RMH(06)53

ROYAL MAIL HOLDINGS plc BOARD

REPLACEMENT OF HORIZON

Executive Summary

1. Purpose of Paper

The purpose of this paper is to request RM Holdings Board approval in principle for the replacement of the Post Office Ltd's Horizon Electronic Point of Sale system, subject to securing long term funding. Approval of £25m interim funding is requested in order to enable the programme to be continued. Any delay in this programme will result in c £44m of irrecoverable benefits being foregone over the course of the existing Horizon contract.

Background

2. Horizon has been in use in Post Office Ltd (POL) since 1998. It was developed, and has subsequently been maintained, by Fujitsu Services. In 2002 the original contract term was extended to March 2010 in exchange for significant cost reductions. However, Horizon remains expensive to operate and change, and lacks the agility essential to respond to the ever changing marketplace. In 05/06 it cost £96m (c.8.7% of turnover) and without this investment the cost as a percentage of turnover will continue to rise as costs increase and revenues fall.

3. One of the biggest opportunities POL has to enhance profitability is by reducing the costs of the Horizon system. A new deal has been negotiated with Fujitsu Services that delivers significant cost savings on more favourable terms, in return for an investment in new IT infrastructure and an extension to their contract until March 2015. None of the other options considered (including a competitive procurement) provide similar benefits.

Benefits

4. For an investment of £127m the proposed new deal delivers an incremental post tax NPV of c.£90m over continuing with the current system / contract until 2015. The scheme generates an IRR of c.39% and pays back in 4.5 years.

5. The Fujitsu supplied Horizon replacement represents the least cost option of all those reviewed. The key drivers of the incremental NPV are: upgrading of the application software and data centre systems to enable lower cost telecommunications links, reduced maintenance and upgrade costs and the ability to use the pre-paid element of the existing contract to fund the development of the replacement system.

6. Annual operating cost reductions, compared to existing contract terms, are circa £8m pa in 06, rising to c.£60m pa by the end of the contract, as set out in Appendix 1. These benefits are contractually locked in and are therefore guaranteed. The percentage of variability in operating costs to cater for changes in POL business needs is also increased from 23% to 50%.

7. The new technical architecture gives the flexibility required to evolve the size and shape of the network, and it will be quicker and cheaper to change.

8. Fujitsu have agreed a number of incentives that will ensure that they continue to deliver the benefits of emerging technologies and new industry practices. Provisions for market testing mean that should these incentives fail, then the POL has a clear route through to competitive industry costs, quality and practices. These potential benefits have not been included in this case.

Why do it now?

9. There are compelling reasons to do this now and to maintain the programme on an interim funding arrangement pending the long term funding deal:

   i. A delay of six months will result in a re-deployment of the Fujitsu and POL project teams and a failure to meet key milestones for data centre migration, resulting in a 12 month delay to the programme. In addition we will not be able to use and, thus will lose, the benefit of £5m of pre-paid services from Fujitsu under the current contract this year.

   This will worsen the P&L by £44m in the plan period as follows:

Impact £m	06/07	07/08	08/09	09/10	10/11	Total
Lost benefits & increased costs	(9)	1	(8)	(26)	(2)	(44)

   This represents the difference between Table 16 and Table 17 in Appendix 1

   ii. Further, the balance of negotiating power will have switched to Fujitsu as we go beyond the time at which it is theoretically feasible to run a competition, select an alternative supplier, develop and roll out a replacement system in time to meet the end of the current contract in March 2010. At best this would mean an extension of the current contract on its unfavourable terms and cost, at worst Fujitsu could significantly increase the annual charges for any extension which we would have to pay.

Recommendations

10. Approval of the Business Case (POL funded model – table 16) and agreement to entering into a revised contract with Fujitsu Services, subject to funding issues being resolved.

11. Approval of early release of up to £25m of capital (in addition to the £10m already approved) from the overall submission to enable the continued development of the Horizon replacement system to allow the cost savings in the POL business case to be maintained.

12. Approval for Post Office Limited to conclude detailed contract negotiations with Fujitsu in line with the business case financials. Post Office Limited will only proceed to full contract once funding has been resolved. POL request that authority be delegated to the order of the Investment Committee to sign the contract at that stage.

Alan Cook
April 2006

Appendix 1 – Financials

13. For an investment of £127m the proposed new deal delivers an incremental post tax NPV of c.£90m over continuing with the current system / contract until 2015. The scheme generates an IRR of c.39% and pays back in 4.5 years.

14. The proposed Fujitsu deal offers a replacement system at a significantly lower cost than any of the other available options.

15. The incremental P&L impact is:

Assuming the project cost is funded over an extended period (Managed service):

£ Millions	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15
Current Contract (Extended) Group PBIT	(96)	(97)	(98)	(101)	(105)	(109)	(114)	(119)	(125)
HNG (Financed as Managed Service)* Group PBIT	(87)	(89)	(99)	(73)	(68)	(67)	(67)	(68)	(68)
HNG Managed Service Compared with Current Inc. Group PBIT	8	7	(0)	28	37	41	46	51	57

*This includes a financing charge of £38m at a rate of 7.5% per annum and assumes we can get third party funding via Fujitsu. This may require an RMG or DTI guarantee.

16. **Assuming the project cost is funded by POL:**

£ Millions	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15
Current Contract (Extended) Group PBIT	(96)	(97)	(98)	(101)	(105)	(109)	(114)	(119)	(125)
HNG (POL Funded) Group PBIT	(87)	(89)	(92)	(66)	(61)	(61)	(60)	(61)	(61)
HNG Compared With Current Inc. Group PBIT	8	7	6	35	44	48	53	58	64

All numbers are quoted in £ millions

17. **Impact of a 1 year delay in implementation (Project cost funded by POL)**

£millions	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15
Current contract	(96)	(97)	(98)	(101)	(105)	(109)	(114)	(119)	(125)
HNG (POL funded) group PBIT	(97)	(89)	(100)	(92)	(63)	(63)	(63)	(62)	(63)
HNG compared with current PBIT	(1)	8	(2)	9	42	46	51	57	62