



Royal Mail Group Ltd

**Regulatory Financial Statements
2006-07**

Part 2: Unaudited financial information

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Introduction

This is Part 2 of the Regulatory Financial Statements and is supplementary to the Audited Financial Information presented in Part 1.

Its purpose is to present other information that whilst providing useful additional insight into Royal Mail's performance is not a requirement of the Licence issued to Royal Mail Group Ltd by Postcomm, and hence does not need to be audited.

Whilst the information in this document is not audited, it has been reviewed by the Auditors for consistency with Part 1 of the Regulatory Financial Statements.

Review of the year

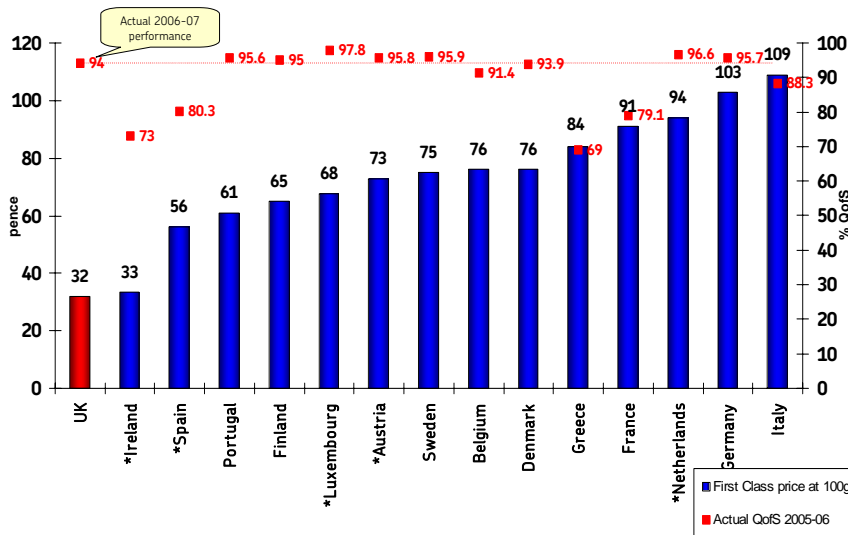
Quality of Service

Royal Mail has yet again had a year of excellent quality of service results as the table below demonstrates

Scheduled Service Or Standardised Measure	Licence Standard ¹	2006-07 Actual ¹	Achieved
1. Retail First Class	93.0	94.0	✓
2. Retail Second Class	98.5	98.9	✓
3. Bulk First Class	91.0	93.2	✓
4. Bulk Second Class	97.5	98.3	✓
5. Bulk Third Class	97.5	99.5	✓
6. Standard Parcels	90.0	94.5	✓
7. European International Delivery	85.0	Not yet available	
8. Special Delivery (Next Day)	99.0	99.0	✓
9. Postcode Area Target % Delivered	118/118	116/118	✗
10. Collection Points Served Each Day	99.90	99.92	✓
11. Delivery Routes Completed Each Day	99.90	99.95	✓
12. Items Delivered Correctly.	99.50	99.70	✓

The graph below shows how Royal Mail's year end quality of service and price compares to our European neighbours for the first class stamp letter service up to 100g weight.

International comparisons of domestic public tariff first class letter prices at 100 grams March 2007



* These countries only have a single service i.e. no differentiation between first and second class

¹ With the exception of measures numbered 9, 10, 11 and 12 the standards are expressed as the percentage of items that are delivered in accordance with the stipulated service specification for that service. Measure 9 is stated as the number of postcode areas out of the total number of 118 postcode areas. Measures 10, 11 and 12 are stated as a percentage out of the total number of collection points, delivery routes and number of items respectively.

Review of the year

It can be seen that the combination of excellent quality of service and low price is the best in Europe.

