



Royal Mail Group Limited

**Regulatory Financial Statements
2007-08**

Part 2: Unaudited financial information

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Introduction and Executive Summary

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 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.

As discussed in detail in note (ix) on page 16 of Part 1 of these financial statements prior year comparative numbers have been restated where necessary to reflect the different treatment of property during 2007-08.

2007-8 was a 53 week year. Unless otherwise stated, the figures quoted do not adjust for the effect of this.

Executive Summary

- First class volumes down 7.3%; second class down 8.0%
- Average price increase for price controlled products of 5%, but underlying revenues declined by 3.2%
- Efficiency of 2.2% in 2007-08 and 3.1% in 2006-07
- Cash gap after two years of price control is some £1.1bn, with a prediction of £2.6bn over the four year control period
- Stamps lost £189m; all other major products saw a decline in profitability
- The USO lost £105m – the first time it has ever reported a loss

Review of the year

Volumes

These financial statements demonstrate that the postal market is continuing to move against Royal Mail. The table below summarises the position by product using working day adjusted revenue derived traffic. ¹

	Year on Year		Volume		
	Growth/(Decline)*	%	2007-08 million items	2006-07 million items	Inc/(dec) million items
First Class**	↓	(7.3%)	4,168	4,435	(267)
Second Class**	↓	(8.0%)	4,559	4,888	(329)
Mailsort ***	↓	(19.6%)	5,830	7,153	(1,323)
Downstream Access (DSA)	↑	65.4%	4,091	2,440	1,651
Presstream	↓	(15.7%)	543	635	(92)
Special Delivery, Standard Parcels,	↓	(5.4%)	91	94	(3)
Total Inland Addressed Products	↓	(3.2%)	19,282	19,645	(363)
Door to Door	↓	(3.3%)	3,146	3,210	(64)
International	↓	(3.1%)	1,213	1,234	(21)
Total	↓	(3.2%)	23,641	24,089	(448)

* The % growth is based on working day adjusted revenue derived traffic, whereas the volumes are the unadjusted values

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

*** Mailsort includes Mailsort, Mailmedia and Walksort

Excludes election mail volumes

The mails market as a whole continues to decline as customers are switching to non-postal products such as the internet and e-mail. Banks, utilities and local government are encouraging their customers to change to “paperless” communication, often giving financial incentives to do so.

Business customers are fully aware of the choices available to them in the competitive postal market, and are choosing products carefully to give them a value for money service. The level of downtrading to cheaper products remains high. The movements between products are not mitigated in the price control.

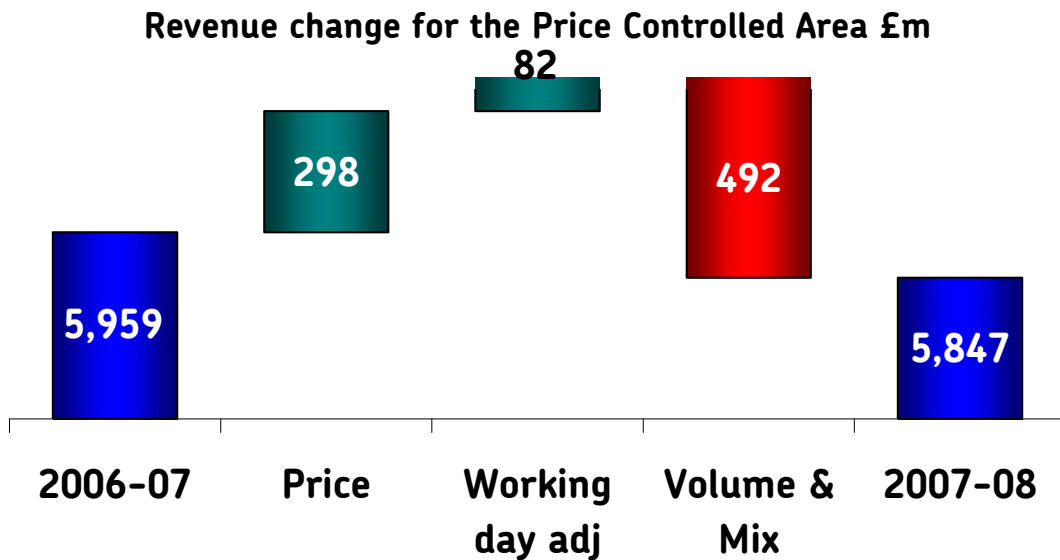
The high level of downtrading, pace of competitor penetration, and market instability was not anticipated in the price control. Consequently the Price Controlled area has made £201m loss in 2007-08, down from a £69m loss in 2006-07 (restated).

