RMH(06)85

ROYAL MAIL HOLDINGS plc BOARD

POST OFFICE LIMITED – REPLACEMENT OF HORIZON

Division	POL	**Investment Class**	Replacement
Sponsor	Alan Cook	**Letters Plan Class**	N/A
Project Lead	Ian O'Driscoll	**Letters Plan Ref**	N/A
Source of Funds	RMG		

	Total	**OPEX**	**CAPEX**	**Cap Lease**
Request	£127.6m	£35.0m	£92.6m	-
	NPV	**IRR**	**Pay Back**	**PV/I***
Economics - Self Funded	£89.3m	39.3%	4.5 years	1.87

* PV/I is the present value of the projects cash flows as a multiple of the investment

Executive Summary

1. On 27th April 2006 the RM Holdings Board approved Post Office Limited's (POL) plan to conclude contract negotiations with Fujitsu with regard to the replacement of the Horizon Electronic Point of Sale system and authorised additional interim funding of £25m (GIA REF: 200603/11) to take the total authorised spend to date to £35m.The purpose of this further paper is to request full authority to sign the contract.

2. Delegated authority is requested to enable the Managing Director of POL to sign the contract, subject to satisfactory conclusion of final negotiations with Fujitsu.

Background

3. The new contract delivers significant cost reductions from 2009 onwards – in excess of £40m per annum – and is a significant part of the cost reduction programme included in the POL Strategic Plan. There is a 3-year lead-time to implement the changes required and we therefore need to conclude a new deal with Fujitsu sufficiently ahead of the current contract expiry in March 2010.

4. The benefits of the revised contract will be delivered by applying the latest technology to the Horizon system to significantly reduce the ongoing running costs and increase the variable element of the cost base. The new contract is future proofed by providing for technology to be updated over the term and benchmarked against alternatives, with an option to market test each service strand should they be out of line.

5. The revised contract, negotiation of which has been conducted under the advice of Slaughter & May and will be finalised in conjunction with Group Counsel and Group Procurement, reflects the deal as set out in the previous submission to the Board with no material changes save for the inclusion of a conditionality clause, which would allow POL to revert to the old contract by 28th February 2007 if the POL long term funding deal is not concluded at that point. The new contract also includes the right to terminate with 12 months notice and the payment of cancellation penalties. During the period in which the long term funding still needs to be achieved, the penalties incurred are not materially different to the existing contract (cf Paragraph 10).

6. Although POL is dependent on securing a further funding deal from Government to enable it to continue trading as a going concern, the timing of signing this contract

does not prejudice those negotiations or the interests of creditors as the new deal includes appropriate termination options in the event that adequate Government funding is not secured.

Key Issues

7. There are 3 key issues relating to the funding of the new contract and IT development. These are:

   I) extension of the contract term from current 2010 to 2015

   II) availability of capital to fund the development costs

   III) what happens in the event that we do not secure long term funding in December 2006.

   These issues are dealt with in turn below.

8. POL will be extending the term by 5 years from the current expiry date of March 2010. However, as the new contract includes the right to terminate with 12 months notice it has been possible to construct it so as to ensure that the total cumulative non-cancellable commitments are not significantly greater than under the existing contract – even after taking account of capital expenditure and termination penalties – for the next three years. This applies to all years except 2010 when the old contract can be cancelled without penalty. In 2010 the difference in termination penalties between contracts is c.£67m, before taking into account the £53m operating cost saving generated by the new contract. Should we continue trading beyond 2010/11 the incremental benefits of the new contract are greater than the termination penalties. Therefore overall we are satisfied that POL is not taking on additional material commitments that might prejudice the interests of its creditors.

9. The current funding arrangements provide enough cash to pay for the £35m investment in 2006/07 already authorised and £32m proposed in 2007/08. Under all scenarios POL needs a further funding deal from Government by December 2006 to enable it to continue trading on a business as usual basis and any such funding deal would also need to include Horizon development costs from April 2008 onwards.

10. In the event that we do not secure a long term funding deal and we are forced to shut down the network and cancel the contract, the total termination costs (including a 12-month notice period) would be as follows:

	06/07	07/08
Current Contract	(127)	(113)
Revised Contract	(129)	(102)
Incremental Benefit / (Cost)	(2)	11

All numbers in £ millions

11. The above table assumes that upon signing a new contract we commit a further £15m of investment for the initial part of 2007/08 and excludes any system run down costs.

12. If the response to the absence of funding were to radically shrink the network, to say 4,000 outlets, the Horizon system would still be needed to operate it and the new contract would still be the most cost effective way of doing so.

Why do we need to sign the contract now?

