

Pearson
Professional Contracting Investor Seminar
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Marjorie Scardino
Chief Executive

Marjorie Scardino: Introduction

Thank you for coming today, and welcome. I want to especially welcome Terry Burns, who is that man way back in the corner, because he's obviously planning to duck out early. Terry is a member of our board, and in fact he is now our Senior Independent Director. He's wondering what that means, but all of you certainly should, if you get a chance, say hello to him and tell him anything you want to tell him. Whatever you're supposed to tell a Senior Independent Director.

But he's here, like you are, to talk about the business. Just one piece of happy news before we start. A lot of you have asked us about Peter Jovanovich. Peter has made very, very good progress in his health, and June 2nd he'll be back to work. He's going to phase in gradually, though knowing Peter, he really doesn't understand the 'gradual' word. But we're helping him with that. I just wanted to use this opportunity to tell you that and to thank you. Many of you sent him and us good wishes for his recovery, and he really appreciated that. That really helped out.

This is another one in our series of seminars, to help you get under the bonnet, the hood of Pearson, and to know us a little bit better. Today's topic is one that many of you have asked for. It's about our professional and government contracting business. We call it Government Solutions and Professional Testing.

It's a very exciting business, for a lot of reasons you'll hear about today. It's small now, though, just to emphasise that. It's around 6 per cent of the total revenues of Pearson. Together it's about \$400m, the part we're going to talk about today. That's about half of the total that you see under our 'Professional' classification in our results. The rest of that is our technology publishing, which is about a quarter, and our scanner business.

Our goal today is educational. It is not meant to be a detailed financial presentation, to really help you with your spreadsheets. We always want to help, but it's really about broad education about how the businesses work. It's also to introduce you to more of our people, and we've got a couple of them here who are going to be the ones who talk to you today. Because they're the ones who lead these two businesses.

Clive Hay-Smith is the former CEO of our worldwide school testing business. As our testing opportunities began to increase around the world and in professional, Clive came back. He's from the UK, so he came back home to lead the UK School Testing business, which we're not going to talk about today, and to lead our burgeoning Professional Testing business, which we will talk about.

The Professional Testing business is about a \$100m business, for which we won about \$600m of new contracts in 2003. So he'll talk about that. And the other person we've got here is Mac Curtis, who had just taken over running the Government Solutions business when we bought NCS four years ago. Mac doesn't totally agree, but I think the conjunction of Pearson and Mac together has

caused this business to triple over those last four years. We think that kind of growth is definitely going to continue.

Before I hand over to them, I'd like to just highlight a few of the themes that I hope you would take away today, and that make clear why these businesses are a very important part of Pearson's plans for the future, and certainly an important part of our growth program.

First they're very strong and scaleable businesses. Both are growing rapidly, organically. Over the past five years they have tripled their sales. Last year together they grew about 40 per cent, and that was at the same time they were winning about \$800m in new contracts to help our future.

They're growing inherently because we have been taking market share from our competitors, as we've won customers and contracts away from them. We are a relatively new entrant into the Professional Testing business, and yet we've taken significant share from our major competitor. Clive will talk about that. In Government Solutions we are also outpacing the market growth, particularly for our niche, which is the end-to-end solutions approach.

Secondly, they are scaleable and strong because our approach and our business model is very replicable. We're inside customers' front offices. We are intimate with their needs. Our systems connect people and technology and processes in ways that are very rigorous and have multiple applications. So these help us replicate our businesses in all kind of customer situations and in all kinds of countries.

The second theme that I hope you're going to hear is that they are great growth businesses, because they are in great growth markets. There are many reasons to remain confident about how these markets are going to continue to grow. Just a few of them are demographics. Demographics are driving growth in government, they're driving growth in professions. By that I mean demographics like older populations: people retiring and being more interested in their pensions and more interested in healthcare. These drive government solutions because government has to give information about these things.

More people in further education drives professional testing. It drives student loan programs, like we are the biggest supplier in. More immigration: more of an immigrant society in the developed world drives information about citizenship. All of those kinds of demographic changes are very important to these businesses.

Secondly changes in the regulatory environment. We really watch this, and we try to help businesses comply. We try to help professionals comply. Skills training and certification. As we become more of a knowledge and service economy, obviously people are looking for training and employees are looking for certification that they've got that training.

The shift from paper to screens is a very big item in driving the growth of these businesses, and we'll talk more about that.

Then, of course, outsourcing of public sector tasks and jobs to the private sector, in order to achieve more efficiency and better service. That's already happening. It's been happening for a while, but it's certainly accelerating, particularly in the US.

The third thing that we're going to talk about today is the very appealing financial characteristics of these businesses. They have predictable revenues. We like predictable revenues, and you do too. In both the businesses we start any given year with about 75 per cent of the budgeted revenues already under contract. Many of our contracts give us decent visibility for five to 10 years out. That's a very attractive attribute.

If we add our School Testing and Software business and IDC, our Data Analysis business, today 22 per cent of Pearson's revenues are contracted-for revenues compared with 6 per cent five years ago. So that really increases the certainty of our total revenue base.

It is important to emphasise that our aim in these businesses, the ones we're talking about today, has been steady growth trajectories. We have had some big one-off contracts in Mac's business. I

know you'll want to talk about some of those. That would have been the US Census, the TSA contract. But those businesses have been up-sides for us. We still see the same growth trajectory in those businesses, and one-off contracts will continue to happen. At least we hope they will. But they won't be a part of our plans for what that steady growth trajectory is.

So there are high growth rates within this business, higher growth rates than in our publishing business, though at somewhat lower margins.

Thirdly, attractive cash and working capital are characteristic. You know this is a focus for all of Pearson now. These businesses have very good payment terms. They're very cash generative. They don't have inventories, advances or royalties, and so they don't use much working capital.

Only the Professional Testing business is much of a user of capital, though not at the level of the book businesses. It repays that with higher margins as the contracts ramp up. It takes a while for them to ramp up. But as they do you see that, in fact, the Professional Testing business is a \$100m business, with those \$600m in new contracts. It will take a couple of years as we invest in that business moderately for those contracts to come through and the throughput to grow enough to produce the margins that it can produce. But that is a very good business.

Finally, one of the themes that I hope you see from this presentation is the benefit these businesses get from Pearson, and the benefit they give to Pearson. They are a natural extension of, and in fact both of them grew out of our School Testing business. School Testing is about large-scale data management. It's about collecting data, whether it comes from a test or whether it comes from a call centre or a customer application. It's about analysing that and reporting out that data. That's still what the School Testing business is about, and that's what these businesses do as well.

Secondly, These businesses gain from the skill of Pearson, from the name of Pearson and from the content of Pearson. Our good name and breadth and reputation certainly helps them get contracts, helps them compete with larger organisations. Our public reputation, which is garnered by our understanding of our public responsibility in education and our educational content, and testing skills and training skills, helps them because they can take those assets and make contracts out of them that many of their competitors don't know how to do or would need a subcontractor to do.

Finally, they contribute to Pearson's ability to provide services. We're not going to talk about this very much today, because we have so much to say, but I think you will have heard us talk before about how important the marriage of content and services is to us. It's a differentiator of our content that we think it's important to apply services to that content as well. These businesses help us be aware of those possibilities and help us achieve some of them.

Possibly most importantly, they give Pearson access to the more attractive, as I've outlined, more cash generative, and higher return characteristics of the service sector.

So I hope you've taken away all of those themes. I know that Clive and Mac will echo those, and I'm going to turn over to them now. Then we'll come back and answer all your questions, I hope.

Clive Hay-Smith
President, Professional Testing

Clive Hay-Smith

Thank you Marjorie. Like Mac, I'm also an ex-NCSer. Since that time I've been responsible for businesses in the US, and as Marjorie said, I'm now back here in the UK. What I want to talk about today is our professional business. I'm also responsible for the Edexcel schools business, which has just started the UK cycle of testing. So if I look a bit tense, it's because we're in that cycle and will be through September.

Marjorie Scardino

But we're also confident!

Clive Hay-Smith

We're absolutely confident.

I want to talk about a very exciting part of our business: the professional testing side. I probably will leap right in, because most people don't actually know what this is and what we do. This business has actually only been in operation since the mid-1990s. So it's a very new business. We started focusing on the IT side.

Most of the names you see there, you'll recognise, Microsoft being a case in point. What we do for those type of clients, which we call sponsor clients, is provide a global testing infrastructure whereby candidates who, for example, have taken a Microsoft engineering course, can be certified. Microsoft clearly is delivering these tests or wants us to deliver these tests all over the world. They need to be secure. Candidates need to be able to go and register, go and sit that test, pay for that test, get their results. And that information needs to be held back at Microsoft, so they can be sure that somebody who says they're a Microsoft engineer has indeed sat an examination, passed it, and has been validated.