¹ 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 increased loss in the Price Controlled area has happened despite an increase in prices of around 5%. (This is higher than would have been expected for the second year of the price control due to under-recovery of revenue in previous years.) The overall average unit revenue for the Price Controlled area in 2006-07 was 29.0p, so if the full effect of the 5% increase had passed through the average unit revenue in 2006-07 would have been 30.5p. The average unit revenue achieved was only 29.4p. This revenue dilution is clearly of concern, as it suggests that Royal Mail continues to be unable to recover fully its allowed revenue within a competitive market.

The high level of revenue dilution, combined with an overall volume decrease for the Price Controlled area of 3.0%, has resulted in a £112m revenue decline for the Price Controlled area, despite the extra week's worth of trading in 2007-08.



The decline in revenue on a like-for-like basis is 3.2%.

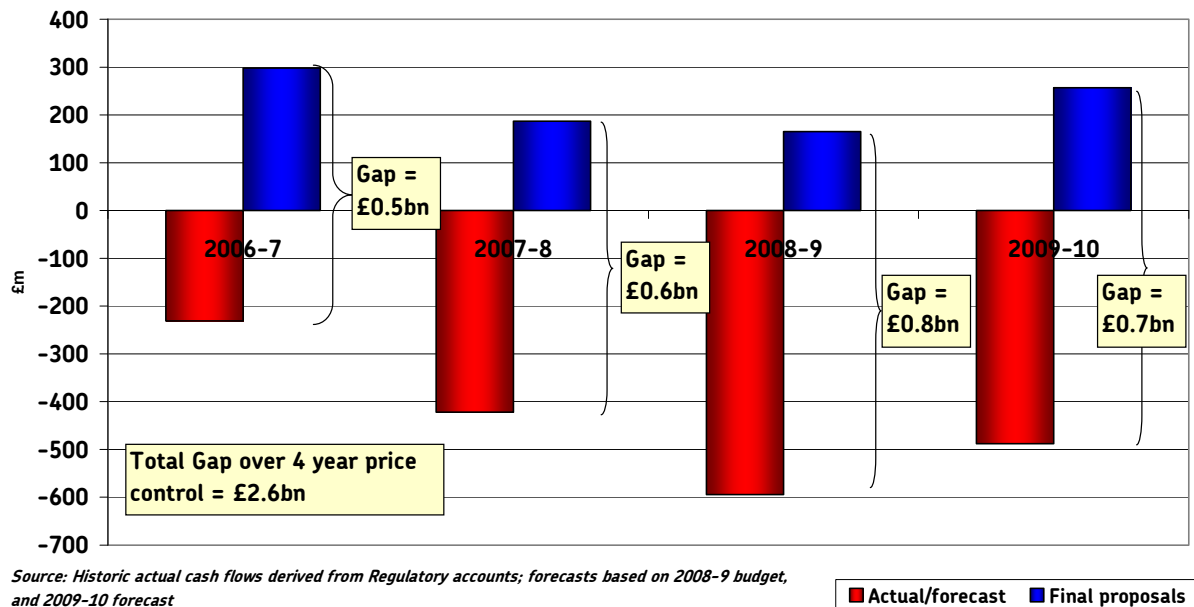
Efficiency and Costs

2007-08 was a very tough year operationally for Royal Mail, in which we experienced an extended period of industrial action and subsequent service restoration combined with a record level of volume decline. In response to these conditions, we delivered a 4.1% reduction in costs in real terms, and a volume adjusted efficiency of 2.2%.