Volumes

These financial statements demonstrate that despite the positive achievements on quality of service the postal market is moving against Royal Mail. Total mails operational volumes for inland addressed products are 2.3% down compared to 2005-06. The table below summarises the position by product using working day adjusted revenue derived traffic.²

	Growth / (Decline)*		Volume (m items)	
		%	2006-07	2005-06 [#]
First Class**	↓	(7.9%)	4,435	4,827
Second Class**	↓	(5.6%)	4,888	5,187
Mailsort	↓	(12.1%)	7,153	8,155
Downstream Access (DSA)	↑	> 100%	2,440	1,157
Presstream	↓	(13.0%)	635	731
Special Delivery, Standard Parcels,	↓	(2.3%)	94	99
Total Inland Addressed Products	↓	(2.3%)	19,645	20,156
Door to Door	↓	(4.1%)	3,210	3,354
International	↑	0.6%	1,234	1,229
Total	↓	(2.4%)	24,089	24,739

* The % growth is based on working day adjusted revenue derived traffic

** First and Second Class includes: Stamped, Metered, PPI, Cleanmail, Packetpost and Response Services

[#] Prior year excludes election mail volumes as 2005-06 was the year of a General Election, and the associated higher volume of mail would otherwise distort the overall trend

As happens when any market is opened up to competition, customers are more aware of their options and are being more sophisticated in their choice and usage of postal services. In addition, the mails market as a whole is in decline with customers switching to other forms of marketing, including the use of alternative media such as the internet and e-mail.

The level of downtrading to cheaper products is higher than in 2005-06, and indeed is gaining pace, and it is impossible to tell when it will plateau. Ironically the excellent quality of service boosts downtrading, as customers exploit opportunities to seek discounts by making their mail more 'machinable.' The movements between products are not mitigated in the price control.

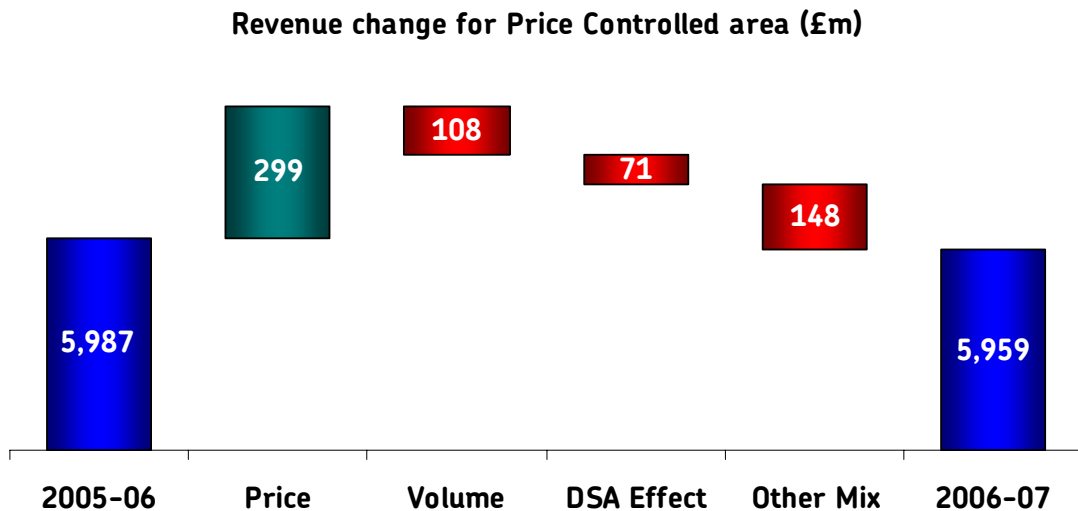
The high level of downtrading, pace of competitor penetration, and market instability was not anticipated in the price control. Consequently the Price Controlled area has made £12m loss in 2006-07 compared to a profit of £197m (on a like for like basis).

² Working day adjusted revenue derived traffic eliminates distortions including those that may arise by any improvements in the counting methodology of operational traffic and differences in working days.

