



Royal Mail Group Ltd
(formerly Royal Mail Group plc)

Regulatory Financial Statements
2006-07

Part 1: Audited financial information

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Summary of results

	2006-07			2005-06 restated to new Licence categorisations of products ¹		
	USO	Downstream Access	Price Controlled Area	USO	Downstream Access	Price Controlled Area
	£m	£m	£m	£m	£m	£m
Revenue	3,459	327	5,959	3,445	152	5,987
Operating costs ²	(3,432)	(371)	(5,971)	(3,391)	(166)	(5,790)
Operating profit/ (loss) before exceptional items ²	27	(44)	(12)	54	(14)	197
Operating exceptional items	(68)	(9)	(126)	(69)	(4)	(125)
Operating (loss)/profit	(41)	(53)	(138)	(15)	(18)	72
<i>Operating Margin Before Exceptionals</i>	<i>0.8%</i>	<i>-13.5%</i>	<i>-0.2%</i>	<i>1.6%</i>	<i>-9.2%</i>	<i>3.3%</i>
<i>Operating Margin</i>	<i>-1.2%</i>	<i>-16.2%</i>	<i>-2.3%</i>	<i>-0.4%</i>	<i>-11.8%</i>	<i>1.2%</i>
<i>Operational volumes (millions of items excluding Door to Door)</i>	<i>9,341</i>	<i>2,442</i>	<i>20,523</i>	<i>9,894</i>	<i>1,157</i>	<i>20,901</i>

- For the first time the Price Controlled area is loss-making; operating loss before exceptional items being £12m in 2006-07, compared to a profit of £197m in 2005-06.
- The USO area also showed a deterioration in operating profit before exceptional items from a restated £54m to £27m.
- Inland addressed mails volumes are down 2.3%, combined with significant customer downtrading to cheaper products.
- Downstream Access volumes have more than doubled in the year to over 2.4bn.
- The impact of the revenue downturn has been partially mitigated by strong cost management. Operational man hours have been reduced by 5m hours (4.0%), and Full Time Equivalent Employees by 6,300.
- In total, stamped mail lost £178m (2005-06: £236m), which was equivalent to 5.6p per item. For the first time profits on business mail (meter and PPI) were insufficient to offset this. Overall the first and second class standard products lost £11m (2005-06: £49m profit). Meter and PPI mail made total profits of £167m (2005-06: £285m). Bulk mail lost £66m in total (2005-06: £45m profit).

¹ For comparability, the 2005-06 results have been restated to align with the product classifications in the current Licence that was issued 25 May 2006. See notes on page 14 for further details.

² Before charges relating to operating exceptional items.

Introduction

This year, as agreed with Postcomm, the Regulatory Financial Statements are held in two documents:

- Part 1: Audited financial information (including the regulatory income statement); and
- Part 2: Unaudited financial information (including a market review and analysis of the results by format).

This review should be read in combination with the market review in Part 2 of the Regulatory Financial Statements. Whilst regulatory requirements specify reporting over the regulatory Services (the “Services”), for business review purposes the Directors believe it is appropriate to focus on the results for the Price Controlled area.

The Licence requires that the Regulatory Financial Statements be produced under International Financial Reporting Standards (IFRS), and that they be reconciled to the audited statutory accounts. In previous years, the income statement has been reconciled to the statutory accounts of Royal Mail Holdings plc. This year, as the Regulatory Financial Statements are being completed prior to finalisation of the Royal Mail Holdings plc audited statutory accounts, the reconciliation in note 1 is presented to the audited statutory accounts of the Licensee, Royal Mail Group Ltd (formerly Royal Mail Group plc).

Consistent with last year, the Income statement has been prepared in line with IFRS in so far as those principles may be reasonably applied.

The audited accounts for Royal Mail Group Ltd are prepared under UK GAAP rather than IFRS. To the extent that Accounting Policies impact on the Regulatory Financial Statements, UK GAAP as applied in the statutory accounts of Royal Mail Group Ltd is entirely consistent with IFRS. Reported revenues, costs and profits included in the Regulatory Financial Statements are therefore the same under UK GAAP and IFRS.

Financial Summary

2006-07 is the first year of operating under the amended Licence issued in May 2006 and the new price control within it.

Total Mails revenue remained virtually flat, increasing by just £19m (0.3%) despite an increase in average prices of around 5% for the Price Controlled area. Revenue grew in International products and Special Delivery, helping to maintain revenue year on year, but these factors were offset by declining market volumes, losses to Downstream Access (“DSA”) and customers downtrading to cheaper products.

Total Mails costs have increased by 2.5%, but most of this increase is because of increased contributions to the pension scheme to fund the deficit, and the impact of a pay deal agreed in previous years. Other costs have been tightly controlled.

Business review

Price Controlled Area Performance

The financial analysis in the remainder of this section focuses on operating profit before exceptional items. A summary of operating profit performance before exceptional items by major product group is shown below:

	2006-07				2005-06 (restated)			
	Revenue	Profit	Margin	Operational volumes	Revenue	Profit	Margin	Operational volumes
	£m	£m	%	m items	£m	£m	%	m items
1c stamp/ meter/ PPI	1,700	121	7.1	4,156	1,732	122	7.0	4,469
2c stamp/ meter/ PPI	1,055	(139)	(13.2)	4,345	1,077	(81)	(7.5)	4,567
Bulk Mail*	1,472	(61)	(4.1)	7,600	1,648	48	2.9	8,600
Downstream Access	325	(44)	(13.5)	2,434	151	(14)	(9.3)	1,151
Other **	1,407	111	7.9	1,988	1,379	122	8.8	2,114
Total	5,959	(12)	(0.2)	20,523	5,987	197	3.3	20,901

*Bulk Mail includes Mailsort, Walksort and Cleanmail

** Other includes Presstream, Packetpost, Response Services, Special Delivery and some International products

Price Controlled area revenues fell by £28m (0.5%). Bulk mail revenues and profit have both been severely affected by the accelerating transfer of significant volumes to DSA. DSA volumes have increased by 111% to 2.4bn items. In addition, the level of downtrading to cheaper products that started in 2005-06 has further increased, driving revenue dilution relating to changes in both class of service used and in terms of the level of presortation performed by the customer.

