RMG(02)122a

Horizon Contract Amendment

Introduction

It is recommended that the Horizon contract is revised and extended to 2010.

1. Post Office Ltd has developed an IT strategy which will:
   - Significantly reduce running costs over time
   - Simplify its business processes
   - Align to its business proposition.

2. There is a target to reduce this year's Horizon spend by £15m with further annual reductions.

3. This is the first of a series of strategic initiatives that will be presented to the Board for approval.

4. Post Office Ltd has carried out a formal market-based assessment of the options for either extending the Horizon contract with Fujitsu Services or undertaking a competitive procurement of a replacement system.

5. After in depth negotiations (with strong competition) from IBM and EDS, Fujitsu Services has produced a compelling proposal when compared with the alternatives.

6. Post Office Ltd has agreed non-binding Heads of Agreement with Fujitsu Services that would extend the Horizon contract till March 2010, resulting in a contract cost reduction of £27m this year with an overall revenue reduction of £165m over the life of the new contract compared to extending the existing agreement.

7. This paper seeks approval to proceed to contract with Fujitsu Services on this basis.

Background

We cannot afford Horizon as it stands.

8. Horizon is Post Office Ltd's core automation system, developed and run by Fujitsu Services (formerly ICL). The system was originally designed for a Benefits Agency project under the PFI in 1996. This was replaced by a standard contract in 1999 which runs to March 2005.

9. Banking was added to the contract in March 2002.

10. The service provided has been good, though expensive to run, and slow and costly to change.

11. Spend on IT is way above industry norms – Horizon is our largest item of IT expenditure (circa £115m p.a.)

The Fujitsu Services Proposal

We gain greater control at reduced costs.

12. Scope of Services:
    - The proposed contract includes the existing Horizon services (including Banking).
    - Fujitsu Services will have the opportunity to bid for new product developments in a competitive environment.
    - Post Office Ltd will be able to exploit new technologies from other business partners. Fujitsu Services will integrate standard 3rd party applications into the Horizon platform.
    - There will be a move to open book costing, making charging more visible. Periodic benchmarking of major services will take place, with prices to be adjusted downwards as appropriate.
    - There will be a move to risk management (rather than avoidance) with associated reduction of Fujitsu Services' liabilities (being reviewed with Group Audit).

13. Operational Service:
    - Help Desk, Maintenance Services and Data Centre operations will be simplified and rationalised. This will result in some reductions in service levels, but in line with normal commercial levels.
    - A new Broadband data communications network (ADSL) will be introduced - besides reducing costs it will provide greater capacity to each branch.

14. Development Service:
    The infrastructure will be simplified to reduce costs and to improve development timescales. There will be a reduction in headcount by approximately 40% over the first 3 years of the new contract. Half of the time of the remaining team will be dedicated to supporting the service, the other half available for new developments at no extra cost.

15. Governance, Risk Management and Ways of Working:
    There will be a more collaborative style of working, based on trust and risk management (rather than avoidance). Post Office Ltd will have control of the strategic direction and framework within which Fujitsu Services will operate. Fujitsu Services will manage the delivery of services within the framework. Fujitsu Services will be encouraged to bring new ideas and opportunities to Post Office Ltd. A clear governance structure will be set up, with a number of joint forums with clear accountabilities between the two companies.

16. Charging Dependencies:
    Key dependencies are:
    - Signing contract with Fujitsu Services (Current year benefits assume agreement by Christmas 2002.)
    - Reducing branch numbers (in line with network re-invention).

17. Further Opportunities:
    The preferred option business case is based on worst-case assumptions in several areas. The total cost in NPV terms (based on an 11% discount rate) of these assumptions is approximately £85m. Careful management of these areas could lead to these costs being reduced by up to NPV £55m.
    To achieve this particular attention will be given to the following:
    - Simplifying end-to-end processes. This will result in a reduction of Fujitsu Services' charge for current services (guaranteed under the terms of the new agreement) plus further internal

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savings in Post Office Ltd. This is a key component of the Post Office Ltd Business Plan. The investment required to do this (circa £30m, of which it is anticipated £14m could be provided from the prepaid capacity in this contract) will be the subject of a further business case.

- Maximising use of the prepaid systems integration capacity under the new agreement
- Introduction of a "lights out" operation at one of the existing data centres.

Additionally, the business case assumes minimum rollout of Broadband in the UK. Further significant reductions are available (up to £3m p.a.) if BT achieves its nationwide plans.

Other Options

Market Test confirms that Fujitsu Services' proposition is competitive and overall much cheaper than moving to a new supplier.

The following options were considered and rejected.

18. Option 1: Do nothing –extend the current contractual terms with Fujitsu Services in 2005.
    This was rejected because:
    - there are no cost reductions until, at the earliest, 2005
    - there is a major risk to business continuity.

19. Option 2: Contract with new suppliers
    A market test was carried out with two of our current major IT suppliers. The solutions they outlined were both technically feasible, and comparable in price.

20. This option was rejected because:
    - costs over the contract life were significantly higher than the Fujitsu Services proposition
    - there were no cost reductions this year
    - there is a major risk to business continuity during any cutover
    - system changes needed to support business plans would be delayed by 2 years.

    See annex A for financial details of options.

Benefits of preferred option

We can afford it within current Business Plan.

21. Financial
    - Yields an NPV (before tax and based on a 11% Test Discount Rate), that is £93m better than option 1 and £60m better than option 2.
    - Significant reductions in annual cash flows achieved (£27m this year).
    - Asset maximisation – the infrastructure will be fully exploited.