So we provide the infrastructure to enable that to happen. We don't own the content. We handle the registration and the delivery of the tests.

Those types of relationships, which we started in the 1990s, have continued. All those clients are still with us. In fact, today we're going to announce that Microsoft has extended its relationship with us for a further three years, which is about a \$40m-plus contract.

So we're building on the strengths of the expertise that we built in IT, and as a logical extension of those capabilities we've started adding professional clients. I'm going to give you a couple of examples of those as we go through. Some of them you may be familiar with.

The one I'll cite is the nurses' contract. You'll see it there as NCSBN, often referred to as the NCLEX contract, whereby anybody who wants to operate as a nurse within US territories – that includes mainstream North America as well as the protectorates – needs to go through a very comprehensive testing program. Now in this particular case we did a bit more than just deliver the infrastructure. We also helped develop those tests as well as deliver them.

So nurses or nurse candidates come into centres. There are 200 of them across the US, and in places like Puerto Rico and Guam. All of them are running on our network, in real time. They sit, do the test. We upload, we will give them their results, and we'll make sure that their data is well protected.

They're very complex programs, very large-scale, and they require a lot of skills and a lot of utilisation of technology.

We had a very busy last part of 2003, where we quickly won two contracts in quick succession, as I'll show you in just a minute, though, although these contracts come fast, the work that's gone into getting them takes some time. And in fact implementation also takes a bit of planning.

The DSA, which is the Driving Standards Agency here in the UK, is the largest contract of its type. It's the delivery of the driver theory test, which I suspect many in this room, myself included, have never taken. This theory test was brought in about five years ago. It involves multiple choice as well as video-streamed theory, the hazard perception test. So it's very complex. That's going to be rolled out in September of this year. We won that in the latter part of 2003, so there's been quite a fast implementation.

In parallel we also won GMAC. Any of you who are familiar with graduate management programs, the MBA programs that are run across US schools, you will have had to sit a GMAT. This is

delivered globally, and we will be rolling this program out in 2006. So work's going on to make sure that we plan that program and have the infrastructure in place.

So long-term relationships, and as we move more into the professional space, longer-term contracts. We've had pretty strong sales growth. Much of what we're doing now is in the Professional space. We still have an increasing market share in our IT space. But obviously the IT area has been impacted somewhat over the last few years by the general slow-down. We had already moved to do more professional work, and so we've kept a fair clip of growth and are confident about continuing it.

TSA, which my colleague was heavily involved in. I supported the TSA work through the delivery of tests through specially set up centres across the US. Although it was a very lucrative contract for us, it didn't actually stop our underlying growth, and we are continuing, as I said, to grow the business very nicely.

This is a rapidly growing market. What's sort of driving that growth? First of all we're living in a world of increasing regulation. I probably don't have to tell anybody in this room that. Tests are being mandated. Those of you certainly in the financial services arena will have seen more and more accreditation and certification becoming a required mandate. It's not unique to this industry. We see others: the healthcare industry, even parts of government. And that's likely to continue. There's a general shift from paper-based testing, which of course our roots have been in. We're very familiar with what's happening in the paper-based world. And as that evolves, the requirements come to deliver tests globally, more quickly, and more securely, then that's in itself driving computer-based testing, or CBT as we call it.

Now this needs to be done in very highly secure environments. This isn't about having a nice little piece of technology and applying that technology to deliver a few tests. Clients are looking for a highly robust infrastructure. They're looking for a highly secure infrastructure. And they're looking for protection of data. These are all core skills that Pearson has.

They're also looking for additional functionality features. Depending on which markets and which professions we're dealing with, the type of questions that we develop, they don't want to see just simple black-and-white multiple-choice questions. They want to see richer question types. I reference the DSA, the Driving Standards Agency, which is delivering the Driving Theory test. That's a video-based test. And we'll see continuing enhancements of those types of tests across all professions.

That in itself gives issues around delivery, and making sure that those are delivered securely. You don't want people sitting on their laptops downloading these tests and taking them off to their friends. It's really important that we're able to deliver both robust solutions, being innovative as well as continuing our secure approach.

It's a very rapidly growing business. Today, based on our roots in IT certification, which we continue to both deliver and expand, our professional licensure business, which has been a source of much growth, particularly in the last 12-24 months. This is further enhanced by our areas such as the academic arena, GMAT being a case in point, the largest academic program of its type in the world. And the driving license system, the DSA, is taking all the skills that we've traditionally delivered in our Professional area and rolling those out across 150 centres here in the UK. And again, it's the largest contract of its type in Europe.

In the future we see more opportunity. We're going to be focused. We're not out picking up any type of business that's there. We're very focused on what we do and where we do it. These are complex programs.

In the distance learning arena we see a natural extension not only for doing testing, but people want to see support materials being delivered to them electronically. Clearly this is an area where the Pearson parent is able to offer a lot of skill and experience.

In terms of the regulatory framework, that's being driven both at state level and local level. The EU has just been expanded in the last couple of weeks by further member countries, and with that comes a whole raft of requirements, for example around driving tests. I don't know if any of you have recently experienced driving in Poland, which has one of the highest death rates in the whole of Europe, but they are going to mandate tests and are going to make sure that they follow some of the excellent work that's been done here in the UK.

For corporate HR selection, this is a type of work that we started doing with TSA, and we've continued that in other parts of our business. We're involved in not only helping people screen candidates and making sure they're certified, but actually making sure they're fit for purpose. You don't particularly want a driving instructor who's going to be delivering tests to be of a nature where he may get fairly flabbergasted if the person doesn't pass the test or drive particularly well. So there is going to be a degree of screening that's going to go on, and we have the tools available to help that happen. This is also about ongoing development of staff.

The last area is one which Pearson clearly has a formidable reputation in: our English-language capabilities. If you're in a situation where you've got professionals, particularly where there's more global movement of professionals, you want to be very sure that they are using the language of choice. Increasingly English is being used as the language of choice. You don't want a situation, as has occurred here in the UK, where nurses – not something that we're delivering by the way, but something we see as an opportunity – nurses who come into the country very, very medically proficient, but unfortunately can't speak the language. That causes all sorts of challenges.

So we see a further enhancement here in terms of just broadening skills of individual candidates, and we're well placed to respond to that.

Why are we winning? This isn't about having the neatest, cutest technology. It's about having technology which is robust, that you can enhance, and is supported by services. These are the kind of things that we do in the background. I mentioned test development. Most professions now are looking to us to help them with the development of their capability, not only in terms of coming up with those tests but how we deliver it. How we make sure we've got set item types which are more interactive? How do we make sure that we are doing that in a secure way? And how are we delivering those reports to both the sponsor client and to the candidate?

These are very complex programs, and the kind of work that we're being asked to do by clients is ever-expanding. We see opportunity, as I mentioned, in our publishing side as well, which I haven't even put on here as yet, as clients look for us to help them with candidate support materials.

So these are complex programs, a very broad set of capabilities. Technology is the bedrock of it, but you've got to have a whole bunch of program management skills around there as well. As part of our technology solution, we have testing centres, including a number of our own, and we also utilise third parties.

In our own centres, we are increasingly using biometric technology. Some people understand what that means. Others don't. We can securely test a candidate. We can also make sure that candidate is the person who they say they are. And that's a problem. If you don't know that the candidate who's standing in front of you is that candidate that's registered, you need to do some pretty advanced tests. It's no good just having a credit card. So we are able to have fingerprint and iris recognition, if necessary, and all sorts of other technology, some of which will remain secret, as I'm sure some of you may sit tests. But be assured we are making sure that those candidates are operating in a secure environment and that they are who they say they are.

We increasingly have to offer new capability. The test centres that we design and operate ourselves, including one which is not half a mile from here in High Holborn, we are offering tests not only in English but in 14 other languages. In fact, our driving theory test will be offered in multiple

languages, to reflect the kind of broad ethnicity and a diverse population. That's an increasing feature of contracts that we have.

I mentioned that we are able to do things such as digital surveillance, with which we can actually capture what a candidate is doing at a particular time on a particular test, at any centre in the world, real-time.

Pearson's educational credentials are critical to this. We are handling highly sensitive data. So it's very important to our professional and academic clients that they know that we're going to treat that data respectfully and properly. That's something which we've been doing for many, many years, so it's a very key component of their decision to move ahead with Pearson.

Equally, they want to be sure that we've not only got a grip on what's happening with the technology, but that we know how to execute what are complex programs. We spend years planning this work. This isn't done on a whim. These programs have to be very, very carefully planned before they're executed.