Margins generally fell in line with reduced volumes. The increase in first class stamp/meter/PPI margins was due to the effect of the 2p tariff increase in April 2006.

Price Controlled area costs from operations

The following table highlights the breakdown of costs in the Price Controlled area:

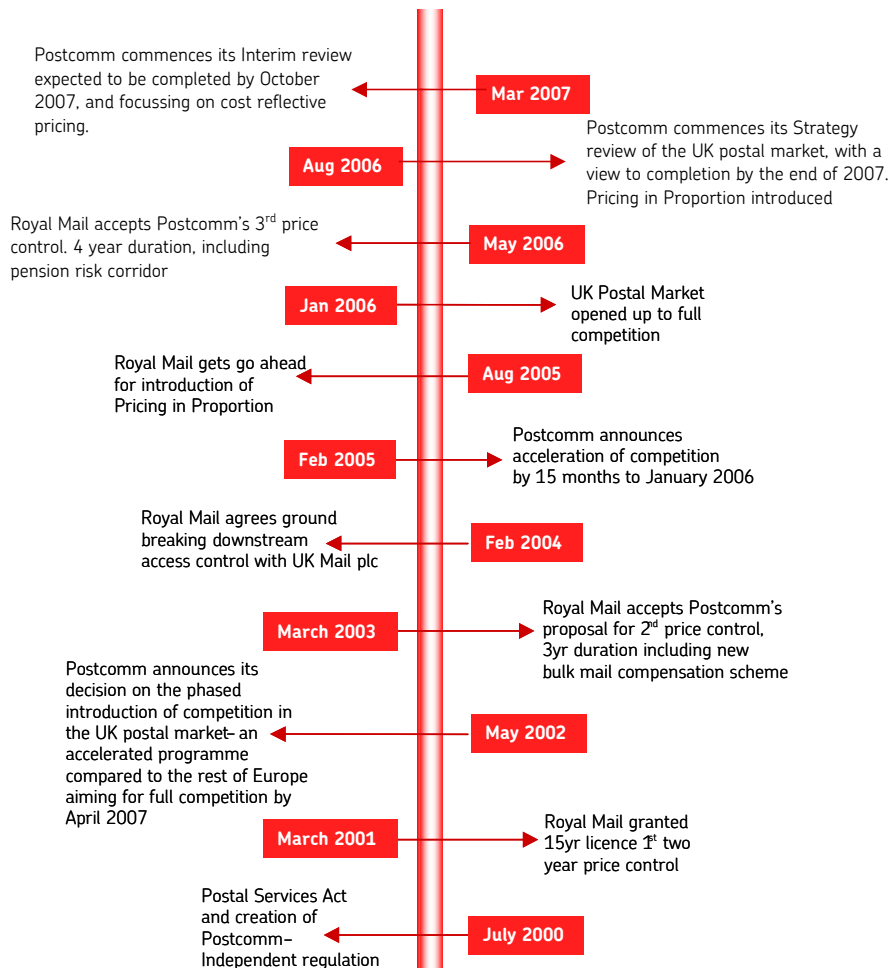
	2006-07	2005-06 (Restated)
	£m	£m
People costs	(4,159)	(4,025)
Depreciation, amortisation and impairment	(88)	(81)
Net operating charges	(1,724)	(1,684)
Total	(5,971)	(5,790)

Despite approximately £140m additional pension costs within the Price Controlled area in 2006-07 as the charge has increased from 19.6% to 26%, total costs have risen by less than the prevailing general rate of inflation. Although total mails volumes are down 1.9%, and despite the high level of fixed costs inherent in the operational network, operational man-hours are down by 4.0% (5m hours), and FTEs (Full Time Equivalent employees) are now 6,300 lower. People costs represent 69.6% (2005-06: 69.5%) of total costs, which remains an extremely high proportion compared to many other regulated industries.

Regulatory Review

The Postal Services Commission (Postcomm) was created as the Independent Regulator for the UK postal sector in 2000. Subsequently, Royal Mail Group Ltd (previously Royal Mail Group plc) was granted its first Licence, which required it to provide a universal postal service at affordable prices.

An overview of significant regulatory events since Postcomm was created is highlighted below:



In November 2006 the Group responded to Postcomm's Strategy Review and believes that four key regulatory principles need to be addressed which will result in a truly competitive industry whereby all stakeholders benefit:

- Realign prices to underlying costs - to create transparency for business customers and to ensure that competition is sustainable. Some competitors in the UK are basing their entry strategies on unsustainable business models which target the historical cross-subsidies in Royal Mail's pricing structure, but cross subsidies are fundamentally incompatible with an effectively functioning competitive market. Postcomm should allow Royal Mail to remove these cross-subsidies, so that customers face the right pricing signals and competitor models going forward are based on efficiency.

Business review

- A narrower range of universal service products - focused on the needs of all social customers and fully funded through stamp prices. Business customers tell us they do not need the protection that the Universal Service Obligation (USO) provides - Postcomm describes many of these customers as "non-captive" and we agree, given the ample choice they have across mail and other communications providers. The USO should therefore be refocused on stamped mail only, and prices should reflect the true costs of this provision.
- Full retail deregulation of business products - the explosion in access competition, expected to represent 40% of bulk mail next year, is encouraging business customers to demand more commercial and innovative responses from Royal Mail. However, Royal Mail is prevented from responding rapidly by regulatory requirements such as an involved process for changing terms and conditions. Royal Mail envisages a near term future in which the intense competition in the business mail market replaces the need for regulation.
- Continued operational integration of the postal network - we have put in place measures to ensure that competitors and customers have access to our network on fair and reasonable terms. Separation of the postal network would create confusion for customers, introduce complex and costly interfaces, endanger quality of service and put at risk delivery of the transformation programme.