22. Non-Financial
    - *Provides IT capability to deliver the Post Office Ltd Business Plan*
      - Commitment to simplify systems
      - Move to a more open architecture
    - *Improves Speed to Market*
      - Faster speed to market due to improved, simplified development processes and a simplified technical architecture.

- *Lowest risk option to business continuity and banking deployment*
  - Builds on current service, no major upheaval
  - Secures banking till 2010 (alignment with government contracts).
- *Current service management and development performance has been good.*
  - Fujitsu services operations proven and to date they have delivered their part of the Banking project on time.

23. Delivering the Benefits.
    - Financial benefits will be delivered through the contract price.
    - Non-Financial benefits achieved through agreed governance model and new Post Office Ltd organisation.

Risks

Some significant changes – needs careful management.

24. Operational
    - Service levels will be reduced to be 'fit for purpose'. These changes will impact postmasters, Head Office staff, and clients, who may see it as a deterioration in service
    - There will be a number of significant business process and technical changes over the next few years that will require careful management.

25. Relationship
    - Post Office Ltd and Fujitsu Services revert to type - new ways of working are not implemented effectively.

Timetable

Post Office Ltd EC	3rd Dec 02
Royal Mail Group Board	16th Dec 02
Contract Signing	20th Dec 02
Contract Implementation	From Jan 03
£17.6m discount	31st Mar 03

Conclusion

26. The Fujitsu Services proposal provides the cost reductions that the business needs. It is significantly cheaper and is a much lower risk than the other options available.

    The Board is asked to agree and authorise the recommendation.

David Mills
December 2002

In Strictest Confidence

Annex A

Analysis of Fujitsu Numbers - inc VAT

Option 1: Current contract costs	2002/03 £m	2003/04 £m	2004/05 £m	2005/06 £m	2006/07 £m	2007/08 £m	2008/09 £m	2009/10 £m	Total £m	NPV
Capital/Balance sheet funded										
Availability fees inc VAT	36.1	36.1	31.6						103.7	
Capital expenditure - Banking	17.7	1.2							18.9	
Capital expenditure - DR Cards	0.5								0.5	
Total capital/balance sheet funding	**54.3**	**37.3**	**31.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**123.1**	
Non recurring revenue/development										
Banking development *	16.4	0.1	2.0	2.0	2.0	2.1	2.2	2.3	29.1	
Debit card	2.6	0.0							2.6	
Total development	**19.0**	**0.1**	**2.0**	**2.0**	**2.0**	**2.1**	**2.2**	**2.3**	**31.7**	
Recurring costs										
Operating payments	99.3	95.9	89.8	92.9	91.3	89.7	89.1	88.4	736.4	
Banking RR	7.4	18.4	19.8	20.5	20.9	21.3	21.8	22.3	152.4	
Committed CCN RR	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.8	
OBC	1.4	2.1	2.1	2.1	2.1	2.1	2.1	2.1	16.1	
Total recurring costs	**108.2**	**116.7**	**111.9**	**115.7**	**114.5**	**113.4**	**113.2**	**113.0**	**906.6**	
Current Contract Costs - ex capital/bal sheet funded	**127.2**	**116.8**	**113.9**	**117.7**	**116.5**	**115.5**	**115.4**	**115.3**	**938.2**	**673.4**
Current Contract Costs - inc capital/bal sheet funded	**181.4**	**154.0**	**145.5**	**117.7**	**116.5**	**115.5**	**115.4**	**115.3**	**1,061.4**	**786.9**

* Assumes write back from balance sheet to P & L relating to 2001/02 accruals

In Strictest Confidence

Option 2 – Contract with new supplier	2002/03 £m	2003/04 £m	2004/05 £m	2005/06 £m	2006/07 £m	2007/08 £m	2008/09 £m	2009/10 £m	Total £m	NPV
Capital/Balance sheet funded										
Availability fees inc VAT	36.1	36.1	31.6						103.7	
Capital expenditure - Banking	17.7	1.2							18.9	
Capital expenditure - DR Cards	0.5								0.5	
Total capital/balance sheet funding	**54.3**	**37.3**	**31.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**123.1**	
Non recurring revenue/development										
Banking development *	16.4	0.1	2.0	2.0	2.0	2.1	2.2	2.3	29.1	
Debit card	2.6	0.0							2.6	
Cost of change/migration to new supplier		0.1	0.4	0.5					1.0	
Total development	**19.0**	**0.2**	**2.4**	**2.5**	**2.0**	**2.1**	**2.2**	**2.3**	**32.7**	
Recurring costs										
Operating payments - To FS	99.3	95.9	89.8						285.0	
Banking RR	7.4	18.4	19.8						45.6	
Operating payments - To New Supplier	0.0	0.0	-5.9	113.8	107.5	101.1	94.8	88.5	499.9	
OBC	1.4	2.1	2.1	2.1	2.1	2.1	2.1	2.1	16.1	
Committed CCN RR	0.1	0.2	0.2							
Total recurring costs	**108.2**	**116.7**	**106.0**	**115.9**	**109.6**	**103.2**	**96.9**	**90.6**	**847.1**	
Current Contract Costs - ex capital/bal sheet funded	**127.2**	**116.9**	**108.4**	**118.4**	**111.6**	**105.3**	**99.1**	**92.9**	**879.8**	**640.8**
Current Contract Costs - inc capital/bal sheet funded	**181.5**	**154.1**	**140.0**	**118.4**	**111.6**	**105.3**	**99.1**	**92.9**	**1,003.0**	**754.3**

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