Performance against the Price Control

Postcomm has set a control based on cash. The analysis below shows that a cash gap of some £2.6bn is predicted over the four year control period and that after the second year of the control the cumulative cash gap is already some £1.1bn.

Comparison of Regulated Cash Flows in Postcomm Final Proposals with actual and forecast Royal Mail results

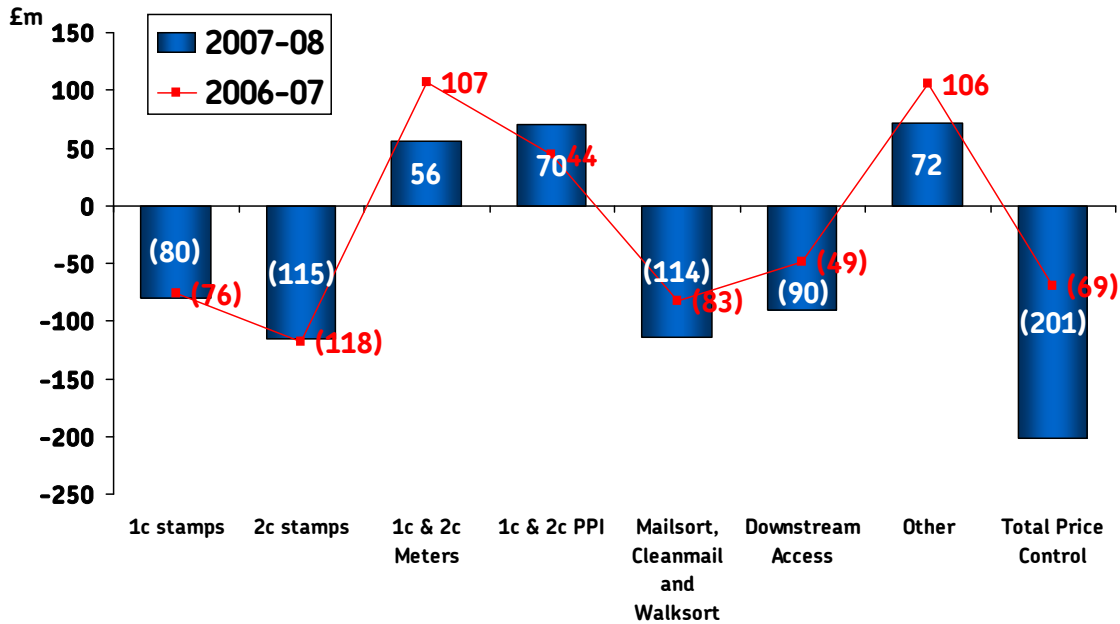


Review of the year

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:

Price Controlled area operating profit before exceptional items by key product group (£m)



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

The table below shows the average unit revenue and profit in 2007-08 for the same product groups.

	2007-08				
	Revenue £m	Profit £m	Operational volumes m items	Average Unit Revenue pence	Average Unit Profit/(loss) pence
Stamps	1,107	(195)	3,094	35.8	(6.3)
Meter	967	56	2,908	33.3	1.9
PPI	599	70	1,933	31.0	3.6
Mailsort, Walksort and Cleanmail	1,235	(114)	6,122	20.2	(1.9)
Downstream Access	566	(90)	4,077	13.9	(2.2)
Other	1,373	72	1,768	77.7	4.1
Total	5,847	(201)	19,902	29.4	(1.0)

On average stamps lost 6.3p per item, which is 0.7p worse than the 2006-07 value of 5.6p, despite a 2p/1p increase on the first weight step in April 2007 for first and second

Review of the year

class respectively. This is because there was a drop in volume, which meant that the full benefit of the tariff increase did not flow through into revenue.