In March 2007, Postcomm commenced an Interim Price Control Review with the intention of completing this by October 2007. Royal Mail has asked Postcomm to consider the following pricing proposals in this review, all of which are consistent with realigning prices to costs and entirely driven by the need to react to both the volume erosion and significant downtrading that has been evident for the last eighteen months:

- Reducing the difference between Downstream Access (DSA) and the equivalent retail prices from a high level set to encourage competition, to a level which reflects the underlying upstream costs, because entry has been significantly higher than the Price Control assumptions.
- Allowing Royal Mail's retail business to price its non-USO bulk mail products by zone, thereby making prices of cheap to deliver areas lower by up to 5% and prices of expensive to deliver areas higher by up to 5%. This does not change the price of the "one price goes anywhere" stamp.
- Allowing Royal Mail to further rebalance its prices so that it has the flexibility it needs to keep up with the pace of change in the postal sector.

Licence requirements

Royal Mail Group Ltd is required, originally under Condition 14 of the Licence granted by Postcomm on 23 March 2001, and as amended under Condition 15 of the Licence dated 25 May 2006, to provide Regulatory Financial Statements.

The Regulatory Financial Statements are based on the statutory accounts of Royal Mail Group Ltd for the 52 week period ending 25 March 2007, on which the auditors have expressed an unqualified opinion.

The revenues, costs, assets, liabilities and cash flow effects of non-letter services and subsidiaries, associates and other undertakings (primarily operating outside the UK), have been agreed with Postcomm as being outside of the scope of regulation. Consequently, the main focus in the Regulatory Financial Statements is on the Group's UK mail operation, particularly those aspects that constitute the USO and Price Control.

The format of the Regulatory Financial Statements is agreed with Postcomm on an annual basis, and where appropriate there are enhancements or exclusions from the Licence requirements to provide readers with information that both Royal Mail and Postcomm believe is more relevant and useful.

The following Services are applicable to the regulatory income statement for 2006-07 and 2005-06:

Service	Service provision
Licensed USO - 0 to 350g ¹	Postal products that form part of the USO, and are below or equal to a 350g weight threshold e.g. first and second class mail below or equal to the weight threshold.
Non-Licensed USO, 350g+ ¹	Postal products that form part of the USO, and are Non-Licensed including those above a weight threshold of 350g.
USO, Non Price Control products	Postal products that form part of the USO, but are not included within the Price Control e.g. Incoming International Mail.
Non USO, Price Control products, excluding Downstream Access ²	Postal products that do not form part of the USO but are included within the Price Control, excluding Downstream Access.
Downstream Access ²	Customer and other licensed postal operators' mail, which enters the Royal Mail pipeline after the outward sortation and distribution processes. This is price controlled.
Other letter products	Postal products outside of the USO and the Price Control e.g. Door to Door.

¹ The split between Licensed and Non-Licensed USO products is shown in Note 2 to these financial statements

² Downstream Access and the other non USO price controlled products are also analysed between Licensed and Non-Licensed services in Note 2 to these financial statements

Licence requirements

The USO

The USO is the Universal Service Obligation required under the terms of the Licence granted to Royal Mail Group Ltd as provider of a universal postal service in the UK.

The USO is now formally defined in the Licence by product. The products categorised as USO are set out in Condition 2 (3)(a) of the Licence.

Other specific items, for which the separation across the Service areas is not appropriate, have been excluded but are shown within the adjustments column in the income statement on page 11 in order to reconcile to the result of Royal Mail Letters. Note 1 presents a reconciliation of this result to the audited accounts of Royal Mail Group Ltd. All items below profit before financing and taxation are as stated in the Royal Mail Group Ltd statutory accounts and have not been repeated within the reconciliation.

The obligation to produce regulatory financial statements

The obligation to prepare Regulatory Financial Statements for Royal Mail Group Ltd is placed on Royal Mail Group Ltd by Condition 15 of the Licence. The principal requirements of the Licence, as agreed with Postcomm, are that Regulatory Financial Statements should:

- provide separate accounts (as if they were separate companies in accordance with the Companies Act 1985) for each of the Services comprising a profit and loss account, Royal Mail Group Ltd balance sheet and cash flow statement, and notes setting out the accounting policies adopted together with a reconciliation to the audited statutory accounts of Royal Mail Group Ltd;
- be prepared consistently with appropriate GAAP in so far as those principles may be reasonably applied, or with such other accounting principles as Postcomm may approve in writing. As in 2005-06, Postcomm has agreed that the income statement will be prepared under International Financial Reporting Standards;
- be subject to audit;
- be prepared and submitted before 31 July 2007; and
- meet requirements of European Directive 97/67/EC Article 14.

Postcomm has agreed that no balance sheet and cash flow statement should be submitted in 2006-07, but instead unaudited information on the changes in the Regulatory Asset Base are presented in Part 2 of the Regulatory Financial Statements.

Financial statements

This document contains only audited financial information and should be read in conjunction with the unaudited financial information presented and published in Part 2 of the Regulatory Financial Statements.

The basis of preparation of these regulatory financial statements is disclosed in notes A to F on pages 12 to 17.

Licence requirements

Accounting records

The organisation, management and accounting structures of Royal Mail do not align with the Services defined in Condition 15(2)(a) of the Licence as shown on page 8. In addition, an inherent feature of the postal industry is the use of common resources to provide services and products. Royal Mail does not maintain separate ledgers for each of the Services. As a consequence, processes have been developed and estimates have been applied in determining the assignment of costs and revenues to products.

This means that the records are not those that would exist if each of the Services was carried on by a separate business as required by paragraph 2(b) of Condition 15 and accordingly are not such that if each of the separate Services was carried on by a separate company incorporated under the Companies Act 1985 each of those companies would comply with subsections 221(1) and (2) of that Act.

This is consistent with the records supporting the production of previous regulatory financial statements.

Internal trading eliminations

Royal Mail operates through business units that make use of each other's services in order to take advantage of Group synergies, having regard to the mutual dependencies that exist. Charges for internally provided services have been assigned to products. Adjustments have been made to eliminate internal profits and losses where appropriate, apart from the Post Office Ltd charges that are set using a basis of charges reached through a negotiation between the respective businesses.

Methodology

The methodology adopted has been documented in "An overview of the principles and methodologies used in preparing regulatory financial statements for 2007". This methodology was developed following discussions with Postcomm. The methodology and approaches used to create these regulatory financial statements are not intended to establish precedents for future regulatory financial statements.

Royal Mail continues to review and improve its approach and methodologies.