Pricing

The loss in the Price Controlled area has happened despite the increase in prices of around 5% allowed in the first year of the new price control. The overall average unit revenue for the Price Controlled area in 2005-06 was 28.6p, so if the full effect of the 5% increase had passed through the average unit revenue in 2006-07 would have been 30.1p. The average unit revenue achieved was only 29.0p. This revenue dilution is clearly of concern, as it suggests that Royal Mail is unable to recover fully its allowed revenue within a competitive market.

The revenue dilution, combined with an overall volume decrease for the Price Controlled area of 1.8%, has resulted in a slight total revenue decline for the Price Controlled area.

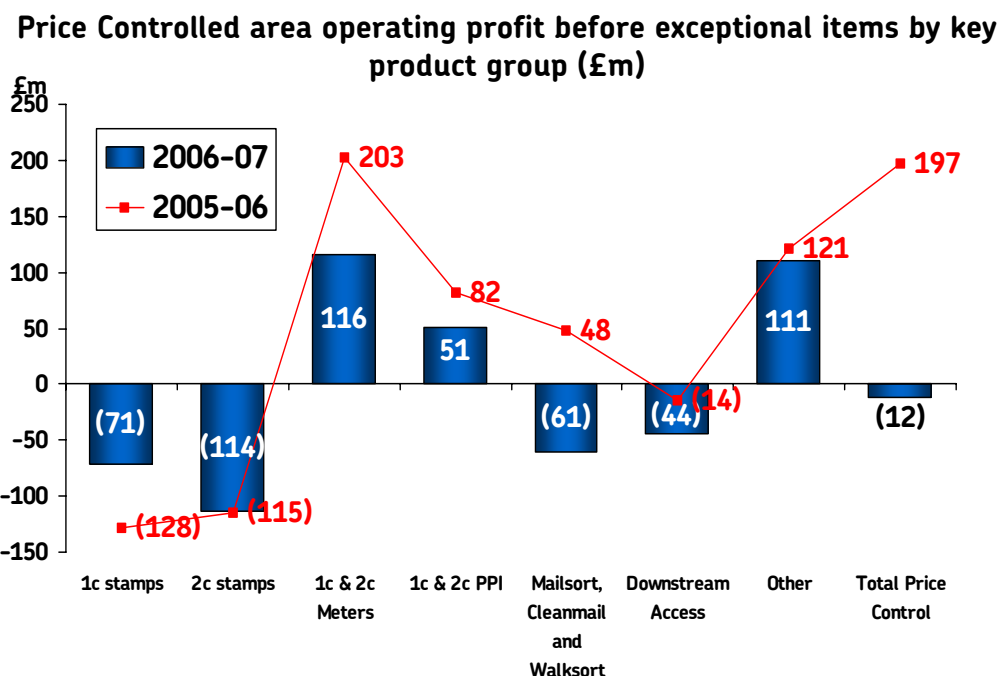


The financial impact on Royal Mail income of the switch to DSA was a dilution of £71m. The other mix variance of £148m represents further revenue dilution as customers move to cheaper Royal Mail products and changes in weight profile.

Pricing in Proportion, which was a radical restructuring of the way that letters and packets are priced, was successfully introduced in August 2006. This was a significant step towards achieving better alignment between the price charged and the costs of handling, transporting and delivering each item, which is a key regulatory principle for Royal Mail.

Product profitability

The Regulatory results demonstrate that some products make money, but the majority lose money. Significantly, the profits generated by business customers are no longer sufficient to cover the losses generated by social customers using stamps. The following graph highlights product profitability within the Price Controlled area:



“Other” includes Packetpost, Presstream, Response Services, Special Delivery and some International products.

The table below shows the average unit revenue and profit in 2006-07 for the same product groups. All profit numbers are Operating profit before exceptional items.

	2006-07				
	Revenue £m	Profit £m	Operational volumes m items	Average Unit Revenue pence	Average Unit Profit/(loss) pence
Stamps	1,104	(185)	3,304	33.4	(5.6)
Meter	999	116	3,001	33.3	3.9
PPI	652	51	2,196	29.7	2.3
Mailsort, Walksort and Cleanmail	1,472	(61)	7,600	19.4	(0.8)
Downstream Access	325	(44)	2,434	13.4	(1.8)
Other	1,407	111	1,988	70.8	5.6
Total	5,959	(12)	20,523	29.0	(0.1)

On average stamps lost 5.6p per item, which is only a 1.2p improvement on the 2005-06 value of 6.8p, despite a 2p increase on the first weight step in April 2006 for both first and second class. This is because there was a drop in volume, which meant that the full benefit of the 2p increase did not flow through into revenue.

