explanation of how this added value arises and how it can be measured.

External and Internal Performance Measures

2 NS&I has two measures of added value. The first is referred to as the 'lagged' measure and this is a measure of the actual cost effectiveness of raising funds through the retail market against raising funds on the wholesale market. The second, called the 'delagged' measure, takes into account the underlying business performance of NS&I.

3 The difference between the two measures represents the timing differences between movements in the comparable cost of funding on the wholesale markets and the comparable consequent changes in NS&I product interest rates becoming effective. As these timing differences are dependent on the movement of market interest rates they are highly unpredictable and can obscure the understanding of the underlying business performance.

4 The lagging effect will have a negative impact on the 'lagged' value measure in times of falling interest rates and a positive impact when rates are rising. Hence, after adjusting for this effect the 'delagged' value added measure will be greater than the 'lagged' value added measure in an environment of falling rates and vice versa.

NS&I's methodology for calculating added value

5. To calculate the 'lagged' value added measure, NS&I compares the cost of it raising funds through the retail market with the cost of raising funds on the wholesale market as shown below.

For fixed rate products

- (the equivalent gilt yield multiplied by the balances outstanding) less (the interest payable to its customers plus tax foregone by Inland Revenue on tax free products)

For variable rate products

- (the Bank of England base rate less 0.1 per cent multiplied by the balances outstanding) less (the interest and prizes payable to its customers plus tax foregone by Inland Revenue on tax free products)

The calculation is completed by deducting NS&I's operating costs. So the lower NS&I's operating costs, the greater added value will be.

6 From April 2002, NS&I changed the added value measure to enable comparison between the audited accounts of the business and the value added measure. The key change made was that value added on fixed rate products is now recognised over the life of the holding rather than being recognised at the time of sale (on a net present value basis).

7 To calculate the 'delagged' value added measure the 'lagged' measure is adjusted for the timing difference between yield or base rate movements and the new rates coming into effect.

NS&I creates significant value added

8 The following table shows the 2000/01 and 2001/02 value added figures on both the 'lagged' and 'delagged' measures.

	2000/01 £ million	2001/02 £ million
Value Added - 'lagged'	82.5	76.3
Adjustments for timing and other differences	34.9	100.0
Value Added - 'delagged'	117.4	176.3

Appendix 3 Summary of results of benchmarking

Area Benchmarked	Results of Benchmarking	Action Required	Action Taken
Attendance Management	Management of sickness absence equal to or superior to benchmark comparators	Could benefit from introduction of reward scheme for good attendance	Under review
Automated Processes	Fewer automated processes than comparator organisations	Introduction of more automated processes could increase operational efficiency and reduce error rates and rectification costs	Being incorporated into operational strategy review. Leading-edge desk top openers have subsequently been purchased to increase productivity
Business Continuity Planning	SBS and NS&I account at the leading edge of comparator organisations and better than most account within SBS as a whole	No action required. Benchmarking undertaken to provide stakeholder assurance	To be subject of regular review in order to ensure maintenance of high standards
Call Centres	SBS/NS&I Call centre compared favourably with benchmarking partners in terms of having been developed in a professional manner	Some improvements in resource monitoring software and call quality monitoring were required	Action plan produced with many recommendations implemented. Some actions outstanding and due for review
Customer Complaints	Generally compared favourably with BS8600 for internal complaints. For external complaint handling, the findings were favourable compared to benchmark partners	Development of a complaints database and increased support for staff involved in grievance procedures would improve internal performance overall. Staff guidance notes and improved training would improve overall external performance	Action plan produced with many recommendations implemented. Some actions outstanding
Customer Satisfaction	Identified that Customer Satisfaction measures linked directly to KPI measures was not industry standard and was not providing a good overall indication of satisfaction levels	Recommended that overall approach to customer satisfaction measurement be reviewed	KPI regime has since been reviewed as part of the contract realignment in September 2002

Area Benchmarked	Results of Benchmarking	Action Required	Action Taken
Death Claims Handling	The financial level at which NS&I call for Grant of Probate is lower than other financial organisations	Recommended that the financial level is brought in line with other organisations – this will yield process cost savings with no negative impact on customers	Under review
Disability Discrimination Act	The facilities offered by SBS/NS&I to disadvantaged customers compare well with those of other leading financial organisations, but they are not widely advertised	For information and stakeholder assurance	Regular review required
E-mail Management	Benchmark indicated that comparator organisations have seen benefit in staff morale and productivity in developing and implementing e-mail guidelines	Outline guidelines have been produced and sent to SBS UK and NS&I for review	Under review
Internal Communications	Internal communications compare favourably with benchmark organisations	Improvements could be made through the development of an intranet site, more two-way communication and personnel satisfaction survey	Action plan produced with many recommendations implemented. Some actions outstanding
Published Service Standards	Published service standards of NS&I were equal or superior to those of other financial organisations	No action required – undertaken to provide stakeholder assurance	Regular review required
Postage Standards	High level research and not a full study. No industry standards identified with regards to the usage of first and second class postage. NS&I compared equally or favourably to the comparator organisations	Some opportunities for cost saving identified where customer impacts were negligible	Some areas already implemented and cost savings being delivered – some recommendations still under review with respect to customer impact
Same Day Banking	Internal benchmark only as no comparable partner organisations prepared to share the level of detail required. The internal benchmark indicated that in the main, the KPI targets were being met	Areas of weakness in minor workstreams were identified as contributory factors to KPI failure. Recommendation was that work was undertaken to address these areas	Under review