Royal Mail continues to classify Business Collections as Other Letter Products. Should this product have been classified as price controlled, the net effect would be to increase the 2006-07 operating profit in the Price Controlled area by £28m (2006-07 £26m).

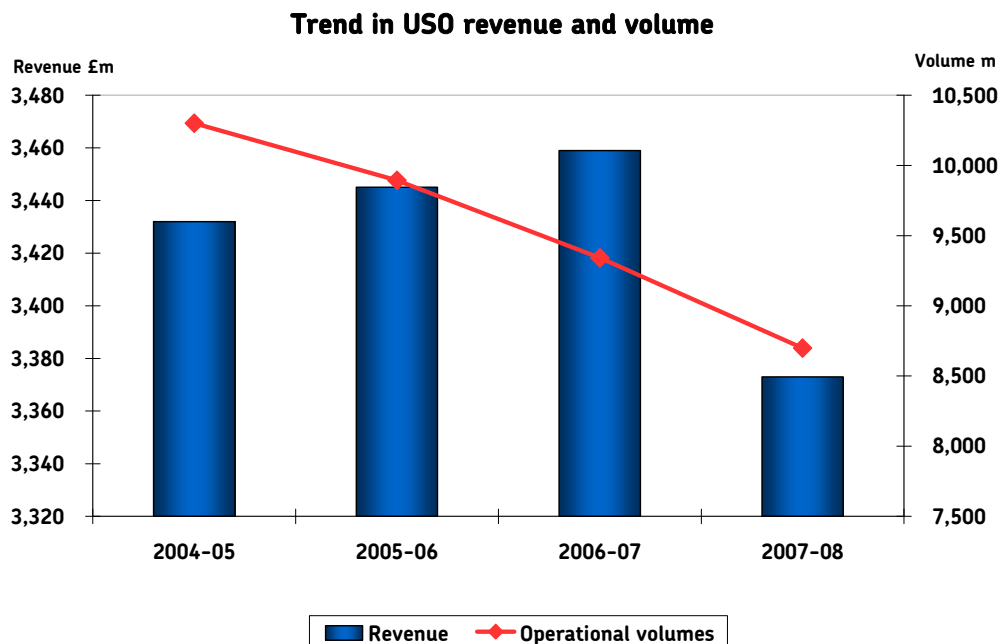
USO Performance

	2007-08				2006-07			
	Revenue £m	Profit £m	Margin %	Operational volumes m items	Revenue £m	Profit £m	Margin %	Operational volumes m items
1c stamp & meter	1,360	15	1.1	3,117	1,383	58	4.2	3,309
2c stamp & meter	724	(148)	(20.4)	2,900	733	(138)	(18.8)	3,016
Bulk Mail*	378	16	4.2	1,545	442	28	6.3	1,875
Other	911	12	1.3	1,137	901	54	6.0	1,141
Total	3,373	(105)	(3.1)	8,699	3,459	2	0.1	9,341

* Bulk Mail includes Mailsort and Cleanmail

USO volumes have decreased by 6.9% from 9,341m to 8,699m due to a reduction in social mail, combined with the migration of some meter and bulk mail to DSA.

The graph shows the revenue and volume trend for the USO stated on a like-for-like basis consistent with the post-2006 Licence definition of the constituents of the USO.



It can be seen that whereas in the past tariff increases have resulted in steadily increasing revenue even in the face of volume decline, in 2007-08 this trend has been broken. In 2007-08 revenues for the USO have declined for the first time, even when boosted by the extra week of trading, and 2p/1p tariff increases in first class and second class respectively.