Review of the year

USO Performance

The table below restates prior year results to take account of the definition of the USO in the new Licence issued May 2006 to allow comparison on a like-for-like basis. All profit numbers are Operating profit before exceptional items.

	2006-07				2005-06 (restated)			
	Revenue £m	Profit £m	Margin %	Operational volumes m items	Revenue £m	Profit £m	Margin %	Operational volumes m items
1c stamp & meter	1,383	67	4.8	3,309	1,394	50	3.6	3,496
2c stamp & meter	733	(130)	(17.7)	3,016	715	(84)	(11.7)	3,019
Bulk Mail*	442	33	7.5	1,875	487	58	11.9	2,125
Other	901	57	6.3	1,141	849	30	3.5	1,254
Total	3,459	27	0.8	9,341	3,445	54	1.6	9,894

*Bulk Mail includes Mailsort and Cleanmail

USO volumes have decreased by 5.6% from 9,894m to 9,341m due to a reduction in social mail, combined with the migration of bulk mail to DSA. In addition in 2005-06 there were 141m items of mail associated with parliamentary elections in the General Election year, whereas there has been minimal activity of this kind in 2006-07.

Royal Mail continues to classify Business Collections as Other Letter Products. Should this product have been classified as USO, the net effect would be to increase the 2006-07 operating profit in the USO by £26m (2005-06 £25m).

Regulatory accounting principles and basis of preparation

Supplementary information has been included as agreed with Postcomm, and this is detailed below.

(i) Pricing in Proportion analysis of income statement

Pricing in Proportion (PIP) was introduced in August 2006. The analysis in Note 1 creates pro forma figures that estimate the financial results for the USO and non-USO services as if PIP had been in place for the entire year. As there were no mechanisms in place to capture product data by PIP format prior to the implementation date, this process necessarily involves a large degree of approximation, apportionment and assumption. For account products, the figures have been derived based on actual PIP format data since the implementation date, combined with estimates derived from sampling results for the part of the year leading up to this. For stamp and meter the entire year has been based on sampling results together with modelling based on post-PIP average unit revenues.

In view of the level of estimation inherent in the methodology that has had to be adopted, the figures should be treated as indicative only.

(ii) 0-50g weight step performance

Under EU Directive 2002/39/EC, as from 1 January 2006 the weight limit for the reserved area is 50g. All national USO providers must separately state their results (unaudited) for the reserved area.

Consequently, Note 2 summarises the results for this weight band for the full financial year.

(iii) Costs by pipeline activity

The analysis in Note 3 details the costs by pipeline area for 2006-07 and 2005-06 by:

- Fully allocated cost (FAC) - the full activity cost including a share of the overhead costs; and
- Long run marginal costs (LRMC) - the element of the FAC that is assessed as being variable with volume over the long run. A separate assessment of this is carried out for each activity within each pipeline area.

The pipeline areas are groupings of activities identified by Royal Mail, which define the operational and non-operational processes from which products attract costs.

(iv) Property, plant, vehicles and equipment information by pipeline

Note 4 shows the property, plant, vehicles and equipment analysis by pipeline segment, which is based on the historic net book values of the property, plant, vehicles and equipment for Royal Mail Group Ltd.

The majority of property assets are no longer included within Royal Mail Group Ltd figures, as they are now owned by a separate company, Royal Mail Estates Ltd. The properties are leased at market rates to the business units that deliver the regulatory Services.

The property fit out assets relate to the assets used to bring properties into full operational use and are recorded within the relevant individual operating business units' books.