Income statements

Income Statement 2006-07											
	A	B	C	D=B+C	E	F=A+D-E	G	H	I=F+G+H	J	K=I+J
	Note 2			Note 2	Less	Sub Total	Add back	Add	Sub Total	Note 3	Total
	USO Total	Price controlled non-USO products excluding Access	Downstream access ¹	Total Price Controlled non-USO products	USO Non-Price Control products	Total Price Control products	USO Non-Price Control products	Other Letter products	Total Mails	Non-mails activities within RM Letters and other adjustments	Royal Mail Letters total ²
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Revenue	3,459	2,366	325	2,691	191	5,959	191	638	6,788	175	6,963
Operating costs	(3,432)	(2,378)	(369)	(2,747)	(208)	(5,971)	(208)	(461)	(6,640)	(129)	(6,769)
People costs (Note 3)	(2,243)	(1,776)	(294)	(2,070)	(154)	(4,159)	(154)	(294)	(4,607)	(95)	(4,702)
Depreciation, amortisation and impairment	(63)	(26)	(4)	(30)	(5)	(88)	(5)	(7)	(100)	(42)	(142)
Net operating charges	(1,126)	(576)	(71)	(647)	(49)	(1,724)	(49)	(160)	(1,933)	8	(1,925)
Operating profit/(loss) before exceptional items	27	(12)	(44)	(56)	(17)	(12)	(17)	177	148	46	194
Operating exceptional items:											
Share in Success	-	-	-	-	-	-	-	-	-	-	-
Other	(68)	(54)	(9)	(63)	(5)	(126)	(5)	(9)	(140)	(13)	(153)
Operating (loss)/profit	(41)	(66)	(53)	(119)	(22)	(138)	(22)	168	8	33	41

Volumes (excluding door to door)	9,341	9,319	2,434	11,753	571	20,523	571	776	21,870	-	21,870
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Income Statement 2005-06 as restated

					Less	Sub Total	Add back	Add	Sub Total		Total
	USO Total	Price controlled non-USO products excluding Access	Downstream access ¹	Total Price Controlled non-USO products	USO Non-Price Control products	Total Price Control products	USO Non-Price Control products	Other Letter products	Total Mails	Non-mails activities within RM Letters and other adjustments	Royal Mail Letters total ²
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Revenue	3,445	2,595	151	2,746	204	5,987	204	578	6,769	197	6,966
Operating costs	(3,391)	(2,466)	(166)	(2,632)	(233)	(5,790)	(233)	(455)	(6,478)	(144)	(6,622)
People costs	(2,226)	(1,831)	(136)	(1,967)	(168)	(4,025)	(168)	(264)	(4,457)	(124)	(4,581)
Depreciation, amortisation and impairment	(57)	(27)	(3)	(30)	(6)	(81)	(6)	(6)	(93)	(30)	(123)
Net operating charges	(1,108)	(608)	(27)	(635)	(59)	(1,684)	(59)	(185)	(1,928)	10	(1,918)
Operating profit/(loss) before exceptional items	54	129	(15)	114	(29)	197	(29)	123	291	53	344
Operating exceptional items:											
Share in Success	(38)	(32)	(2)	(34)	(3)	(69)	(3)	(5)	(77)	(2)	(79)
Other	(31)	(25)	(2)	(27)	(2)	(56)	(2)	(4)	(62)	(11)	(73)
Operating (loss)/profit	(15)	72	(19)	53	(34)	72	(34)	114	152	40	192
Volumes (excluding door to door)	9,894	10,564	1,151	11,715	708	20,901	708	684	22,293	-	22,293

¹ There is a small element of DSA service that is not price controlled, which is included within Other Letter Products above. These DSA services generated nil profit in the year. The total for all DSA including this is stated in the summary of results on page 3.

² The total described above as Royal Mail Letters is reconciled to the Royal Mail Group Ltd statutory accounts in Note 1.

³ The restatement is discussed further in note (ix) on page 14

Regulatory accounting principles and basis of preparation

A. General

These regulatory financial statements are based on the financial records of the business and reconciled to operating profit within the Royal Mail Group Ltd statutory accounts on which the auditors have expressed an unqualified opinion. These statements have been prepared in accordance with the accounting policies set out on pages 12 to 17 of the Royal Mail Group Ltd statutory accounts unless otherwise stated.

The financial year ends on the last Sunday in March, and accordingly these accounts cover the 52 week period ended 25 March 2007.

The revenues, costs, assets, liabilities and cash flow effects of non-letter services and subsidiaries, associates and other undertakings (primarily operating outside the UK), have been agreed with Postcomm as being outside the scope of regulation.

Activity and cost driver information is used to assign costs to products; these product costs and revenues are then aggregated into the appropriate Services.

These statements have been prepared adopting the following principles:

- Principles as documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2007”; and
- Accounting Policies for the income statement consistent with International Financial Reporting Standards. In so far as they impact on the Regulatory Financial Statements, the UK GAAP based Accounting Policies used in the audited accounts of Royal Mail Group Ltd are consistent with IFRS.

In cases of conflict the principles as documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2007” prevail.

B. Income statements

(i) General principles

The income statements of the Services have been prepared by applying activity based costing methods and principles to the financial records of the business to assign costs. The resultant statements present the fully allocated costs of products covered by the Licence.

Costs and revenues have been directly allocated to products as far as practicable. Common operational costs that cannot be directly assigned are, using an activity based costing system, attributed to the products equitably. Overhead costs are apportioned to products based on traffic volumes. One off operating costs have been charged to business units where appropriate. In line with activity based costing approaches, estimates and judgements are required and have been applied in order to comply with the requirements of the Licence.

Regulatory accounting principles and basis of preparation

(ii) Revenue

Revenue is defined as turnover plus internal income for core services. Revenue is assigned directly to the appropriate product, with the exception of stamp and meter revenue. Account traffic revenue is sourced from the billing systems.

Stamp and meter revenue is assigned to Royal Mail products by applying a statistical analysis of mail stream characteristics. Special Delivery stamp and meter revenue is calculated from the volumes recorded by the track and trace system.