We've got test centre networks; these are now giving us global coverage. In fact, by the end of 2005 we'll have 350 Pearson-operated centres across about 20 countries. Those will deliver tests for GMAT and for a number of other clients. Of course, once that infrastructure is there, we have a very unique and compelling story for our clients and our prospects.

We also utilise a number of third-party-authorized channels. There are two reasons for that. One is that we want to be a global spread. We don't want to incur the investment in some countries where there is small volume on programs that we have. And it's also useful because it gives us a much better way of covering some of the more remote territories. Uzbekistan springs to mind as one where we do have a very competent and professionally-monitored third-party centre. But we are very diligent about making sure that they perform, and if they don't perform, we do change them out.

I'll just talk briefly about the Driving Standards Agency. This was a contract which was awarded to us in the latter part of 2003. I mentioned that we tend to spend lots of years working on the program rollout, both winning the contracts and then rolling those contracts out and getting a revenue stream.

This was a bit exceptional. This contract was called for bid. It was a competitive contract. The existing incumbent is Thompson Prometric, who are certainly getting to know us even better now, having taken the US nurses program off them, which is the largest professional contract of its type in the world, we subsequently won the DSA, which is the largest government contract in the UK of its type. And GMAT was also a contract that they had. I bet Marjorie and I are not on that particular Christmas card list.

We were delighted to win this contract. It's complex. It involves electronic delivery of the theory test. This year there will be about 1.6m of those tests taken. I won't give you the percentage of those tests that will be failed. I can assure it's quite a few. And by the way, every time somebody fails, whilst I'm personally disappointed, I'm privately delighted, as I tried to explain to my sister this weekend, as she failed for the sixth time. Obviously my driving lessons are working.

By September this year, we will have rolled out 151 of the testing centres across the whole of the UK. We also will have set up a 200-seater customer contact centre. That's actually going to be in Manchester, and that will be operational on July 7, ahead of schedule. We're going to transfer about 750 staff from the existing incumbent, Prometric. And we're going to implement technology which will provide an additional capability to the client, not the least of which is a much, much more secure environment, both for the candidate as well as for the DSA as a sponsor.

Equally importantly, that test centre network is available for new clients. In fact, whilst we're focused on getting the program implemented, we already have new customers well down the road with us.

GMAT is another one which actually took a bit longer. As you see from the point of view of our sales process, we tend to spend time planning these programs. It requires us to get very intimate knowledge of what that client is trying to achieve. It makes sense, it makes the rollout that much more effective. This is a seven-year contract. And we're seeing more and more longevity in our contracts, because clients want a long-term relationship. They don't want the pain and suffering of having to change vendor.

It's a significant contract. The GMAT is highly prestigious. It does see us moving into the academic space. And it will utilise in the US, the testing centres that were built for the nurses' program. So we are able to use those for incremental delivery.

There will be about 230,000 of those tests globally each year, and that program will roll out in its entirety in 2006.

So we like the predictability of these types of long-term contracts. It doesn't mean we're arrogant or complacent. We need to work very hard to make sure that we've done an excellent job of program management and program delivery. But they are long-term contracts. In the IT space you tend to see contracts that are 2-3 years. In this space you'll see them between 5-7, even 10. We're currently averaging out at about five.

We've got very strong renewal rates. Clients want to stay with us. We work really hard to keep them, and to expand our services. We are having to make investment. You can't deliver these tests unless you've got a robust environment. So as we did in 2002 with the nurses, when we had to build 200 Pearson Professional Centres across the entire US. Those are up, running, fully implemented, and are now being leveraged for additional clients, GMAT being a case in point. This year, 2004, we'll be investing for the delivery of the DSA contract. That will come on stream in the latter part of this year. We'll have all of those centres up and operational by the first part of September.

Then we've got a much more modest investment in expanding out GMAT capability into other parts of the world not covered by the UK and our existing network. So as we get into the end of 2005 and early 2006, our network is complete and is unique. As we go through this investment period, clearly we have to make sure that not only are we managing those contracts, but that they kick in on time, that they keep our investment plans in line with our expectations.

We're making this investment so that we can deliver this strong growth, and as these contracts come on stream, which is what they're doing now, we want to be able to add additional contracts as they come through our pipeline. So it's important that this infrastructure is put in place. It's important that we've got it robustly program managed.

As importantly, we want it in place because once these businesses are up and we've done this investment, we're very good at generating cash, very good at collecting that cash. Many of these people are paying us with credit cards, which is nice to get. And we're very good at making sure that we don't have to worry about things like inventory, because we don't have any. So this is about robust delivery.

Of the contracts we've won, I mean, we're a \$100m business. We've contracted about \$600m of additional business. I talked briefly about the GMAC and briefly about the DSA.

NASD was a contract for which we have delivered international tests for about four years. We now have the domestic delivery as well. For anybody who wants to deal in the North Americas securities market, this is a mandated test, a series 7 test. About 200,000 people a year have to go through that. And this is a relationship which will continue to evolve, particularly since there's a requirement to reaccredit.

Again, we're very confident that the kind of revenue profile that we've got can be met. And it's a strong growth path.

In summary, this is a fast-growth business. We are winning new contracts and building on a lot of the strengths that we have captured over many years. As we finish the implementation of one program, for example the nurses' program, the team that helped delivered that then have moved to support their UK colleagues on the implementation of the DSA. Then subsequently there will be a move of a similar team to implement GMAT.

There is careful planning that goes on. We are increasingly looking at global opportunities because there is a force of globalisation going on, and we need to be responsive. So it's very important that we take that outlook and we make sure that security and integrity is there, whether you are sitting a test in Tokyo or whether you are sitting a test in Tallahassee. It should make no difference to our clients.

That's helped us become the partner of choice. We are not the cheapest partner. We are certainly the most robust and disciplined partner. And we like to think that we are stepping ahead and staying ahead in terms of our implementation and capability. We will invest in areas such as biometrics. We can and we have the capability today to implement technology such as iris recognition, if so required.

As we go through our investment phase, and as we move into the latter part of 2005, we'll have rolled out our testing centres for GMAC. Then we're going to be leveraging our infrastructure.

We've invested for DSA, covering the UK. We've invested in the US, in terms of US nurses.

That's a great, great selling advantage for us. And it means that the more we sell, the more we're using existing infrastructure and adapting that infrastructure, we're not rebuilding it.

Most importantly, as I mentioned, a lot of these programs are about confidence, confidence in our ability, Pearson's ability to deliver and to understand the customer's requirement. Our educational assets are critical to that. In my personal view, we would not have won GMAC if we had not had the professional and education profile that we have within Pearson.

So on that, I will hand over to my American colleague, Mac Curtis, who runs our Government Solutions business.

Mac Curtis
President, Government Solutions

Mac Curtis

Thank you Clive. It's a pleasure to be here this afternoon to talk to you about the Government Solutions business. My objective in the next 20 minutes is basically to tell you about where this business has come from, then to talk about the market - the US market primarily - and then transition and talk about what we do, how we do it, and why we're confident we'll continue to grow this business in double digits in the future.

Evolution. Marjorie talked about this and this truly is an extension of the testing business. And what I mean by that is it's about large-scale data management, large-scale data capture, and the essence of what our customers are looking for now is how you slice and dice that data to give them the information that they need. Inherently government agencies are responsible for providing information services to the citizen and so that's how we really transition this business.

The first customer we had was the Department of Education in 1983 and I want to take just a second to talk about that, because I will refer to this customer throughout the presentation. But what our US Department of Education does and what we do for them is basically determine eligibility and provide student loans for after high school, for American kids to go to college. So in the US you have to pay for yourself or you get a loan. It's a \$62b a year loan business that we're involved in and I'll talk about the critical parts of that.

But what they need is understanding the data, the data capture, how to provide that information so it's useful to know whether students are eligible for a certain amount and a loan, and basically where they're going to go to school. That was the first contract.

Throughout the nineties it was a single-digit growth business. Pretty steady. Again, leveraging off this ability of providing information to citizens and the key piece is that this business is, it is inherently fixed price business. In other words, as this business was growing it is built from the bottom up. You understand the cost element. So at the end of the day you can pretty much predict how much each test will cost.

So that was one of the benefits of that business, it's really understanding where the costs come from and that discipline in that arena. And secondly it was the ability to teach programme managers how to manage that business in an operationally efficient way and additionally to build the systems so that it's predictable how much they would cost. That's what happened in the nineties. It was an internally focused business, of good skill sets and very disciplined in the process set.

What we basically have done since 2000 is to take that capability and just basically take it next door to another government agency that had that same requirement to disseminate information. Instead of student financial aid, it's healthcare information or it's information about pension and benefits. So it's really the same common model and again, it's a disciplined operation.