13. Under normal circumstances we would not consider extending contractual commitments until a long term funding solution is in place. However, we believe that this contract is an exception for the following reasons:

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14. There is a 3 year lead time to replace or upgrade the current system to achieve cost reductions and this is likely to be longer with an alternative supplier - with whom the savings would need to be even greater to offset the migration costs and the delay in the benefits coming on-stream.

15. Fujitsu will seek to reduce the favourable terms the closer we get to the expiry of the current deal as they will know that we will have no option remaining - so we want to lock them into the reduced cost terms now, including operating cost benefits for 2006/07 of £8m (included in the POL budget), whilst we still have the bargaining power to do so.

16. Should we sign the new contract and subsequently need to terminate the cumulative total financial exposure, including termination penalties, is equal to or less than the current contract in all years apart from 2010 when the existing contract is due to end and there are no termination penalties. Should POL wish to continue past 2010 then the lower costs of the new contract would outweigh the lower termination costs of the existing contract.

Financials

17. The financial benefits are as follows:

For an investment of £127.6m the new deal delivers an incremental post tax NPV of £89.3m over continuing with the current system/contract until 2015. The scheme generates an IRR of 39.3% and pays back in 4.5 years.

18. The Fujitsu supplied Horizon replacement represents the least cost option of all those reviewed.

19. The key terms of the contract are set out in Appendix 1.

£m	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15	Total
Current contract (extended) Group PBIT	(96)	(97)	(98)	(101)	(105)	(109)	(113)	(119)	(125)	(962)
New contract Group PBIT	(87)	(89)	(83)	(57)	(52)	(52)	(51)	(52)	(52)	(576)
PBIT Improvement	8	7	15	44	53	57	62	67	73	386
Capital Incurred to date (Sunk)	(35)									(35)
Exceptional costs (impairment of capital)		(32)	(19)	(6)	-	-	-	-	-	(57)
PBIT and Cash Impact (new vs old)	(27)	(25)	(4)	38	53	57	62	67	73	294
Cumulative PBIT and Cash Impact (new vs old)	(27)	(51)	(55)	(18)	35	92	154	221	294	
Cumulative Impact on a Sunk Cost Basis (new vs old)		(25)	(28)	9	62	119	181	248	320	

The P&L and in year cash impact is:

As £35m of capital has been incurred to date the above table shows the cumulative impact of the new contract on both a full and sunk cost basis.

Investment Appraisal

20. This investment represents a medium to long-term commitment to a company whose short term funding is still to be confirmed. Should a long-term funding deal be secured then the revised contract delivers significant savings over continuing with the current one.

Recommendation

21. The Board is asked to:

- authorise Post Office Limited's plan to conclude negotiations with Fujitsu systems regarding the replacement of the Horizon Electronic Point of Sale system: and
- delegate authority to the Managing Director of POL to sign the contract, subject to satisfactory conclusion of final negotiations with Fujitsu.

Alan Cook
August 2006

Appendix 1 – Key terms of Contract

Reduced Cost Profile
The reduced operating costs are fixed in the contract up to March 2015.

Strive & Gain-share
Fujitsu are incentivised to achieve Strive – i.e. further Horizon operating cost reductions, POL revenue opportunities and reduction in other non-Horizon costs in return for a capped share of the saving or benefit. These are not reflected in this case and would be an additional benefit.

Termination Rights
POL has the right to terminate for convenience at 12 months notice on payment of a penalty equivalent to Fujitsu's lost profit over the term plus rundown costs.

Systems Integration Partnership
Fujitsu are required to provide up to 15 skilled personnel at cost of employment plus access to Fujitsu Group R&D for use by POL during the term of the contract in developing its future IT needs. Fujitsu only achieves recovery of margin on these personnel by way of gain-share for achievement of Strive (see above).

Market Testing
POL has the right to benchmark each service strand at agreed intervals. If any benchmark shows the Fujitsu costs to be too high they must either match the benchmark or submit to competition for the service. Ultimately POL may cancel the service from the contract and use an alternative source.

Flexible pricing
The contract provides a greater level of flexibility to reduce the operating charge if offices, counter positions, transactions and/or services are reduced or removed.

Ownership of Intellectual Property Rights (IPR)
IPR in the new HNG software developed under the contract will vest in POL. POL has the right to secure licences to all other software used under the contract Including Fujitsu background in the event of termination of the contract for any reason. If Fujitsu wishes to exploit the development for other customers it will pay a royalty to POL.

Gain/Risk share on Development
The development of the new application is on a Time & Materials basis. POL has excellent experience with Fujitsu of bringing similar sized developments in on or below budget. However we have added an incentive that provides for Fujitsu to share the benefit of any cost under-run and to contribute significantly to any cost over-run.

Open Book
POL has rights to review Fujitsu costs of operation and development to establish that cost savings have been passed on to POL.

Other
The rights and liabilities of the parties are broadly unchanged from those in the existing contract, including liquidated damages for non-performance and liability for fraud.