(iii) Operating costs

Accommodation and vehicle costs relating to operational postal activities have been included within operating costs in the regulatory financial statements. For the purposes of the regulatory financial statements, depreciation, amortisation and impairment, and people costs have been separately identified.

(iv) Operating exceptional items

The total operating exceptional items (including Share in Success) relating to the mails operations are spread across the regulatory Service columns on the face of the regulatory income statement.

(v) Share of post tax profit in associates and joint ventures

The share of the post tax profit of associated undertakings and joint ventures has been assigned to non-letters services (excluded from the Regulatory Financial Statements total) and is included within the adjustments column in the income statement on page 11.

(vi) Net profit on disposal of property, plant and equipment

Profits and losses on sale of properties have been assigned to non-letters services (excluded from the Regulatory Financial Statements total) and are included within the adjustments column in the income statement on page 11.

(vii) Profit / (loss) on disposal of businesses

The profit / (loss) on disposal of businesses has been assigned to overseas subsidiaries or non-letter services as appropriate (excluded from the Regulatory Financial Statements total) and is included within the adjustments column in the income statement on page 11.

(viii) Excluded items

Postcomm has agreed the items below profit before financing and taxation are excluded from the regulatory financial statements.

Regulatory accounting principles and basis of preparation

(ix) Prior year comparatives

During 2006-07, Royal Mail agreed with Postcomm an amended format for the income statement. In addition, a new Licence was issued in May 2006, and this has resulted in changes in the constituent products of both the USO and Price Control Regulatory Services.

The USO under this definition is considerably smaller than the USO that was reported in previous sets of Regulatory Financial Statements.

Key transfers out of the USO (but remaining within the Price Control) include:-

- all Mailsort products except Mailsort 1400 first and second class; and
- first and second class PPI.

Cleanmail Plus was transferred into the USO.

In addition, the Special Delivery Next Day account service was removed from both the USO and the Price Control.

Royal Mail has restated the prior year income statement both into the new format and also to reflect the 2006-07 USO and Price Control definitions. Royal Mail considers that this will help the reader evaluate year on year movements more transparently, though it recognises that the restated 2005-06 results are not representative of the Licence that existed at April 2005.

The impact on operating profit before exceptional items of restating the prior year to the new USO and Price Control definitions is shown below.

	USO £m	Price Controlled £m
2005-06 as originally reported	215	238
Adjustments for revised Licence	(161)	(41)
2005-06 Restated	54	197

C. Key drivers

(i) Income statement

Revenues are primarily driven directly to products by sales account detail or traffic volumes. Resource costs within the ledgers are driven to activities by activity and utilisation analysis. Appropriate drivers are used to assign activity costs to products. Traffic volumes are used as the primary driver of activity costs to sales products, though weighting factors are also applied to differentiate the cost assignment between product types. Products are then analysed into Services.

(ii) Traffic volumes

The activity based costing system makes extensive use of traffic volumes to assign costs to products.

Operational traffic methodology, based on sampling at mail centres, has been used as the basis for measuring inland stamped and metered traffic volumes. This approach involves determining traffic in the workplace by machine counting or by counting numbers of containers and applying statistical techniques.

Royal Mail recognises that there are inadequacies in the current traffic measurement and statistical procedures for stamps and meter traffic and has ongoing initiatives to improve the processes.

Non stamp and meter traffic i.e. “account traffic” volumes are sourced from billing or track and trace systems.

International traffic volumes are determined by applying a statistically derived “items per kilo” to the weight of mail carried to international destinations.

(iii) Activity analysis

People costs have been assigned to activities based on an analysis of operational hours and samples of the time spent by staff on specific activities. Whilst Royal Mail believes this provides a fair representation of activities in the operation, it has recognised the potential for improvement.

Royal Mail actively reviews the quality of the operationally sourced data that is used to drive costs within its activity based costing system. This year the focus of attention has shifted from traffic volumes, where measurement processes are now more stable, to processes surrounding the recording of operational hours worked.

There are inherent limitations in accurately recording staff time by individual activity. Time is recorded in accordance with Authorised Working Duties ('AWDs'), which set out the duties for staff at each operational site against expected traffic volumes. These are amended by 'pressure' (overtime to cover peak workloads) and 'lapsed' (where duties or part of the duties are not undertaken, due to lower workloads) time adjustments each week. Royal Mail recognises that there are inadequacies in the current time recording procedures within mail centres, and is in the process of deploying an action plan to improve the position, covering inter alia updating of AWDs, and reduction and simplification of categories of activity to which time can be assigned. As part of this plan, 500 staff have been given refresher training in time recording, and reporting has been put in place to identify key issues and pursue resolutions.

Royal Mail has prepared its regulatory financial statements using methodologies that are consistent with previous years.

Other costs have been assigned to activities by the use of appropriate drivers.

(iv) Statistical information

In assigning costs to products and services, Royal Mail makes use of statistically sampled information that is collected from operational sites. This information is used to determine relative weighting factors that allow cost differentials to be generated during the cost assignment process. One of the characteristics sampled is the average size of an item.

Historically, Royal Mail has refreshed this data for the latest sampled information each year, basing measurement on the latest 12 months of mails characteristic sampling data.

For 2006-07, Royal Mail has sought to increase the effective sample size by using the last 24 months of data in calculating the average size. Royal Mail believes that this change will help provide a more robust view of the average size of products used within the costing system.

In August 2006, Royal Mail introduced Pricing in Proportion. Mails characteristic sampling in the last quarter of 2006-07 suggests that the change in pricing structure may have had an impact on the average size of mail items. Royal Mail is continuing to evaluate the impacts of Pricing in Proportion on mail formats and sizes, and will consider the need to make a step change in average size based weighting factors in 2007-08.

D. Internal trading and transfer charging

Royal Mail operates through business units that make use of each other's services in order to take advantage of Group synergies, having regard to the mutual dependencies that exist.

Transfer charges are raised for internal trading and eliminated on consolidation. The elimination is shown in the reconciliation to the Royal Mail Group Ltd results.

Charges made for core services provided by Royal Mail Letters to other business units (i.e. Official Mail) are accounted for within revenue, whilst charges incurred by Royal Mail Letters for other services such as market rental charges for property, are accounted for within other operating charges.