So simply put, what we do is we design, we build and operate systems that help our government customers optimise the information that they have to provide to the citizens. That's really what it is. So our customers pay us to deal with their customers. It's really what it is about. So the way we capture it in the elevator speech, if you would, is we connect people to government and government to people. And that's what we do. And so we'll talk more about that.

The benefit of Pearson, of being part of Pearson, that's also helped accelerate the growth, is the size and scale. It's being an international multi-billion dollar company as well as looking at the ability from the education perspective. And to give you an example, we won a contract, a new learning contract to provide continuing education for sailors on board ships and submarines in the US navy. We would not have won that contract had we not been part of Pearson. Here's why.

Because we use the e-learning and the content management systems that existed within Pearson. We also used the ability to provide assessment and testing and certification if they completed those tests. So without being part of an education company there's no way we would have won that contract.

We are looking at a lot of other opportunities along that line, with content repurposing, and I'll talk about some of those later. That's a lot of discussion about one slide, but I think it's important to understand where we've come from.

So I'll get into the business model a little later, but I think it's important to look at the contract growth. We do have these one-time contracts, such as Census and TSA. The key point on this slide is to note that there's been basically a 32 per cent CAGR beneath those big one-time contracts. I'm sure there'll be some questions about TSA at the end and we're happy to discuss that.

This slide really talks about the drivers and these are drivers that clearly will push the US market. You'll see the last bullet and I'll hit the last bullet right now. These are consistent with what's happening in the UK and it's consistent with what's happening in Canada. So when we talk about demographics, it goes something like this, and there are two parts to the equation.

The first is the baby boomer generation, from 1946 to 1964, is the largest generation in the history of the United States. They are retiring. And what that does to the opportunities in our business is first of all, many work for the US Government. In the next six years almost 50 per cent of the government civil servants in the US can retire. Now that's an awe-inspiring number. And what that

means for us, understanding government processes and how to provide information and do the government's work, that's a great opportunity for us. That's a great opportunity for us. And the government's going to have to outsource some of that business.

The second piece of that is as they retire, they then become our customers – in healthcare, in pension and benefits information, and some of the other systems that we're involved with the design, building and operating for the government. So those are a real demographic push. Marjorie mentioned the impact of immigration and we're involved with answering, providing information about immigration to those who want to get into the country, as well as passport information, and we've won some of those systems. So the demographics are a big push and it's just going to drive this business.

And as such, in addition to that, there's always – we call it the national performance review in the US – it's that the government's going to be able to operate more efficiently. It shouldn't cost so much to deliver student financial aid. It shouldn't cost so much to get information. It's also driven by the web. Why can't I have the same experience dealing with my government that I have when I deal with Amazon.com? Why can't I?

Well, that's really the push and it's also looking at saying well, if government can do it, can industry do it cheaper? Better, cheaper and faster. So these are all connected.

Now the other thing about this baby boomer generation is that they're very demanding. I won't say whiney, but very demanding. And to this point, as they retire, they're very well versed in information technology as well. So again, they see what I can do online and they want the same benefit and the same reaction and the same dealings with their own government. And again, a lot of that, it's clearly the same issues they're dealing with in Canada and the baby boomer generation are a challenge here in the UK.

So these are real market drivers that we've latched onto and I'll talk about how we put that to work here in just a second.

So this is a look into the US Government market. It's a little under \$60b in annual spending in IT alone. And the key point on this slide is we're pretty specific about what we do and what we don't do. The two boxes on the left are in telecommunications and computer systems, and we're not in that business. We're just not in that business. Where we do focus, however, is on the right in professional services. And that is the design market, that's the build market, that's the operating market. That's where they capture a lot of information.

That's a 7 per cent CAGR, from 2004 to 2009. In fact, the UK public sector market is just a smidge behind at about 6 per cent growth. And about 50 per cent in US dollars, in US dollars from about 12 to about 17 over that period of time.

So the markets are growing. There are opportunities around to be able to provide what our government customers need.

So what do you want to call this? A rugby ball or the eye chart? I do think I'll spend just a minute to talk about what we do, because what it is, is again to design, build and operate. And it all centres around the people that we have and the people that understand the government processes. Each agency, each ministry is a little different with what they're responsible for. So we have people that understand how the government processes work and the appropriate technology, and in some cases the affordable technology, to be able to deliver that information.

So up at the top, the design business, and in parentheses it's consulting because that's the way the US market captures the dollars. So they split professional services out by consulting, systems integration and outsourcing. Here in the UK it's primarily the business process outsourcing captures it all.

But we talked about Pearson. We've got a strong capability in the front office. In other words, talking to customers about job skill analysis, about building curriculum and content to be able to deliver more effective training. That's a small commercial business and we're moving that into the government space, using some of the capabilities across Pearson's organisational development and clearly understanding the customer service delivery models, how to provide customers with that information.

Now, why is that important? Because now we're in the front office and as the customers are making decisions on how they want to build the system and how they want to operate it, we're there with them. And if we can we want to influence those requirements so we can play in the game at the bottom.

In the middle, we call it the build. We build the systems that we run and we're pretty good at it, because we have to live with what we do. And a lot of that, in some cases there's acronyms, it's Enterprise Resource Planning, Customer Relationship Management and integration. We do a lot of that, because part of our requirement in providing the information to the citizen, it's also providing evaluation of that data back to the customer because they have to drive a policy.

And the last piece is the operations piece and I'll talk more about that. That's clearly the largest part of our business and that's the way we like it because a lot of these contracts are fixed price. When you increase the efficiency most times you can increase your margins.

The competition. I'll just talk about that very briefly here. In the consulting market it's names that you'll hear of, it's Accenture, it's Baring Point. They do a great job of consulting but they really don't do so well in integration and clearly they're not in the operations side of the house in the federal space.

In the middle you have the behemoths, the Lockheed Martins, the Northrop Grummans and again they do the integration. They call them integrators because they integrate the system and then they don't operate it.

In the operations space you have a lot of some of the smaller niche players and some of these agencies. And we are unique because we can do all three, and we're very focused in what we do. A key point is when we compete against the Accentures, the Lockheed Martins, the Northrop Grummans, we're competing against the government sector. In the case of Accenture the government sector in the US is not much bigger than we are. So it's not as if we're competing against the \$11b enterprise.

So that's basically what we do. We're unique because we grew up in the fixed price operational mode and we understand how to build systems because historically we have to live with what we build.

So I won't go back through that. I think that covered the end-to-end services. But the point there on the slide is that's where the customers are headed. That's where they're headed. Clearly in the UK and clearly in the US, they want a one-stop shop for someone to come in and take over their operation that understands the process, can build the system, can reduce costs and provide information to the citizens.

The operational model's got really two components. One, I talked about the discipline and program management, our investment in the software and systems integration, which is akin to ISO 9000, but it is a proven model by which we develop software. As well as the model we've got where our business deals in the US space are won in Washington and we deliver them outside. We deliver them in university towns in the Midwest, because we get the best and the brightest in students, engineers, from business school. The labour rates are lower and the labour force is very stable. In the services business the biggest cost you have is having to replace your workforce.

So it's worked out well for us, we've been doing it for 20 years and it works out very well.

The next bullet is again, it's management-speak for fixed price contracts with service level agreements and performance metrics. It is in vogue. It is in vogue in the US, and that's what you hear. It's what we've been doing basically for 20 years. So it is right in our sweet spot on how to do that. So that business model is important. It is a competitive advantage for us to win.

And the high customer satisfaction and retention - and I'll talk about some of the customers in just a second - that's what wins the deals, because customers want to be able to come and say, and talk to our customers, where did you design a system like this? Where did you build the system and how do you operate it? So we've had international customers come to Washington and spend an hour or two with our existing customers, one-on-one. They'll then go out and as Marjorie says, look under the bonnet to make sure, kick the tyres and make sure that they're comfortable with our ability to deliver that system and deliver that information.

So that is important and our retention rates are above 90 per cent. So we're very confident about how we treat our customers, have good partnerships with our customers. And it's important in winning the business.

So let me just - I'll breeze through this pretty quickly, but I want to provide you with enough understanding of what we do. I spoke about student financial aid and what it is. And if you go through the arrows, students in the 12th grade of high school that want to go on to college will enquire about whether they're eligible for student financial aid. And again, it's \$62b worth of loans a year.

We are in the front end of that process, and we'll take your application and we'll provide real time determination on a series of algorithms and models that the Department of Education develops, whether they're eligible or not. If they are, it goes through the whole process, similar to a loan, that you would get a mortgage loan or a bank loan. But it is identity verification and these kinds of things, and this ties to a lot of other systems in the federal government. This ties to the internal revenue. This also ties to social security.

So it goes out, and what we are really is the front to that student, to that school, and to that parent, to make sure they get the right - if they're eligible - the right money at the right time to go to school.