Regulatory accounting principles and basis of preparation

The attribution of the remaining property, plant, vehicles and equipment across the pipeline areas is based on the costs incurred in operating and maintaining the assets within each pipeline area.

(v) Property, plant, vehicles and equipment - average asset lives

Property, plant, vehicles and equipment is recognised at cost, including directly attributable costs in bringing the asset into working condition for its intended use.

Depreciation of property, plant, vehicles and equipment is provided on a straight-line basis by reference to original cost and to the remaining useful economic lives of assets and their estimated residual values.

The lives assigned to major categories of property, plant, vehicles and equipment and remaining lives, consistent with the Royal Mail Group Ltd statutory accounts, are:

	Average remaining lives	Range of asset lives
Land and buildings:		
freehold land	not depreciated	not depreciated
freehold buildings	14 years	up to 50 years
leasehold land and buildings	9 years	the shorter of the period of the lease, 50 years or the estimated remaining useful life
Plant and machinery	5 years	3 - 15 years
Motor vehicles and trailers	3 years	1 - 12 years
Fixtures and equipment	2 years	2 - 15 years

Unaudited notes to the financial statements

1. Pricing in Proportion analysis of income statement

	USO					Price controlled non-USO products					
	Letter £m	Large letter £m	Packet £m	Other £m	USO Total £m	Letter £m	Large letter £m	Packet £m	Other £m	Downstream Access £m	Total Price Controlled non-USO products £m
Revenue	1,571	538	455	895	3,459	1,290	868	199	9	325	2,691
Operating costs	(1,540)	(604)	(477)	(811)	(3,432)	(1,195)	(829)	(350)	(4)	(369)	(2,747)
People costs	(1,104)	(428)	(319)	(392)	(2,243)	(885)	(625)	(263)	(3)	(294)	(2,070)
Depreciation, amortisation and impairment	(31)	(6)	(4)	(22)	(63)	(16)	(7)	(3)	-	(4)	(30)
Net operating charges	(405)	(170)	(154)	(397)	(1,126)	(294)	(197)	(84)	(1)	(71)	(647)
Operating profit/(loss) before exceptional items	31	(66)	(22)	84	27	95	39	(151)	5	(44)	(56)
Volumes (excluding door to door)	6,466	1,533	286	1,056	9,341	6,221	2,826	268	4	2,434	11,753

As discussed in more detail on page 9, Pricing in Proportion (PIP) was only introduced in August 2006, and consequently there were no mechanisms in place to capture product data by PIP format prior to this. The above results have been derived based on actual PIP data since the implementation date, combined with estimates derived from sampling results for the part of the year leading up to this. As a consequence the above numbers should be treated as indicative only.

Unaudited notes to the financial statements

2. 0-50g weight step

	US0	Price Controlled including Access	Total
	£m	£m	£m
Revenue	1,707	1,469	3,176
Operating costs	(1,790)	(1,546)	(3,336)
Operating loss before exceptional items	(83)	(77)	(160)

Unaudited notes to the financial statements

3. Analysis of Costs by Pipeline

Costs by pipeline	FAC					LRMC				
	Processing £m	Delivery £m	Other operational costs £m	Overheads £m	Total £m	Processing £m	Delivery £m	Other operational costs £m	Overheads £m	Total £m
2006-07										
Bulk	(362)	(1,828)	(593)	(426)	(3,209)	(290)	(1,107)	(234)	(174)	(1,805)
Non-bulk	(1,006)	(1,188)	(743)	(494)	(3,431)	(843)	(748)	(241)	(202)	(2,034)
Total	(1,368)	(3,016)	(1,336)	(920)	(6,640)	(1,133)	(1,855)	(475)	(376)	(3,839)
2005-06										
Bulk	(387)	(1,726)	(556)	(425)	(3,094)	(320)	(1,091)	(279)	(256)	(1,946)
Non-bulk	(967)	(1,136)	(789)	(492)	(3,384)	(811)	(745)	(286)	(287)	(2,129)
Total	(1,354)	(2,862)	(1,345)	(917)	(6,478)	(1,131)	(1,836)	(565)	(543)	(4,075)

Bulk products defined as Mailsort, Cleanmail, PPI, Response Services, Presstream, Packetpost, Packetsort, Walksort and Access (ie Basket B as per Licence Condition 21, but excluding Special Delivery and including Access.)

