

## ROYAL MAIL HOLDINGS plc BOARD

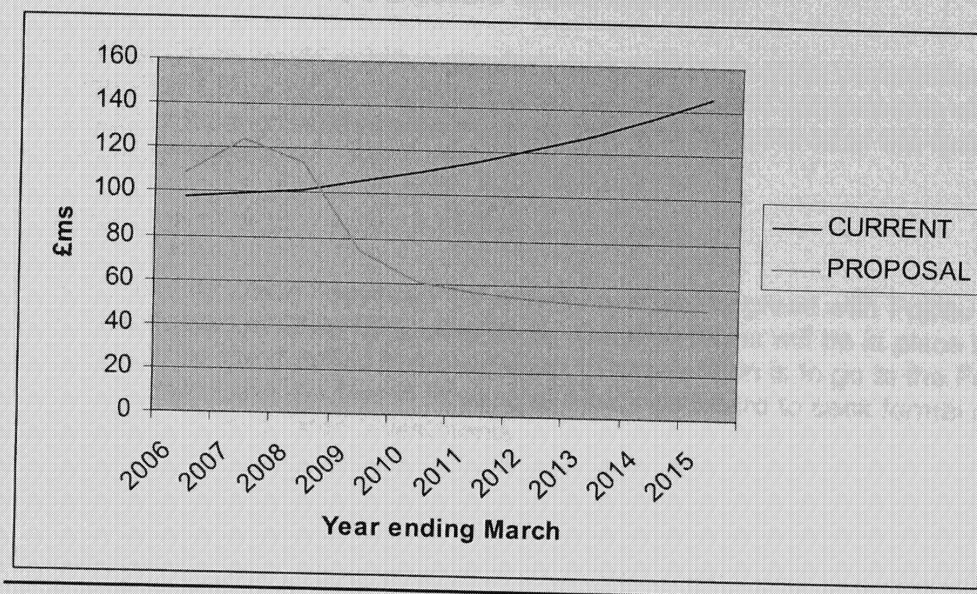
RMH(06)09

**EXTENSION OF HORIZON SERVICES CONTRACT INCLUDING SYSTEM  
REPLACEMENT****Background**

- 1 It is essential that Post Office Limited achieves significant reductions in IT costs if it is to return the business to sustainable profitability. The major opportunity to do this resides with the Horizon system that is provided by Fujitsu Services under a contract that runs through to March 2010.
- 2 Fujitsu Services proposed a major investment in application, branch and data centre hardware which would simplify the solution enabling significant reductions in recurring operating costs on the basis that the term of the existing contract was extended to March 2015. However, this proposition gave a gentle upward increase in operating costs once the benefits of the upfront investment had been realised.
- 3 Post Office Limited concluded that if it was to achieve a contract that delivered year on year cost reductions then it would need to contract on a radically different basis. Post Office Limited has negotiated the basis of a deal with Fujitsu that closely mirrors what it believes would be achievable by going to open market.

**The proposition**

- 4 Is to extend the contract with Fujitsu Services through to March 2015 but on radically changed terms. Under the proposed new contract
  - Savings will be generated of over £0.5billion compare to the existing terms once the initial period of investment has concluded. This is underpinned by both parties agreeing to "strive" to achieve year on year cost reductions through out the contract period.



- Existing assets are "sweated" in order to minimise investment in line with normal retail practices. Together with earlier realisation of some benefits this means that during the investment period as much as £100m less cash outflow will be involved than under Fujitsu's original proposal



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- Post Office gains control of architectural direction and high level design ensuring that direction is driven by Post Office service and cost reduction as opposed to Fujitsu revenue generation and margin protection.
- Gives improved service availability in branches
- The service will be unbundled into a number of components each of which can be tested in the open market. This will typically involved benchmarking giving Fujitsu the option to match the benchmark or go to open competition.
- Creates a Systems Integration Partnership under which Fujitsu will embed skilled resource at cost into the Post Office IT team. Fujitsu will be rewarded on the basis of achieved benefits and the embedded staff personal bonuses will be aligned to Post Office Limited IT performance

**Options**

5 There are a number of options which include do nothing and wait to compete the contract at the end of the current term. None of these options generate the savings required within the necessary timescale.

6 Termination of the existing contract, at a cost of circa £80m, would enable disaggregation of the services in order to procure from best of breed. This might deliver lower steady state costs. However, this would be at considerably increased risk and take longer to deliver.

7 The Gartner Group have benchmarked proposals from Fujitsu which has enabled Post Office Limited to form a view of what it might expect to achieve by going to the market. Post Office Limited firmly believe that the speculative additional savings that might be achieved through open competition do not justify the increased risk.

**Risk**

8 As with any major IT investment there are risks around time, cost and quality. Post Office Limited and Fujitsu Services have now delivered ten major releases of software to time cost and quality. Cost reduction will require investment and doing this through the existing relationship presents the least risk route. Additionally a series of caps and collars are in place that limits Post Office Limited's exposure to cost over runs.

9 The risk that Post Office would achieve greater savings through open competition is mitigated through Post Office Limited right to market test unbundled components of the contract. This market testing could enable the Post Office to compete all of the existing contract over a period of time.

**Current Position**

10 All the major principle areas necessary for a deal have been agreed with Fujitsu and these have been endorsed at Chief Executive level. Detailed terms will be in place by March and work is underway on the detailed business case. The intention is to go to the February Post Office Limited Board and the March Royal Mail Holdings Board to seek formal approval for the new contract and associated investments.

**Recommendation**

11 The Board is asked to note the progress made by Post Office Limited in pursuit of significant IT cost reduction.

David Miller  
January 2006