So we also provide the data analysis and we're involved in - and I mentioned the IRS. If someone defaults on their loan, at some point in time their wages may be **[garnered]**. Now we're not responsible for that and we're not in the loan collection business. But what we do have is all that information for the whole process, whereby we can help them, point them in the right direction, to get the loan refinanced and help clear it up. Because we've been with them in some cases for 10 or 12 years.

So some of the numbers on the bottom you can see. It's 12m applications a year and you can see some of these numbers. We developed the system from the beginning and continue to work.

I think we talked about the e-government, or government online. This is a good case study for us and we've won a lot of awards in the government with this. In 2001 congress came out and said "You guys spend way too much money doling out student loans. We want something North of 15 per cent reduction, or you're not going to get x, y and z." So we worked with the Department of Education. At the time there were 12m applications. At the time, late 2001, we were doing 300,000 applications online, and it's about a 14-page form you have to fill out.

Through this cycle year, which just ended about a month ago, we drove that to a paperless, almost paperless, environment, where we did 9m applications online. And we'll continue to drive that and save the Department of Education 20 per cent of that part of the process of delivering the loans.

And our customers, potential customers, love to hear that, because they can put their arms around that. In that case, as we were working, we worked with the government to renegotiate the contract

so incentives would change, so we could make more margin on pushing in that direction. It was a good contract.

So looking at the business overall, it's about three times the size it was in 1999. A number of things we've done is, we've reduced the dependence on the Department of Education. However, that account from '99 to today has also grown by 40 per cent, by doing the kinds of things I was talking about on the previous slide.

The other key piece of this is that we have focused our, when we look at opportunities we focus it on new laws, legislative mandate, where they're good solid opportunities. And in this case, obviously healthcare. We talked about the demographics. Homeland Security. Looking at moving into the international market. Looking at some opportunities. And then our defence business. So these are all areas, when you go look at the graphs, the bar graphs and the budget today, these are all very hot areas. These are hot areas so we continue to grow the business.

Good solid pipeline of target opportunities, opportunities that we've bid. And so we are comfortable to be able to continue to grow this at double digits.

Now this is a new client. I won't go through all the details, but this business is probably as close to the National Health System you have in the UK, as we have in the US. But what it is, is another case of a government agency being responsible for providing this kind of information to retirees. In the States you pay this, every pay cheque it comes out for years and years and years, then once you retire you get a certain benefit and a certain reduction on your medical costs.

And so this contract's about a year and a half old. We won this deal because they talked to our education customers. They went out to the Midwest. They saw what we had. They said yes, we trust you, we know you can build it and operate it. And this business is good. This business is going to take off.

So we built the content and basically we've got 40m beneficiaries that will contact us telephonically, over the web, web chat, to get information about their benefits. And so I'm not saying we get 40m calls a year. We get about 14m enquiries about information.

The good news on this is that now in the States they just passed the Medicare/Medicaid Reform, which gives all the senior citizens the ability to get prescription drug cards, which should reduce the cost of the medicine they take. So we're implementing the models that will provide that information to them online. We're running the national data warehouse to do all kinds of analysis that help drive policy.

So we're very involved in this customer in only a year and a half, because incremental growth on our contracts is very important.

So our goal is with this customer to be the face to these beneficiaries and there's some 70 Blue Cross, Blue Shield kind of providers, and there's a myriad of connections in the background. Our goal is to continue to build the system and run the system to be able to be the interface between those beneficiaries. Again, it hasn't changed much, where we're in our sweet spot of building the systems to provide information to the citizens. In this case it happens to be healthcare.

So this just gave you some logos of some of the agencies, but in the last four years we've basically added the Medicare/Medicaid customer, the defence/healthcare management system, which is similar to the Medicare/Medicaid contract, and we've added the INS customer in Homeland Security. So we've just taken what we have and moved them to adjacent markets, adjacent customers, with our skill set.

So let's talk about the business model. Marjorie's spoke about this a little bit. It is a predictable revenue stream. The contracts are five years and in some cases, we won a new contract with a customer back in January that's a ten-year contract. So the trend is to go longer and that's good. I mentioned that our renewal rates are at about, above 90 per cent, and as Marjorie said, 75 per cent, three-quarters of our plan is basically in the bank when the year starts. And that's a very solid industry match and that's where we are.

The margins are stable at about 10 per cent. I think some of the other redeeming qualities of the business is that this is a services business. Strong cash generation, our DBO's about 60 days. We have no inventory and it's a very low CAPEX, low capital expenditure. I think our working capital/sales ratio is well under 5 per cent. Probably closer to 3 per cent, when we look at some of the standard bids.

So the revenue recognition is very simple. It's a services business. It's when the transaction happens. It's when the labour hour's delivered. So it's a very clean model. When we bid, we bid some of these larger deals, our bid costs are a little less than normally 1 per cent of the total revenue of a contract. So if it's a \$140m contract, I think that INS contract we won we spent about \$560,000. So that's four tenths of 1 per cent. All of that is expensed. So it's a pretty simple business. It's about basically providing services.

When you look at the addressable market, it's sizeable. \$25b in 2004 in the US, about \$12b in the UK, about half of that in Canada, and our focus is on the US. But this is something that's very important to our business, is the contract add-ons are incremental growth. All of our project managers are challenged and basically incentivised to grow their contracts. That's just good business. That's just good business. Now it may be adding some additional technology to a system. It may be changing a process. Always looking for the value add, but that's an important part of our business and then obviously the new business piece. So that's what our business model is.

So looking ahead, obviously it's a \$25b-\$32b a year market. We've got a pretty good focus and I think our model's working pretty well, so we're not going to stray too far from that.

The education business, one of the things they're working on is being able to find the right mix with some of the Pearson content. We've got some great ideas. We're working them hard and we think we're going to get some pay off taking Pearson content into, in both cases into our Department of Defence. So that's a good idea.

Healthcare, that's just going to continue to grow. And then we've talked about focusing on the business model of e-Government and the outsourcing.

The adjacent moves, obviously we always looked at the next step into a US federal agency as an example. There are millions of veterans. They are covered under what we call our veterans' administration. So it is benefits, it's pension. When they call, the information they're looking for is the most important question they have in their life at that time.

I do want to make that one comment. This is very important to us, because what we're doing is providing information to students, retirees, and it's a passionate thing we have about our business, is providing that right information to that citizen at that point in time. So we're passionate about that.

In summary, it's a strong business. It's good solid metrics. We're making our name in the market. It's a good fast-growing market. In all the markets we're looking at it's somewhere between 6-8 per cent CAGR. The predictable revenues and profits generate a lot of cash and clearly we're leveraging off it and we'll continue to leverage off Pearson's scale. And we do that every day when we go out and sell. And certainly the skills and the content, as we integrate Pearson's capabilities to our customers and new customers.

Thank you.

Q&A Session

Marjorie Scardino

Okay. Questions....

Paul Sullivan – Analyst, Merrill Lynch.

It's Paul Sullivan from Merrill Lynch. A few questions, if I may.

Could you give us a sense of the market share that you currently enjoy in your addressable markets, in both businesses?

And then secondly, can you talk a little bit about pricing pressure that you face on contract renewals?

And then just added on to that, as you leverage the existing infrastructure, say in professional testing, to what extent do those benefits flow through to you, or do you pass that on to your customers through more aggressive pricing?

Marjorie Scardino

Mac, do you want to start with the market share question? If you can.

Mac Curtis

It's such a big market. It's tough to, I'll tell you, in that professional service business, about 20 per cent of our business is in the consulting, roughly 20 per cent in the build, and 60 per cent in the outsourcing. It's tough to pick out the market share. I can tell you out of the top 100 federal IT contractors, we're clearly in the top 50. But then again you are looking at some of the behemoths like Northrop Grumman and IBM. I can't give you the specific market share, is really the short answer.

Marjorie Scardino

You also have to think about our market. As Mac said, we're pretty religious about not straying too far from the home base. So we are in the end-to-end services market and very few of them are. So we will win contracts because of that, whereas they'll win contracts with subs. So they may take the contract as a prime but they won't actually get the revenues of that full contract, if you see my point. So it's kind of hard. You can say that better?

Clive Hay-Smith

Yes. We can confidently say we are the leading professional testing company. The realisation of the recent contracts has helped us enormously. That'll get translated as those contracts come on-stream. So having the revenues to back up the statement and really the primary competitor is Thompson Prometric. And we have been taking share off them consistently for the last three years and we have no reason to believe we will not continue to do that.

Marjorie Scardino

Pricing pressure?

Mac Curtis

Because we do operate systems, there's already been the investment in that system. And certainly, when you're in a competitive environment when you're in the renewal business, there are pricing pressures. Our benefit is that we normally win about 90-95 per cent of our reconvened business because we have the system, we understand the process and somebody else coming in normally has to build that particular system and put that infrastructure in place to be able to deliver that solution. So that's why our renewal rates are so high.