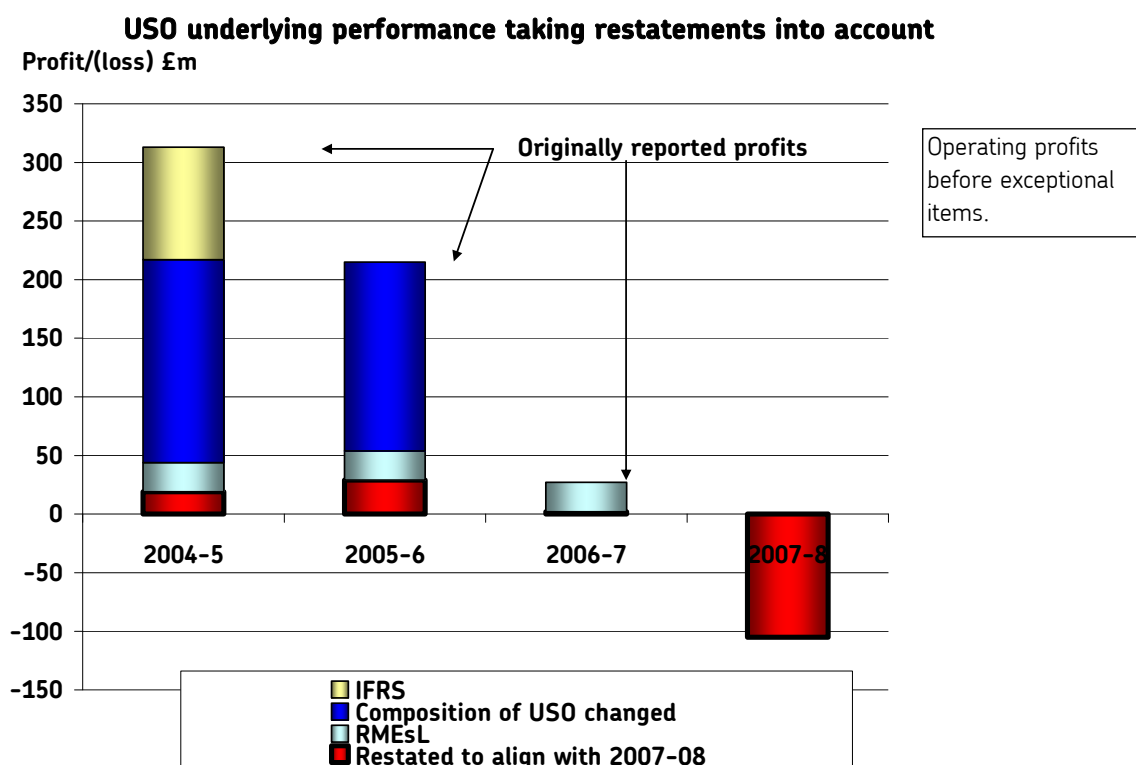
Review of the year

There have been three restatements of the business' results affecting the past four years, two of which arose because of external events:-

- the adjustment to move to International Financial Reporting Standards (IFRS), which was introduced in 2005-6; and
- the adjustment to reflect the change in composition of the USO in the new Licence issued in May 2006.

The adjustment to reflect the move of most properties to a separate company, Royal Mail Estates Limited (RMEsL), is fully discussed in note (ix) on page 16 of Part 1 of these financial statements. This is by far the smallest of the three adjustments in terms of its effect on the USO performance.

The following graph shows the impact of the various restatements on the originally reported USO profits/(losses), and hence the underlying trend (the red areas) can be seen.



Once again, after 3 years of relatively stable performance, albeit at very low margins, in 2007-08 there is a significant deterioration in performance as a consequence of the volume and revenue decline discussed above.

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 on a PIP classification of products. For account products, the figures have been derived based on actual PIP format data captured within the billing system. For stamp and meter each quarter has been based on sampling results together with modelling based on the average unit revenues by PIP format.

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

(ii) Costs by pipeline activity

The analysis in Note 2 details the costs by pipeline area for 2007-08 and 2006-07 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.

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

Note 3 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 Limited.

The majority of property assets are no longer included within Royal Mail Group Limited figures, as they are now owned by a separate company, Royal Mail Estates Limited. 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, vehicles and equipment across the pipeline areas is based on the costs incurred in operating and maintaining the assets within each pipeline area.