Royal Mail operations manage a pipeline of activities, whereby letters are collected from the customer, Post Office or from pillar boxes, processed (sorted), then delivered to the receiving customer. These can be shown as either fully allocated costs (FAC or all inclusive costs), or as long run marginal costs (LRMC).

Unaudited notes to the financial statements

4. Property, Plant, Vehicles and Equipment - information by pipeline

2006-07

	Processing	Access, National and Local Distribution	Delivery	Other	Total Mails	Non Mails assets	Total Royal Mail Group Limited
	£m	£m	£m	£m	£m	£m	£m
Property	-	-	-	-	-	109	109
Property fit out	113	45	211	8	377	7	384
Vehicles	2	92	40	2	136	8	144
Plant and machinery	267	9	4	7	287	-	287
Fixtures and equipment	7	4	13	-	24	15	39
Total	389	150	268	17	824	139	963

2005-06

	Processing	Access, National and Local Distribution	Delivery	Other	Total Mails	Non Mails assets	Total Royal Mail Group Limited
	£m	£m	£m	£m	£m	£m	£m
Property	-	-	-	-	-	617	617
Property fit out	118	47	223	8	396	5	401
Vehicles	2	68	30	1	101	10	111
Plant and machinery	277	10	4	7	298	-	298
Fixtures and equipment	4	3	7	-	14	2	16
Total	401	128	264	16	809	634	1,443

Most of the property assets are not included within Royal Mail Group Ltd figures, as they are now owned by a separate company, Royal Mail Estates Ltd. The properties are leased at market rates to the business units that deliver the regulatory Services. The property fit out assets relate to the assets used to bring properties into full operational use and are recorded within the relevant individual operating business units' books. The attribution of the remaining property, plant and equipment across the pipeline areas is based on the costs incurred in operating and maintaining the assets within each pipeline area.

The 2006-07 property, plant, vehicles and equipment profiles across pipeline areas have been applied to both 2005-06 and 2006-07, and as such the comparative values have been restated. 2005-06 values have also been restated to include some Vehicle Services assets within Mails not Non-mails.

Unaudited notes to the financial statements

5. Movement in the Regulatory Asset base (RAB)

	2007 £m
Opening RAB as at the start of the year	2,645
plus total capital expenditure	189
less proceeds of disposals	(54)
Closing assets prior to 2006-07 indexation and depreciation	<u>2,780</u>
Asset specific indexation for 2006-07	116
Regulatory depreciation allowance	(209)
Closing RAB at year end	<u>2,687</u>

Capital expenditure for the purposes of this table is expenditure on property, plant and equipment and intangible assets other than goodwill. It is stated net of grants and other contributions to fixed assets.

6. Reconciliation between the regulatory asset base and capital employed

	2007 £m
Closing RAB at year end	2,687
less difference between opening RAB and opening Total Mails property, plant and equipment (note 4)	(1,836)
less indexation in year	(116)
add shortfall of actual compared to allowed depreciation	75
less property additions not included in Total Mails balances	(15)
add property disposals not included in Total Mails balances	52
less additions to non-capitalised assets and intangible software assets	(23)
Closing net book value of Total Mails property, plant and equipment (note 4)	<u>824</u>

Property land and shell is retained within a separate property management business unit. Legal and other fees associated with the purchase and sale of property are not allocated to the Total Mails area. For both these reasons there is a difference between the property total within the RAB and that assigned to Total Mails.

Non-capitalised assets are those that cost below a de minimis threshold, and include bicycles and sorting frames. These are included in the RAB.

The asset types included within the RAB values stated above are based on Postcomm's final determinations when the current price control was set in 2006. The Directors of Royal Mail are of the view that this materially understates the asset value of the business as no value is attributed to the Royal Mail brand.