Internal charges used in the production of the regulatory financial statements have been adjusted to reflect actual cost, which ensures that central functions within the Group do not generate a notional profit or loss. The principal exception to this are Post Office Ltd charges that are set using a basis of charges reached through a negotiation between the respective businesses.

E. Balance sheet

(i) General principles

As set out on page 9, Royal Mail has agreed with Postcomm that it is not required to include a balance sheet for 2006-07. Instead the Regulatory Asset Base is analysed in detail in Part 2: Unaudited financial information.

F. Cash flow statement

As set out on page 9, Royal Mail has agreed with Postcomm that it is not required to include a cash flow statement for 2006-07.

Notes to the statements

The following pages contain note information as follows:-

Note 1 Reconciliation of the regulatory income statement to the Royal Mail Group Ltd audited operating profit

Note 2 2006-07 Analysis of the USO and other Price Controlled products between Licensed and Non-Licensed services

Note 3 2006-07 People costs analysis

Note 4 Non-mails activities within Royal Mail Letters and other adjustments

Note 5 Royal Mail Letters exceptional items included in operating charges

Note 6 Royal Mail Group Ltd provisions for liabilities and charges

As agreed with Postcomm comparative information is not required for notes 2 and 3

Notes to the statements

1. Reconciliation of the regulatory income statement to the Royal Mail Group Ltd audited operating profit

2006-07

	Revenue £m	People costs £m	Depreciation and amortisation £m	Other operating charges £m	Operating profit/(loss) before operating exceptional items £m	Operating exceptional items £m	Operating (loss)/profit £m
Royal Mail Letters per Regulatory Income Statement (page 11)	6,963	(4,702)	(142)	(1,925)	194	(153)	41
Other Units	344	(288)	(29)	(23)	4	(2)	2
Inter business eliminations and recharges	(92)	-	-	92	-	-	-
Removal of impairment of investment in Spring (not in RMG Ltd)	-	-	-	-	-	10	10
Royal Mail Group Ltd	7,215	(4,990)	(171)	(1,856)	198	(145)	53

2005-06

	Revenue £m	People costs £m	Depreciation and amortisation £m	Other operating charges £m	Operating profit/(loss) before operating exceptional items £m	Operating exceptional items £m	Operating (loss)/profit £m
Royal Mail Letters per Regulatory Income Statement (page 11)	6,966	(4,581)	(123)	(1,918)	344	(152)	192
Other Units	323	(261)	(26)	(36)	-	(2)	(2)
Inter business eliminations and recharges	(94)	-	-	94	-	-	-
Removal of impairment of investment in Spring (not in RMG Ltd)	-	-	-	-	-	8	8
Release of inter company bad debt provision	-	-	-	-	-	318	318
Royal Mail Group Ltd	7,195	(4,842)	(149)	(1,860)	344	172	516

Notes to the statements

2. 2006-07 Analysis of the USO and other Price Controlled products between Licensed and Non-Licensed Services

	USO products			Non-USO Price controlled products, Including Access		
	Licensed 0 - 350g £m	Non licensed £m	Total £m	Licensed 0 - 350g £m	Non licensed £m	Total £m
Revenue	2,354	1,105	3,459	2,226	465	2,691
Operating Costs	(2,525)	(907)	(3,432)	(2,314)	(433)	(2,747)
People costs (analysed below)	(1,801)	(442)	(2,243)	(1,745)	(325)	(2,070)
Depreciation, amortisation and impairment	(42)	(21)	(63)	(26)	(4)	(30)
Net operating charges	(682)	(444)	(1,126)	(543)	(104)	(647)
Operating profit/(loss) before exceptional items	(171)	198	27	(88)	32	(56)
Operating exceptional items			(68)			(63)
Operating profit/(loss)			(41)			(119)
Volumes (excluding door to door)	8,577	764	9,341	10,873	880	11,753

People costs analysis

	USO products			Non-USO Price controlled products, Including Access		
	Licensed 0 - 350g £m	Non licensed £m	Total £m	Licensed 0 - 350g £m	Non licensed £m	Total £m
Wages, salaries and social security	(1,560)	(383)	(1,943)	(1,511)	(282)	(1,793)
Pensions	(241)	(59)	(300)	(234)	(43)	(277)
People costs total as above	(1,801)	(442)	(2,243)	(1,745)	(325)	(2,070)

Notes to the statements

3. 2006-07 People costs analysis

	USO Total £m	Price controlled non-USO products excluding Access £m	Downstream access £m	Total Price Controlled non-USO Products £m	USO Non Price Control Products £m	Total Price Control products £m	USO Non Price Control Products £m	Other Letter Products £m	Total Mails £m	Non-mails activities within RM Letters and other adjustments £m	RM Letters total £m
Wages, salaries and social security	(1,943)	(1,538)	(255)	(1,793)	(133)	(3,603)	(133)	(255)	(3,991)	(82)	(4,073)
Pensions	(300)	(238)	(39)	(277)	(21)	(556)	(21)	(39)	(616)	(13)	(629)
Total People costs	(2,243)	(1,776)	(294)	(2,070)	(154)	(4,159)	(154)	(294)	(4,607)	(95)	(4,702)

4. Non-mails activities within RM Letters and other adjustments

Non-mails activities include the Address Management Centre, Customer Management, Logistics and Stamps & Collectables. Other adjustments relate to the elimination of inter-business activities and reclassifications, where there is different treatment of costs between the statutory accounts and the regulatory financial statements. Centrally held costs are those which relate to regulated activities but are held within the holding company.

