



Royal Mail Group Ltd

**Regulatory Financial Statements
2008-09**

Part 2: Unaudited financial information

Contents

Introduction and Executive summary	3
Review of the year	4
Regulatory accounting principles and basis of preparation	9
Unaudited notes to the financial statements	11

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 Auditor for consistency with Part 1 of the regulatory financial statements.

As discussed in detail in note (ix) on page 15 of Part 1 of these financial statements, prior year comparative numbers have been restated where necessary to reflect the different treatment of overheads and POL interbusiness charges during 2008-09.

2007-08 was a 53 week year, whereas 2008-09 was a standard 52 week year. Unless otherwise stated, the figures quoted do not adjust for the effect of this.

Executive Summary

- First class volumes down 10%; second class down 9%; Mailsort down 25%;
- Average price increase for price controlled products of 5%, but underlying revenues declined by 3.6%;
- Cash gap after three years of price control is some £2.0bn, with a revised forecast of £3.1bn over the four year control period;
- Stamps lost £244m; and
- The USO lost £108m – the second year in succession that a loss has been reported.

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

	Growth/(Decline)		2008-09	Volume	Inc/(dec)
		%	million items	2007-08#	million items
				million items	million items
First Class*	↓	(10%)	3,741	4,168	(427)
Second Class*	↓	(9%)	4,165	4,559	(394)
Mailsort	↓	(25%)	4,348	5,830	(1,482)
Downstream Access (DSA)	↑	31%	5,353	4,091	1,262
Presstream	↓	(13%)	471	543	(72)
Special Delivery, Standard	↑	2%	93	91	2
Total Inland Addressed	↓	(6%)	18,171	19,282	(1,111)
Door to Door	↓	(9%)	2,858	3,146	(288)
International	↑	1%	1,223	1,213	10
Total	↓	(6%)	22,252	23,641	(1,389)

* 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 increasingly 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.

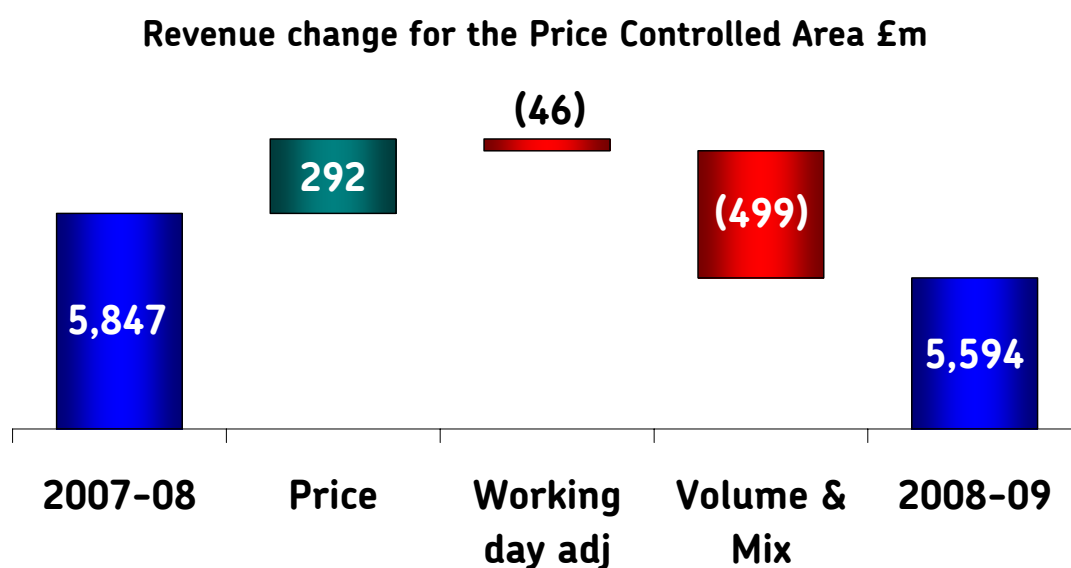
The high level of downtrading, pace of competitor penetration, and market instability was not anticipated in the price control. Consequently the Price Controlled area has continued to make a loss, £92m in 2008-09, compared to a £160m loss in 2007-08 (restated).

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 continued 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 third 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 2007-08 was 29.4p, so if the full effect of the 5% increase had passed through the average unit revenue in 2008-09 would have been 30.9p. The average unit revenue achieved was only 30.5p. 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 8%, has resulted in a £253m revenue decline for the Price Controlled area in 2008-09.