And price is not always the most important thing. It's important when customers are evaluating the bids, but they will look at the risk model associated with somebody coming in. Can they deliver? Do they have the experience? And that goes back to that past performance comment. So price is important, but it's not always the key in deciding. I would say it's equal to probably past performance and your ability to meet the mission.

Clive Hay-Smith

Our business, because obviously this is organic growth, and we have not bought the business. We are, in fact, in most cases the most expensive provider. And that's because people know what they're going to get from us. They do want a competitive price, but what they also want is to make sure they've got secure candidate delivery, they've got the robust network, because the cost of not having that is huge. You do not want to have failure in your testing environment and they realise there's a cost that has to be met in terms of those investments.

So we aren't the cheapest. We like to think that we're the best.

And maybe I can answer your last question. We are looking continually to find ways of being innovative, to deliver new services, new capabilities, to our clients. Us investing in biometric technology is not a cheap thing to do. If I contrast, if you walked into a Driving Standards Agency testing centre today, you will find a centre which I suspect most professionals would not want to go and sit a test in. So we took a decision that we would have a centre which could meet DSA candidates and could equally meet a requirement for a professional. It clearly gives us some economies of scale, we don't have to then duplicate testing centres, but it requires a bit more smart thinking up front.

So clients are looking, yes, they're looking for competitiveness, but that competitiveness is not just price driven. And as we realise the benefits of our infrastructure, that's how we get our margin improvement. It's all about growth of the right type of volume through those centres.

Marjorie Scardino

And I tell you, it's an easy answer that of the most big contracts we've won we were not the low cost bidder. We were the high bidder. Did that answer your professional testing leverage question?

Unidentified Participant – Analyst

I just want to understand both your revenue - how the revenue works. From what I understand, if the candidate goes to take a GMAT, they actually pay to take the test, right? And you get a

proportion of that revenue, is that generally how your business works, is you collect a proportion of the fee that the candidate pays? Is that consistent?

Clive Hay-Smith

Invariably the candidate is, they are going to pay a fee. They will pay that fee normally to us. So we have a responsibility for the back end of making sure that that money's collected as far as the candidate is concerned. The DSA's an exception to that because there's a different payment mechanism. People are paying over the Internet, they're paying in local offices, some of them are paying with postal orders. So it's not quite the same model, but we get our money and we get our money before we deliver our test. We're not delivering services without any pre-payment.

Unidentified Participant

How much of that fee do you keep?

Clive Hay-Smith

Well that can vary. In the IT world, that tends to be a smaller proportion than it does in the professional space, simply because in the IT world it's a pure transaction, whereas in the professional space we will have done the test development, we will have provided more of the infrastructure, we will be controlling a lot more of the content. And that's really starting to be reflected in the type of business we see. So when I talk about the IT space, much as we love it, we don't want to see that kind of transaction-based pricing, which has increasingly moved into that sector, being reflected in the professional space.

Unidentified Participant

And how much freedom do you have to increase the candidate's price?

Clive Hay-Smith

Well in the IT space, frankly you don't, because you're dealing with sponsors who effectively are looking for you to deliver the transaction in a secure way. By the way, they're also very keen to make sure they are providing additional capability to that candidate. And in fact the Microsoft arrangement I just referred to, we're doing a number of things which fall outside of the normal type of arrangement, transaction-based arrangement. So that, for example, we are working with them on marketing programmes for vouchers, for new types of qualification, and that's where you tend to find the more value-added services and therefore our margin improvement.

Unidentified Participant

And then can I just ask you the same question, if I'm a retiree and I want to know my Medicaid payment, do I get that for free and you're just paid by the government per candidate?

Clive Hay-Smith

That's correct.

Unidentified Participant

So you can charge the government per candidate, or per person that you inform – is that how you charge them, or....?

Mac Curtis

In some cases that's exactly right. In some cases they are transaction-type contracts where we've negotiated the cost of each transaction with the government. So it's just paid by the click.

Edward Hilder – Analyst, Morgan Stanley

Hi. It's Edward Hilder, Morgan Stanley. I'm just wondering if you could just give us an idea what the margins are in the testing business. You gave us a summary within the services business. And just try to give an idea of how the profitability schedule, the \$80m of additional revenues you've got coming by '06, is going to pan out.

Clive Hay-Smith

The great thing about this type of business is we're winning lots of contracts. We have to invest before we deliver, and I mentioned that the type of lag you have, you have to build the infrastructure before you can deliver the test. So this year we've invested in DSA, we'll have a much more modest investment next year in terms of an expansion for GMAT. We'll see margin improvement, this is fundamentally a breakeven business at the moment, and as those contracts come on-stream – and of course, they're adding fair clips of revenue each year – then we see our margin improving. We'll hit the double-digit commitment that we have made and I'm sure Marjorie will hold me to that.

Marjorie Scardino

By the toenails. But it does take time for it to ramp up, as you saw the time line. I'm not sure you showed it but it takes time. We said we'd have £15m investment this year, for instance, while we build those testing centres. And then the idea is throughput in the testing centres. The more we leverage those testing centres the higher our margin rises. So it just really is driven by how fast we can leverage those and get throughput, more tests given in the testing centres.

Edward Hilder

So, for example, at what point in time would the DSA contract become profitable without adding additional contracts?

Clive Hay-Smith

Well it's profitable from day one, actually. The DSA contract, we didn't build a contract reliant on other incremental business. We built an infrastructure that assumed we would have other incremental business. So we didn't design something, as I mentioned, that would – I could probably have invested a lot less money and made something which frankly was vandal-proof and, as I said, if you've seen an existing test centre you'll know what I mean. What we did is we made an investment and that's going to be completely recovered against the DSA contract. By the way,

they're also delighted that we did that because it means the candidate experience is much, much better, and there are other savings because of, frankly, the candidate being much more willing to come to centres as they fail more regularly, which unfortunately a lot of them are doing.

Marjorie Scardino

Don't talk about that.

Clive Hay-Smith

I won't.

Marjorie Scardino

I failed once. But the truth is you couldn't test a nurse, or you couldn't test a business school applicant, in one of those Prometric test centres. So we're building for a larger business. That's how it ramps up.

Guy?

Unidentified Participant - Analyst

Marjorie, when you bought NCS, did you expect this business to be as big and successful as it's turned out to be? As I recall, in the presentation in Chiswell Brewery, those years ago when you bought it, this wasn't an area of focus at all. It was other things. And again, with the rider that it's clearly a successful business and you're doing very well, basically it lays Pearson open to the accusation of the fact that you're drifting off away from your core competencies towards areas that are outside your core competency, but very attractive from a return on investment.

Marjorie Scardino

Well, as I said in the beginning, I think that it's true that we didn't buy NCS for these businesses. They were small. Mac had just taken over when we bought it. This professional testing business was just the IT testing and therefore kind of lumpy, and the professional testing beyond that. I think you'd just won the nurses' contract, maybe. So it was pretty non-existent. We didn't plan on that. But what we did see was the testing infrastructure and the large-scale data management infrastructure, and if you remember that presentation we talked a lot about how valuable the large-scale data management skill would be to Pearson and would be to our education business. And that has proven true. And we have tried to steer these businesses with their leaders toward the things that we thought were germane to the kinds of things we do. So using our content to do the Navy Afloat. We're bidding on a couple of contracts now that around the world will help us deliver editorial content and testing. The TSA did that as well, and the same thing with Clive's business. So I think what we're doing is taking a small platform that we found in NCS and leveraging it to Pearson's core, and I think we've done a pretty fantastic job of that. And as I said, it's very attractive that we're able to tap into the financial characteristics of the service business and we're able to use these skills to deliver services to our teachers. If we can use one of these call centres that delivers pension information to old people and use it to deliver information to teachers about how they teach, which is something that we're working on - we're way ahead of any other education company.

So those are the kinds of things we could whack on a long time about.

Unidentified Participant

On the question of strategic drift, Mac, I think you said, “We’re not in the loan collection business.” But actually, your business that you’re running here is closer to a loan collection business than it is to the FT or to Penguin, or to a number of other businesses within FT Group. Marjorie, how would you respond, were someone to say that there’s strategic drift here, that you made an acquisition of NCS, part of the strategy didn’t work out, but you found a little gem that’s growing very nicely?

Marjorie Scardino

Actually, which part of the NCS strategy didn’t work out?

Unidentified Participant

I thought that whole thing about parents linking into schools and checking out what their kids are...

Marjorie Scardino

That’s working out. That’s – as I told you at the beginning, that would take a while to come along, but integrated learning, if you ask anybody, is now the benchmark for what schools need to do. Everybody wants to link technology to developing an integrated personalised learning plan, and we’re still the leader in that and only because we bought NCS. So I have to say, I don’t agree with you on that.