	2006-07			
	Revenue	People costs	Depreciation, amortisation and impairment	Net operating charges
	£m	£m	£m	£m
Non-mails activities	120	(54)	-	(42)
Interbusiness / Other adjustments	55	(41)	(42)	50
Centrally held costs and income	-	-	-	-
Total	175	(95)	(42)	8

	2005-06			
	Revenue	People costs	Depreciation, amortisation and impairment	Net operating charges
	£m	£m	£m	£m
Non-mails activities	123	(69)	(1)	(51)
Interbusiness / Other adjustments	74	(40)	(29)	47
Centrally held costs and income	-	(15)	-	14
Total	197	(124)	(30)	10

5. Royal Mail Letters exceptional items included in operating charges

	2006-07	2005-06
	£m	£m
Share in Success	-	(79)
Provision for restructuring	(139)	(63)
Impairment of property plant and equipment	-	(2)
Impairment of intangible assets	(4)	-
Impairment of goodwill relating to associates	(10)	(8)
	(153)	(152)

The £139m restructuring charge is all in respect of employee related costs (2005-06 £63m). The total Royal Mail Letters exceptional charge of £153m (2005-06 £152m) is as shown on the Regulatory income statement on page 11.

6. Royal Mail Group Ltd provisions for liabilities and charges

	2006-07 £m	2005-06 £m
Total provisions for liabilities and charges	114	109

The provision includes amounts relating to onerous property contracts £35m (2006 £51m) and decommissioning costs £9m (2006 £13m), with the balance of £70m (2006 £45m) principally relating to redundancy. During the year £141m (2006 £60m) was charged to operating exceptional items, £12m (2006 £11m) to other operating costs and £8m (2006 £nil) to profit/(loss) on disposal of tangible fixed assets.

The provision is in the main expected to be utilised in 2007-08, with the remaining amount expected to be utilised over the next two to three years, except for £24m relating to onerous property contracts and £8m relating to decommissioning costs which are expected to be utilised over a longer period. The timing of cash flows for these provisions are by their nature uncertain and dependent upon the outcome of related events.

The change in the carrying value of the discounted element of the provision due to the passage of time is not material.

Statement of responsibilities

Royal Mail Group Ltd is required, as agreed with Postcomm and under Condition 15 of the Licence, to provide Regulatory Financial Statements in respect of each regulatory Service.

Royal Mail Group Ltd confirms that the Regulatory Financial Statements have been prepared, after agreeing formats with Postcomm, in accordance with the above requirement and:

1. The statements have been prepared using accounting systems operating on the basis of objectively justifiable cost accounting principles that assign cost and revenue data to the Services;
2. Costs and revenues have been directly allocated to products as far as practicable. Common operational costs that cannot be directly assigned are, using an activity based costing system, attributed to the products equitably. Overhead costs are apportioned to products based on traffic volumes. In line with activity based costing approaches, estimates are required and have been applied in order to comply with the requirements of the Licence. Where there is no obvious driver to assign overhead costs to products, judgements are applied to ensure such costs are reasonably assigned;
3. The regulatory financial statements have been prepared adopting the following principles:
 - Principles as documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2007”; and
 - Accounting Policies for the income statement consistent with International Financial Reporting Standards. In so far as they impact on the income statement, the UK GAAP based Accounting Policies used in the audited accounts of Royal Mail Group Ltd for the year ended 25 March 2007 are consistent with IFRS.In cases of conflict the principles as documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2007” prevail; and
4. The regulatory financial statements are based on the financial records of the business and have been reconciled to the Operating profit within the audited Royal Mail Group Ltd statutory accounts.

The methodology adopted to produce the regulatory financial statements has been documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2007” and in notes A to F on pages 12 to 17. The methodology and approaches used to create these financial statements are not intended to establish precedents for future Regulatory Financial Statements.

Signed on behalf of the Board of Royal Mail Group Ltd.

Adam Crozier
31 July 2007

Ian Duncan
31 July 2007

Independent auditors' report

Independent auditors' report to the Directors of Royal Mail Group Ltd ("the Company") issued as required by Condition 15 of the Licence dated 25 May 2006 granted by the Postal Services Commission ("Postcomm").

We have audited Part 1 of the Regulatory Financial Statements on pages 3 to 23. Part 1 of the Regulatory Financial Statements, which have been prepared by the Company, comprises separate statements for the year ended 25 March 2007 for each of the services described on page 8 ("the Services").

This report is made solely to the Company's directors, as a body, in accordance with the requirements of Condition 15 of the Licence and the terms of our engagement. Our audit work has been undertaken so that we might state to the Company those matters we are required to state to them in a report of the independent auditors and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's directors as a body, for our audit work, for this report, or for the opinions we have formed.

Basis of Preparation

Part 1 of the Regulatory Financial Statements has been prepared using the "Regulatory accounting principles and basis of preparation" set out on pages 12 to 17, as agreed with Postcomm to meet Condition 15 of the Licence.

Part 1 of the Regulatory Financial Statements is separate from the Statutory Financial Statements of the Company and has not been prepared on the basis of the presentation and disclosure requirements of International Financial Reporting Standards ("IFRS"). Financial information other than that prepared on the basis of IFRS does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.

As explained in the "Regulatory accounting principles and basis of preparation" on pages 12 to 17, as agreed with Postcomm to meet the requirements of paragraph 2 of Condition 15 to the Licence, Part 1 of the Regulatory Financial Statements is prepared by disaggregating balances recorded in the general ledgers and other accounting records of the Company maintained in accordance with the Companies Act 1985 and used, in accordance with that Act, for the preparation of the statutory financial statements of the Company for the years ended 25 March 2007 and 26 March 2006 ("the Statutory Financial Statements").

As explained on pages 12 to 17 in the "Regulatory accounting principles and basis of preparation", in selecting appropriate attribution methods and appropriate non-financial data for use within the attribution models employed in the production of Part 1 of the Regulatory Financial Statements, the Company has had to make certain estimates and exercise its judgement, having regard to the terms of Condition 15 to the Licence, including cost causality and objectivity. The Company has informed Postcomm that attribution methods and non-financial data sources will be subject to ongoing review and, where deemed appropriate, improvement. Some changes have been made in the current year to certain attribution methods and these are described in the "Regulatory accounting principles and basis of preparation" and notes to Part 1 of the Regulatory Financial Statements.

Respective responsibilities of the Directors and independent auditors

The Company's responsibilities for preparing Part 1 of the Regulatory Financial Statements as agreed with Postcomm to meet the requirements of Condition 15 of the Licence are set out in the Statement of responsibilities on page 24.

Our responsibilities, as independent auditors, are established in the United Kingdom by the Licence, and by professional guidance.