Appendix 4 The allocation of risks

Risk	NS&I	SBS
Operational		
Failure to meet key performance standards	Has discretion to set performance deductions within an agreed range	Faces substantial performance deductions for failing to meet KPIs
Post Office Counters Automation		Bears a £5m per annum risk on operating costs for Ordac and Invac until counters automation is delivered or NS&I withdraws the products from sale
Failure to implement business transformation by the dates specified		Will have to employ more staff than expected and cannot recover those costs in the contract price. It will also have to pay NS&I 70 per cent of the contingency provision it has not used
Failure to further improve KPIs if business transformation programme not in place by December 2000		Still has to meet the improved KPIs even if it has not completed the programme by the required date
Year 2000 compliance		Has indemnified NS&I for all loss or damage resulting from breach of this obligation. Contract can be terminated and SBS will pay the cost of a third party to undertake the work. SBS will be penalised through failure to meet KPIs, but can gain relief from such penalties if third party computer systems' non-compliance leads to poor performance
Euro compliance	NS&I specified system and process requirements for which SBS has the right to charge a maximum of £9m. SBS have the right to charge an additional sum for ongoing euro compliance should the UK join the single currency	Responsible for development of a suitable Euro Compliance Plan. If SBS misses a key date in the plan, it must take steps at its own cost to fulfil that key date. If it fails to do so, NS&I can arrange for a third party to carry out the work and SBS shall reimburse costs incurred. SBS must deliver euro compliant systems at a cost of below £9m
Fraud	Annual exposure to fraud reduces from £250,000 to £90,750 over the life of the contract	Bears higher losses resulting from fraud and will indemnify NS&I in respect of any claim and loss of any person arising out of operational error

Risk	NS&I	SBS
Commercial		
Product variations		Implements at own cost except where an adjudicator judges the change is necessary because of negligence by NS&I
New NS&I products and channels		SBS will not be able to charge NS&I more than it bid and NS&I can share in lower costs below a given threshold
Transaction Volumes		The unitary payment is adjusted if transaction volumes fall outside a nil adjustment band. SBS bears the risk that the cost of additional transactions exceeds the price for those transactions
Change of Law		SBS will bear all this risk unless the change of law is unforeseen and an unreasonable cost or business burden

Appendix 5 NS&I Products

SBS has continued to service a similar number of products since April 1999. The closure of products is balanced by the launch of new products. Six products in NS&I's current portfolio are on Thaler and a significant number of accounts are still processed manually or on legacy systems, including Premium Bonds. More than half of the total funds invested with NS&I are invested in Savings Certificates or Premium Bonds.

	Products on Sale April 1999	**New Product post April 1999**	**Product closed to new business after April 1999***	**Products on Thaler**	**Value of funds invested March 2003 (£ million) (estimate)**
Premium Bonds	●				19,677
Savings Certificates	●			●	16,989
Income Bonds	●			●	8,612
Investment Accounts	●				7,214
Pensioner Guaranteed Income Bonds	●			●	3,982
Ordinary Accounts	●				1,374
Capital Bonds[1]	●			●	1,293
Childrens' Bonus Bonds	●				1,228
Individual Savings Account		●		●	1,190
Fixed Rate Savings Bonds		●		●	624
First Option Bonds	●		●	●	338
Guaranteed Equity Bond		●		●	317
Treasurers Accounts	●				65
Tessa[2]		●		●	37
Yearly Plan[3]					29
SAYE[4]					13
Deposit Bonds[5]					6
TOTAL FUNDS INVESTED					**£62,998 million**

** Still hold a residue of un-redeemable funds where NS&I has been unable to effect repayment as NS&I has lost contact with customers.*

1 *Sales of Capital Bonds made from February 2003 are administered on Thaler. Sales made prior to February 2003 are still administered on a legacy system.*
2 *NS&I have never administered Tessas but do allow customers with maturing Tessas from other organisations to invest those funds into Tessa ISAs for up to 6 months following maturity. The last Tessas are dated Spring 1999 for maturity in Spring 2004.*
3 *The last agreements started in 1995 with final monthly payments and certificates issued in 1996. The last certificates matured in 2001.*
4 *The last contracts started in 1994/95 and last payments made in 2001/02.*
5 *The last bonds were sold in November 1988 – a full redemption exercise took place in June 2002.*

Appendix 6 The Rebate Mechanism

This table presents a brief overview of the rebate mechanism. Under the terms of the contract, NS&I could be entitled to a rebate at the end of each contract year. There are six areas which could lead to a rebate being made. These are detailed below.