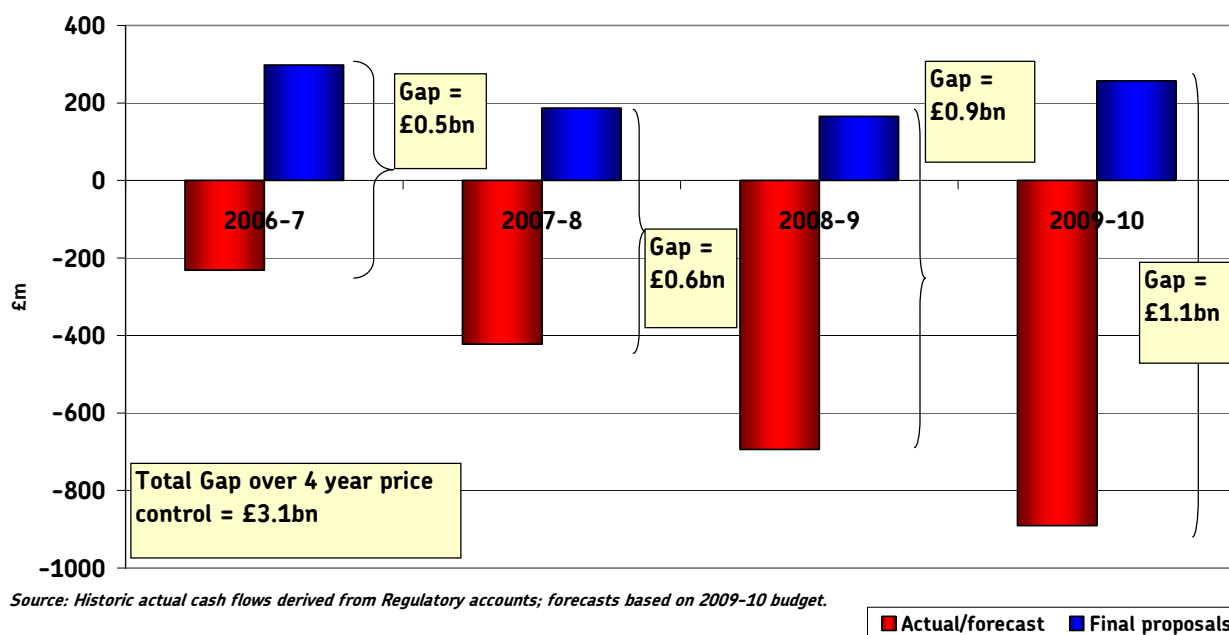
The decline in revenue on a like-for-like basis is 3.6%.

Review of the year

Performance against the Price Control

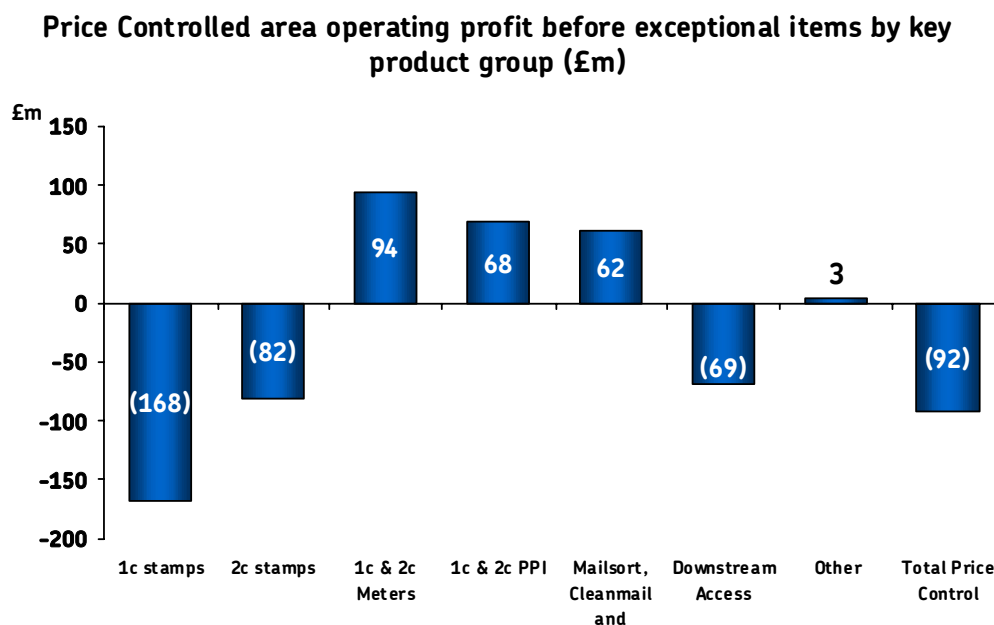
Postcomm has set a control based on cash. The analysis below shows that a cash gap of some £3.1bn is predicted over the four year control period and that after the third year of the control the cumulative cash gap is already some £2.0bn.

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



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 2008-09 for the same product groups.

			2008-09		
	Revenue £m	Profit £m	Operational volumes m items	Average Unit Revenue pence	Average Unit Profit/(loss) pence
Stamps	1,062	(250)	2,800	37.9	(8.9)
Meter	901	94	2,602	34.6	3.6
PPI	519	68	1,634	31.8	4.2
Mailsort, Walksort and Cleanmail	963	62	4,438	21.7	1.4
Downstream Access	766	(69)	5,280	14.5	(1.3)
Other #	1,383	3	1,600	86.4	0.2
Total	5,594	(92)	18,354	30.5	(0.5)

Other includes Special Delivery, Presstream, Packetpost and Airmail

On average stamps lost 8.9p per item, which is 0.4p worse than the 2007-08 value of 8.5p, despite a 2p/3p increase on the first weight step in April 2008 for first and second 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. On the cost side, there were some technical adjustments, such as the new POL interbusiness contract, which is discussed further on page 6 of Part 1.