Regulatory accounting principles and basis of preparation

(iv) 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

(iv) Supplementary disclosure of specific products

Postcomm has agreed that certain products may be exempted from the requirements of Condition 7 of the Licence provided that Royal Mail publishes details of their performance in the regulatory financial statements. Accordingly note 4 provides details of Branch Direct, and International Bulk Mail.

(v) Postcode Address File income statement

Note 5 sets out a proforma income statement for the Postcode Address File (PAF), the disclosure of which was agreed as part of Postcomm's review into the future management of PAF.

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	1,505	514	462	892	3,373	1,081	808	187	18	566	2,660
Operating costs	(1,578)	(551)	(507)	(842)	(3,478)	(1,102)	(728)	(312)	(6)	(656)	(2,804)
People costs	(1,105)	(385)	(358)	(395)	(2,243)	(792)	(536)	(237)	(5)	(496)	(2,066)
Depreciation, amortisation and impairment	(38)	(8)	(4)	(25)	(75)	(17)	(9)	(3)	-	(8)	(37)
Net operating charges	(435)	(158)	(145)	(422)	(1,160)	(293)	(183)	(72)	(1)	(152)	(701)
Operating profit/(loss) before exceptional items	(73)	(37)	(45)	50	(105)	(21)	80	(125)	12	(90)	(144)
Volumes (excluding door to door)	6,276	1,183	268	972	8,699	5,319	2,184	203	4	4,077	11,787

As discussed in more detail on page 10, the above results have been derived based on actual PIP data, combined with estimates derived from sampling results for the non account based products. As a consequence the above numbers should be treated as indicative only.

Unaudited notes to the financial statements

2. 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
2007-08										
Bulk	(373)	(1,866)	(539)	(501)	(3,279)	(299)	(1,112)	(224)	(174)	(1,809)
Non-bulk	(1,049)	(1,199)	(726)	(559)	(3,533)	(878)	(738)	(211)	(208)	(2,035)
Total	(1,422)	(3,065)	(1,265)	(1,060)	(6,812)	(1,177)	(1,850)	(435)	(382)	(3,844)
2006-07 (Restated)										
Bulk	(362)	(1,828)	(593)	(464)	(3,247)	(290)	(1,107)	(234)	(186)	(1,817)
Non-bulk	(1,006)	(1,188)	(743)	(514)	(3,451)	(843)	(748)	(241)	(208)	(2,040)
Total	(1,368)	(3,016)	(1,336)	(978)	(6,698)	(1,133)	(1,855)	(475)	(394)	(3,857)

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

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

2007-08

	Processing £m	Access, National and Local Distribution £m	Delivery £m	Other £m	Total Mails £m	Non Mails assets £m	Total Royal Mail Group Limited £m
Property	-	-	-	-	-	74	74
Property fit out	107	39	207	7	360	9	369
Vehicles	-	86	57	1	144	12	156
Plant and machinery	276	10	8	4	298	2	300
Fixtures and equipment	12	5	23	1	41	9	50
Total	395	140	295	13	843	106	949

2006-07

	Processing £m	Access, National and Local Distribution £m	Delivery £m	Other £m	Total Mails £m	Non Mails assets £m	Total Royal Mail Group Limited £m
Property	-	-	-	-	-	109	109
Property fit out	113	40	216	8	377	7	384
Vehicles	-	79	53	1	133	11	144
Plant and machinery	265	10	8	4	287	-	287
Fixtures and equipment	6	4	13	-	23	16	39
Total	384	133	290	13	820	143	963

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 2007-08 property, plant, vehicles and equipment profiles across pipeline areas have been applied to both 2006-07 and 2007-08, and as such the comparative values have been restated.

Unaudited notes to the financial statements

4. Disclosure of performance of specific products

	Revenue (£m)	Fully Allocated Cost (£m)	Operating Profit/(loss) before exceptional Items (£m)
International Bulk Mail	103	(79)	24
Branch Direct	18	(24)	(6)

5. Postcode Address File Proforma Income Statement 2007-08

	£m
Revenue	22.8
Operating Costs	(20.0)
Operating Profit	<u>2.8</u>