Rebate Category	Description
Volume of transactions	If the number of transactions fall below a specified minimum level, then a repayment occurs for each transaction below the level. The number of transactions carried out via the Post Office in relation to Ordinary and Investment Accounts are not included in the count for the purposes of calculating any rebate due
New Product Development	The monthly fee includes allowance for a set number of new NS&I products – four in years 1 and 2, two thereafter. If NS&I chooses not to take up the full allocation of new NS&I products then a full rebate of the funds for the unused product(s) becomes due. Similarly if the total costs incurred in developing the products is less than the budgeted allocation for the number of products developed then NS&I get fifty per cent of the savings versus budget
SBS Profit Margin	If the SBS profit margin percentage exceeds the amount specified in the contract then fifty per cent of the excess is returned to NS&I
Accommodation	If SBS makes savings against the agreed accommodation costs then NS&I shares in fifty per cent of the saving. Also, if SBS are able to let surplus space to third parties then NS&I receives 50 per cent of the rent receipts less SBS's letting expenses. In addition if the said rent covers space already charged as part of the fee to NS&I then the proportion of the fee covering the space let by SBS is returned in full
Third party business	For third party business profit that is related to the NS&I activities a proportion (percentage to be agreed at the time) will be shared with NS&I
Severance costs	The agreement specifies target severance numbers and associated costs. NS&I shares 70 per cent of any savings SBS make against the expected total over the first three contract years. This was only assessed at the end of the third contract year and as SBS had not saved any money, NS&I did not receive a rebate

Appendix 7

Definitions and cost liabilities of product and channels

<table>
<tr><th>Area</th><th>Definitition</th><th>Cost Liabilities</th></tr>
<tr><td>Product Variations</td><td>Includes interest rate changes, changes in minimum or maximum holdings, changes to eligibility of product holders, changes to rollover or penalty repayments</td><td>SBS bears all costs</td></tr>
<tr><td>Channel Variations</td><td>Includes, for example, changes to call centre script that is made available to customers via the telephone</td><td>No charge to NS&I</td></tr>
<tr><td>Product Enhancements</td><td>Anything which is not a new NS&I product but the change is too significant for it to be considered a product variation. For example changes in the way interest rates are applied to products, introduction of new or enhanced product features such as initial introduction of variable terms for products</td><td rowspan="2">Up to £300,000 – unitary charge (SBS liability)

Between £300,000-£600,000 – liability shared equally between NS&I and SBS

Costs over £600,000 as below for new products and channels</td></tr>
<tr><td>Channel Enhancements</td><td>Anything which is not a new NS&I channel but the change is too significant for it to be considered a channel variation. For example enhancing the functionality of an existing channel such as telephony whereby customers can select services by keying in a number to be routed to appropriate operator.</td></tr>
<tr><td>New Products</td><td>A new product to be issued by or on behalf of the Director which is not an NS&I Product or a Fundamentally Different Product*, including for the avoidance of doubt Statement Based Savings Accounts and Fixed Rate Savings Bonds (FRSBs)</td><td rowspan="2">Up to £600,000 unitary charge (SBS liability)

Between £600,000-£1 million – SBS liability

Between £1 million and £1.8 million – NS&I and SBS share liability equally</td></tr>
<tr><td>New Channels</td><td>A new method by which a Customer or New Customer (as the case may be) may contact NS&I which is not an NS&I Channel or an FD Channel* and, for the avoidance of doubt, but without limitation, includes the Internet Channel and the IFA Support Channel</td></tr>
</table>

A Fundamentally Different Product means any new product, which is not an NS Product, proposed by NS&I where the skills involved or the costs that would be incurred by SBS in developing, implementing or operating the infrastructure necessary to sell and administer the product are fundamentally different from the skills and costs necessary to develop, implement or operate the infrastructure necessary to sell and administer any existing NS&I products.

A Fundamentally Different Channel means any proposed new means which is not an NS&I Channel by which a Customer or New Customer may contact NS&I where the skills involved or the costs incurred by SBS in developing, implementing or operating the infrastructure necessary to enable the use of such means are fundamentally different from the skills involved or the costs that would be incurred by SBS to develop, implement or operate the infrastructure to enable the use of any of the existing means by which a Customer may contact NS&I.