Unidentified Participant

Putting that specific bit aside, in terms of drifting away following the marginal dollar, did you recognise that as something, as an issue, or not?

Marjorie Scardino

No. It’s just what I said, just a minute ago. I think I answered that. That large-scale data management is what testing is all about. Collecting the information, analysing it and figuring out to what effect to use it and reporting it out to people who need it, is what the testing business is all about.

Unidentified Participant - Analyst

Can I ask about the testing centres again, just in terms of the capacity? You mentioned that there’s capacity there. I just wondered how much, it’s paid for, I guess, on the original contract, but how much spare capacity is there there? How much can you actually take on? Are these places sitting empty some of the time? What would you have to do in terms of ramping it up if you get another contract?

Clive Hay-Smith

Well, I’ll give you an example. Some of these centres, under the contract we have commitment to have centres in place, which are paid for by our client, which may be delivering only a fistful of tests each year. And those are managed – this is where you get down to very good yield management – you don’t want to have that centre sitting there open for 52 weeks of the year. And

we are responsible for booking the tests, for scheduling the tests, when people go, and we have the capability of opening those centres longer. If, for example, a professional doesn't want to go and do his or her exam during the working day, which is often the case, the employer does not want somebody going off and doing an NASDE test during the working day. They would like to go and do those tests in off hours and we're very able to do that and this is not a dependency that we have on the DSA contract. But we have designed our test centre capability to be able to do that, and that's serving us well.

Marjorie Scardino

We'll be giving you a premium to take your driving test at three in the morning, to keep our centres 24 hours.

Unidentified Participant

And ask another question about government solutions. I just wondered, obviously it's not an issue now, given the contracts you've been winning, but being owned by Pearson as opposed to a US company, is that something that comes up in your negotiations with the government entities at all?

Mac Curtis

No. No it doesn't. No it doesn't.

Marjorie Scardino

That's because I go visit them all and they can hear I'm from Texas, and so they don't even think about this British thing.

Unidentified Participant

I wonder if I could ask about the returns on either side of the business. Could you talk through how you model these contracts when you're looking at bidding for them, whether it's presumably an IRR or an ROI-type model, and what the hurdle rates are? Whether it's group cost of capital or whether you've got your own? And could you talk about the distribution of returns? Whether you got some contracts that are really quite low return, very close to your cost of capital, some stuff that's really very valuable indeed to you?

And then lastly, could you give me an idea how many of your contracts are negotiated on an open book basis, where your customers can see the returns that you're going to generate?

Marjorie Scardino

Why don't you answer that last one first, maybe Rona and I can talk about it, if required.

Mac Curtis

I think the best way to answer that question is, some of the contracts that we have are open book and some aren't. And really that means some of these contracts are fixed price and some of them are cost plus. So fixed price means the transaction base as Meg was asking where a customer calls. It's on the transaction that we get paid. It's pre-negotiated and we bill them at the end of the month.

Other contracts we talk about as “cost plus” and it’s cost reimbursable. So we are billing on like labour hours plus the ODCs. So each has its own behaviour as you go through the life of the contract. The margins are roughly the same, but what normally happens in the fixed price contracts is that as time goes on you get well versed in the operations. You can squeeze the efficiency because the fixed price contracts are the anti-labour contracts. The less labour you have the more margin you can make. So over time, the margins will kind of increase.

So those are the two kinds of contracts. I think we look at the margins that we make. Obviously we’re at about 10 per cent. Some of them are a little higher, some are a little lower. Some are older and some we’ve just won. So it’s hard to give you a specific answer, but when you put it altogether it comes out at about a 10 per cent margin business with the different contract mix over the life of the contracts

Marjorie Scardino

And some of them are performance based. So as we improve the efficiency of the contract, we might get some of the upside.

Mac Curtis

So it really is kind of a mix of all of these variables in the equation.

Marjorie Scardino

And as for the investment assessment models, we’re pretty rigorous about this throughout Pearson. Maybe Rona wants to talk about the kind of hurdle rates they have to achieve in order to pass muster.

Rona Fairhead

I think generally in terms of the Government Solutions business that does tend to be an area where we can grow and increase the top line without very significant invested capital. And therefore what we’re aiming for are margins that are well beyond the 10 per cent over the life of the contract because what we want to be is in that sort of 10-12 per cent which we think is the achievable sort of sustainable margin for our Government Solutions business. But what we obviously are measuring is whether it’s a cost plus, or a fixed price and then we will assess the risk of that contract and clearly if it is a more risky contract, if it is in a different part of the world, we would expect a higher return than the classic relative low risk Government Solutions in the US business.

But for Clive’s business it’s somewhat different because that is a business where there is an investment. Not just the revenue investment we’ve talked about in terms of 2004, but also a fixed asset investment. We’re not talking major scale. We’re still overall as a company going to be spending at, or around, our depreciation level. But there is some more investment and much more sort of the classic DCF analysis. But I have to say that again, it tends to be relatively small given the sorts of margins we expect and it’s sort of a 15 per cent margin is definitely our long-term goal for this business, or beyond, if we can accelerate that. And therefore to my mind, what we’re really looking at is cash pay back and an ability to see, particularly in the setting up the infrastructure in the US, in the UK and now with GMAT across the world, something that we more than cover that cost, have a decent margin on top of that and have basically the potential to increase our margins from 2005, 2006 onwards.

So it's classic DCF, but I think what we're trying to do is push those margins over time and that this is kind of the long-term strategic plan for our Testing business.

Unidentified Participant

In calculating your return on capital, does that involve estimating a sell-on price at the end of the contract if somebody else were to win it?

Second question, we were given the growth expectations from existing contracts from the Testing arena. If the Government Solutions business wasn't to win any further contracts, what sort of growth can we expect from contracts in the pipeline already?

Rona Fairhead

Just let me touch on the return on invested capital and all the analysis that we do is for the length of the contract that is to be contracted. So we don't say at the end of the contract there's an optionality that we can get. We're the incumbent. We have a 90 per cent renewal rate. We don't take that into account. It's the pure contract as we see it that we judge whether the risk is there and whether we will make the margins through the life of that contract.

Marjorie Scardino

We don't even add the optional add ons.

Unidentified Participant

On the Testing side of your business, on the contracts that you've won but yet not to hit the revenue line, you pointed towards £80m of extra revenues. On the Government Solutions side, from the contracts that you've won that have not yet hit the P&L, how much extra revenue should we expect?

Mac Curtis

What I will tell you is with the revenue, because the working capital is so small, we are normally in a positive cash situation about 12 months on average with new contracts. I think if that is your question.

Marjorie Scardino

I think one of the complicating factors and really it is going to be hard for him to answer is because if you remember his pie chart, a part of the contract, but a largish part of it is contract add ons, is increasing the contract scope within the contract period and getting that extra. So that's about 20 per cent, 15 per cent of the total right there. So that's going to add on. It doesn't happen for every contract, but it's a big deal.

Mac Curtis

We have a minimum. We expect our programme managers to get at least 10 per cent. Some get a bit more, some get a bit less - when you add up all the different programmes.

Rona Fairhead

And I think if you just want a sort of a number, a sort of order of magnitude, we would expect this business to be in the double-digit growth. Annual double-digit growth through the next few years. I think that's what Mac said.

Unidentified Participant

Thank you. Can you just give us an idea of the sort of concentration of contracts within the two businesses? So you've got effectively sort of £180m of revenues now in Clive's business pro forma for the new contracts. If you took the top five, or the top 10 contracts within there, how much revenue does that account for and if it is possible, to do the same thing for the other business? Can you just give us a feel for that?

Marjorie Scardino

It's easier for Mac to do and let Clive have something.

Mac Curtis

I would say that probably with the top five contracts, or customers, because in some cases the Department of Education is more than one contract. But clearly the Department of Education is probably number one. The Department of Defence and those customers are number two. The Health Care contracts are number three. Number four is probably Immigration and then after that it's a distant fifth. I would say about 70-75 per cent of the revenue is in those big five accounts and again, they're not all single contracts. In some cases it's four or five different contracts that we've got. But those are the top five.

Marjorie Scardino

Different parts of the agencies.

Clive Hay-Smith

Interesting obviously because if you look at the spread of activity on the IT side, Microsoft, surprisingly enough is the largest and of course that's why we're delighted they've renewed their relationship with us. So we've got that for another three years.

US Nurses was our largest professional client. Has now just been outstripped by what we're doing in GMAT. Then DSA is the large UK client. I think the characteristic of all of those is that none of these contracts is going to come up for any kind of re-bid. We've got Microsoft extended for three years and in our professional space, none of those will be up for re-bid within the next five years. So we've got pretty good sight of what's going on.