We report our opinion as to whether Part 1 of the Regulatory Financial Statements for the year ended 25 March 2007 has been properly prepared, in all material respects, in accordance with the "Regulatory accounting principles and basis of preparation" on pages 12 to 17 and with the requirements of paragraph 4(a) of Condition 15 of the Licence.

We also report our opinion as to whether the records maintained pursuant to paragraph 1 of Condition 15 to the Licence comply with the requirements of paragraph 2 of Condition 15 to the Licence, amended as agreed with Postcomm.

We also read the Business review and Licence requirements in Part 1 and the Review of the year section of Part 2 of the Regulatory Financial Statements and consider the implications for our report if we become aware of any apparent misstatements within them.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board except as noted below. This includes examination, on a test basis, of evidence relevant to the amounts and disclosures in Part 1 of the Regulatory Financial Statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Part 1 of Regulatory Financial Statements, and of whether the accounting policies are consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that Part 1 of the Regulatory Financial Statements is free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of Part 1 of the Regulatory Financial Statements is determined by the Regulator, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Auditing Standards (UK and Ireland).

Our opinion on Part 1 of the Regulatory Financial Statements is separate from our opinion on the statutory accounts of the Company on which we expressed an unqualified audit opinion on 31 July 2007, which are prepared for a different purpose. Our audit report in relation to the statutory accounts of the Company (our "statutory" audit) was made solely to the members of the Company, as a body, in accordance with section 235 of the Companies Act 1985. Our statutory audit work was undertaken so that we might state to the members of the Company those matters we are required to state to them in a statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the Company and the members of the Company as a body, for our statutory audit work, for our statutory audit report, or for the opinions we have informed in respect of that statutory audit.

Opinion

Although the Company maintains records for each service, many of the Company's revenues and costs are not directly identifiable with individual services because of the extent of common assets and services. Therefore the preparation of the Regulatory Financial Statements requires a significant number of apportionments. This means that the records are not those that would exist if each of the Services were to be carried on by separate businesses in accordance with paragraph 2(b) of Condition 15 and accordingly are not such that if each of the separate Services was carried on by a separate company incorporated under the Companies Act 1985 each of those companies would comply with subsections 221(1) and (2) of that Act. Except as indicated above in our opinion the above records have been maintained to comply with the requirements of paragraph 2 of Condition 15 to the Licence, amended as agreed with Postcomm; and

In our opinion, Part 1 of the Regulatory Financial Statements of the Services for the year ended 25 March 2007, have been properly prepared, in all material respects, in accordance with the "Regulatory accounting principles and basis of preparation" on pages 12 to 17 and with the requirements of paragraph 4(a) of Condition 15 of the Licence.

Ernst & Young LLP

London

31 July 2007

Glossary and explanation of terms

£m

Million pounds sterling.

2006-07

52 week period ending 25 March 2007.

2005-06

52 week period ending 26 March 2006.

Account traffic

Account traffic is the volume of mail associated with customers who pay for postal services on account.

Activity based costing (“ABC”)

Activity based costing is a widely used and accepted method of costing products, services, customers and sales channels based upon the cost of the activities required to produce these outputs. The method identifies the resource consumed by activities and assigns a cost to the resource utilised by each activity. These are aggregated to derive activity costs.

Activity costs are then assigned to outputs, based upon pre defined cost drivers. These cost-drivers provide a measure of the intensity or frequency of an activity demanded by a product or service and reflect a cause and effect relationship.

Bulk Mail

The Bulk Mail definition includes Mailsort, Walksort and Cleanmail products.

Business units

Business units are the separate divisions that make up Royal Mail Holdings plc.

Downstream Access

Customer and other licensed postal operators’ mail, which enters the Royal Mail pipeline after the outward sortation and distribution processes.

EC Directive

A requirement placed upon the postal administrations of all EU member states to produce accounts in accordance with a prescribed specification.

Fully allocated cost (“FAC”)

The summation of direct and assigned costs for products or services such that no common costs are left unassigned.

Group

The business units that together make up Royal Mail Holdings plc, including Royal Mail Letters, Parcelforce and Post Office Ltd in the UK.

IFRS

International Financial Reporting Standards.

Long run marginal costs (“LRMC”)

Glossary and explanation of terms

The cost incurred in processing additional volumes of mail, assuming that levels of efficiency and service are maintained and that changes are made to all resources that need to be changed in order to achieve this. The assessment is typically made over a 3 to 5 year time horizon.

Mail stream characteristics

The payment method, class and format of mail items.

Pipeline

The sequence of operational processes that is followed by an item of mail. The full pipeline includes collection, sortation/ processing, distribution and delivery.

Postal services

A collective term for the Licensed USO, Non Licensed USO and Other letter products.

Postal Services Commission (“Postcomm”)

The body created under the Postal Services Act 2000 to regulate postal services in the UK.

Products

Products and services offered to customers.

For a full list of products refer to www.royalmail.com and select Product A-Z.

PSA

Postal Services Act 2000.

Regulatory financial statements (“Regulatory accounts”)

The statements, accounts and reports as expressed in the terms of the Licence which specifically refer to the year ended 25 March 2007 and comparative information for the previous year.

Revenue derived traffic

Volumes where the stamped and metered elements are derived from ledgered revenue using average unit revenues and the Mail Characteristics Survey – a survey of mail types (product stream and content) and volume which is used to derive payment method and class of mail items.

Royal Mail

The business units that collectively deliver the regulatory Services.

Royal Mail Group Ltd

A wholly owned subsidiary of Royal Mail Holdings plc and immediate parent undertaking of Post Office Ltd and General Logistics Systems International Holdings B.V., for which company statutory accounts are prepared.

Royal Mail Holdings

Royal Mail Holdings plc.

Royal Mail Letters

The principal business unit within Royal Mail.

Glossary and explanation of terms

The Licence

The Licence granted to Royal Mail Group Ltd, by the Postal Services Commission on 23 March 2001, as amended up to 25 May 2006.

The Services

The regulatory Services as defined by Postcomm.

UK

United Kingdom.

UK GAAP

UK Generally Accepted Accounting Practice.

Underlying growth

Volume growth based on revenue derived traffic volumes.

USO

Universal Service Obligation.