So I know to directly answer your question, I've tried to show some of the stream of activity as it comes on over the next couple of years as we convert contracts into deliverable revenue and I think that's the chart you've got in your pack.

Marjorie Scardino

But they do have fewer clients. But remember it's a \$100m business and they've just added a huge bulk of customers and I think you'll carry on adding.

Clive Hay-Smith

Yes. I mean the type of customer we go for I think will continue to be in the profile that we have gone for so far. We want to leverage that global infrastructure wherever possible. Or on a national level it's got to have substantial volume. Or it's going to be paying for a test which is high value and for example, a nurse's test is not a cheap thing to do. If you look at Microsoft on the one hand who may, in a country like China, be charging \$10 or \$15, which is not particularly attractive for us. In the professional space you're seeing some tests, which are \$200, \$300, \$400. Now, that's the mix of the type of contracts that's also a critical important to us.

Marjorie Scardino

I think if you want to understand the profitability profile of Clive's business, you need to look for us to be winning more contracts in that space because that's the leverage. That's the way we're going to get those professional testing centres to pay up. Anything else?

Unidentified Participant

Yes. There was just a follow up in terms of again the Testing business. Presumably the contracts generally have some sort of break clauses in there related to service level achievement and so on. Can you just tell us any of the contracts you've taken from Prometric were those at the full end of those contracts, or did any of them arise through early breaks?

Clive Hay-Smith

Most of them were coming to logical break points in terms of a decision had to be made by a client because remember as you will appreciate, to move a programme – certainly these complex programmes – is not a five minute task. So for example with the DSA contract, we were aware that it was going to come up for a bid. I suspect that there was a huge degree of confidence that it would stay with the incumbent just because of the difficulties of moving this type of infrastructure. I mean there was already, there is a network of 150 sites already across the country. So we are very keenly aware of when these type of contracts come up. It is unusual for them to be prematurely terminated, although that has happened, and particularly in the IT space. Less obvious in Government and GMAT is a contract, that contract had been in place for many, many years and so it was a monumental shift. So those are the type of clients that we're after.

Marjorie Scardino

There have been at the end of the contract. Yes.

Unidentified Participant

Thank you. Regarding the Professional Testing business, can you tell us how many contracts are offered on an exclusive basis, i.e. you are the sole provider, versus contracts where you may share with Prometric, like the NASDE I think in the US?

Related to that, the \$600m you were referring to, are these the revenues that pertain to Pearson, or are these the contract size that maybe shared with other test providers?

Clive Hay-Smith

Two questions. Firstly, glad for the prompt because I probably forgot to say something. The IT business tends to be dual vendor. Ourselves and Prometric have traditionally kind of slugged it out. We have won more business off them again because of service delivery, security and a lot of other things I've talked about. Not necessarily because of price. So those tend to be dual vendor.

Although that profile is changing and I think it is again they're looking for more from the provider and we are very confident that in the IT space you will see more and more movement towards single source. That's already the profile that exists within the Professional space. The DSA is a single source contract. A huge single. GMAT is a single source contract. So that's important for us. We know where we stand with that client and those are the type of clients – not that we don't want to have Microsoft. Delighted to have them and we will continue to work with them. But we're expanding our type of services and it's really about us having competitive edge over people such as Thompson Prometric.

Unidentified Participant

And then the \$600m?

Marjorie Scardino

The \$600m, that's all ours.

Clive Hay-Smith

That's all ours. Yes, that's our revenue.

Unidentified Participant

Can we get a figure on maybe the capacity utilisation rate for your testing centres? If we look at the 200 tests you've opened in the US, is that a metric you track? Where is it now and where would you expect it to be?

Clive Hay-Smith

Oh boy do we track that! Yes, absolutely we track that and this is not just the type of test. It is all of the other infrastructuring. You don't want to be manning, resourcing test centres which are under-utilised. I will give you a very good example. We have been going through a debate here in the UK about a site in Ullerpool. Anybody know where Ullerpool is? I don't know if you've been through it. It's not the most logical place that you would think for a testing centre.

Marjorie Scardino

You know where it is now?!

Clive Hay-Smith

As much as I love Ullerpool, which I do. But it does 50 tests a year. 50 driving tests a year, which clearly says don't drive in the Ullerpool area because they're not doing enough tests. But for us to invest heavily in infrastructure and multiple staff to run that centre wouldn't make sense. However, we've got other clients, in fact some of which are in, if you like, the Pearson family. I am very keen to deliver tests from my Edexcel examination channel, which are national and international tests through the same sort of infrastructure.

So it's about yield management. It's about profiling the type of tests and it's managing the resources that are in place. On average, in a testing centre, we would look to about 50 per cent utilisation from day one. We don't assume anything else.

Marjorie Scardino

For some of those places where we can't get enough throughput to make it worth our while, we're going to be providing mobile tests. So we're going to be kitting out mobile testing centres that go around to these weird places.

Unidentified Participant

And the 15 per cent margin target you have, does that assume a significant ramp up of the utilisation rate?

Clive Hay-Smith

I mean we've got capacity over and above what we've built into our model and in fact we have capacity to expand some of those centres should we so desire both in terms of physical space, or in terms of delivering tests outside of the normal hours.

DSA specifically here in the UK has very, because it is a Government contract, has very specific times when the centres have to be available. So we have a lot of free time. If we so decide to have centres open longer, open for five days a week, don't go and try and do your test in Ullerpool on anything other than half a day every month because you won't get in. So that type of capability is availability to us.

Marjorie Scardino

Okay a couple of more questions because we've got some drinks out there and you can always catch one of these guys out there. So why don't you take the last.

Unidentified Participant

A couple of questions for Clive. First of all was just you said that there were no major contracts coming up for renewal on the Testing business. So just looking at what you've got for the incremental revenues coming in...

Clive Hay-Smith

I said our ones are not coming up. The ones we've already won are not coming to come up for renewal....

Unidentified Participant

....not coming up again. So I'm just wondering about, we look at the incremental \$80m coming in in 2006, what shall we factor into your existing sales base of \$106m? Are there contracts that you've won in the past that are going to be rebid over the next couple of years that we should be aware of?

Second was just on the link that I think Pearson has talked about in the past between your business, especially the IT Testing business, and their IT Technology Publishing business. I wonder if you could just say a little bit about that, how that helps you and then also business having being fairly moribund over the past few years whether or not at least on the Testing side you're seeing some signs of a pick up?

Clive Hay-Smith

Well, I will answer the second one first if I might because it is fresh in my mind. We clearly have tried to leverage. My personal view, we could do a lot better job in leveraging our IT presence. We have strong relationships with IT providers. Sun is one where we do next to no testing for Sun, whereas we're the biggest publishing partner for Sun, which I remind my general manager daily. So those are logical relationships which we need to develop.

I mean the IT market as you said yourself, I think moribund is a good description. That doesn't mean we can't be much more creative. There is testing available. So providing other surround material, support material. We did a programme fairly recently which actually was very helpful for one sponsor, where we actually as part of that programme offered subscriptions on the FT and the guys also got discounts against professional books, which they bought on the web.

So we can be creative. I don't think we're going to get back to the heady days of 1999 and 2000 in IT. Certainly not in the near term.

Marjorie Scardino

I think just to expand on that, we have seen, as you know, our Technology Publishing go down quite a lot just as Clive has seen in the Technology Testing. So enrolments in technology courses, enrolments for engineering, science, math degrees, all of those things are down and one of the great successes of Clive's business is to move it so nicely into the other professions because I don't think we're going to see that kind of level and it's not our favourite kind of testing.

Clive Hay-Smith

True.

Marjorie Scardino

What was your first question? You forgot too.

Unidentified Participant

On the \$80m dollars.

Clive Hay-Smith

We've got a very solid book of business. That's great. But it's a book of business that we think we've got an infrastructure which we can leverage more. Clearly the more business we get through there it drives our margins. We are very obsessive about margin delivery. We are very obsessive about growth. We're very focused I will say also about the type of business we go after. So this isn't go after anything that is moving because we want to fill the channel. We're selective about what we do and we have walked away from as many bids as we have prosecuted.

So this discipline has served us well and I am confident that we can continue to have the growth trend that we've had.

Marjorie Scardino

Suffice to say that I expect growth from Clive's business. These two businesses are part of our growth efforts in the Pearson portfolio and if we say 75 per cent of his budgeted revenue is contract at the beginning of the year, that's obviously got to be a growing number every year or he doesn't make his goals. So enough said.

I think I will let you ask your question outside, if there are no other questions from anybody. Thank you very, very much and why don't we go have a drink and catch any of these guys and ask them any questions you want to.