Review of the year

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 2008-09 operating profit in the Price Controlled area by £29m (2007-08 £29m).

USO Performance

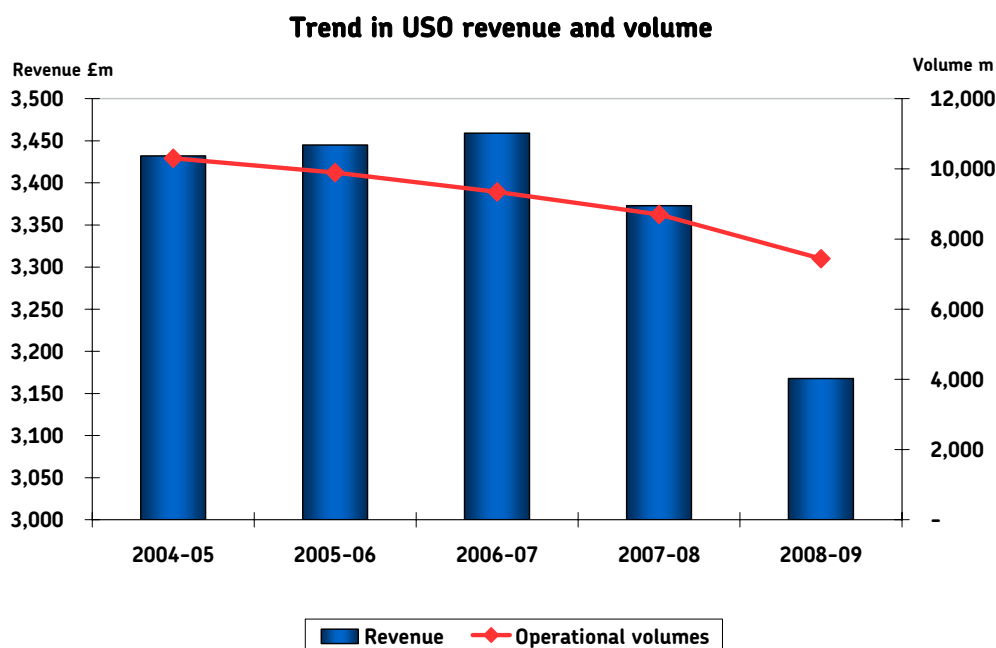
	2008-09				2007-08 (Restated)			
	Revenue £m	Profit £m	Margin %	Operational volumes m items	Revenue £m	Profit £m	Margin %	Operational volumes m items
1c stamp & meter	1,249	(82)	(6.6)	2,767	1,360	(59)	(4.3)	3,117
2c stamp & meter	724	(69)	(9.5)	2,648	724	(123)	(17.0)	2,900
Bulk Mail*	306	43	14.1	1,132	378	43	11.4	1,545
Other #	889	-	-	838	911	(43)	(4.7)	1,137
Total	3,168	(108)	(3.4)	7,385	3,373	(182)	(5.4)	8,699

*Bulk Mail includes Mailsort and Cleanmail

Other includes Special Delivery, Airmail and incoming international mail

USO volumes have decreased by 15.1% from 8,699m to 7,385m. Of this a net 144m decrease is due to a reclassification of some minor products between USO and non-USO, as detailed in note B (x) of Part 1 of these financial statements. The bulk of the decrease is due to a reduction in social mail, combined with the migration of some meter and bulk mail to DSA.

The graph below shows the 5 year revenue and volume trend for the USO consistent with the post-2006 Licence definition of the key constituents of the USO.



It can be seen that whereas up to 2007-08 tariff increases had resulted in steadily increasing revenue even in the face of volume decline, in 2007-08 this trend was broken, and in 2008-09 revenues dropped even more significantly, as 2007-08 revenues were boosted by the extra week of trading. USO revenues dropped by £205m between 2007-08 and 2008-09, of which £57m (net) was due to the reclassification of some products between the USO and non-USO (further discussed in note B(x) of Part 1), and the remaining £148m was due to trading effects.

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 2008-09 and 2007-08 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 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 Limited. The properties are leased at market rates to the business units that deliver the regulatory Services.

Property fit out costs are those incurred in order 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 – 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 net book value and to the remaining useful economic lives of assets and their estimated residual values.

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

	Range of asset lives
Land and buildings:	
Freehold land	not depreciated
Freehold buildings	up to 50 years
Leasehold buildings	the shorter of the period of the lease, 50 years or the estimated remaining useful life
Plant and machinery	3 – 15 years
Motor vehicles and trailers	1 – 12 years
Fixtures and equipment	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, International Bulk Mail, and Special Delivery account.

(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	1,373	475	431	889	3,168	839	705	232	72	766	2,614
Operating costs	(1,332)	(537)	(550)	(857)	(3,276)	(734)	(606)	(407)	(58)	(834)	(2,639)
People costs	(942)	(345)	(359)	(395)	(2,041)	(563)	(450)	(297)	(37)	(669)	(2,016)
Depreciation, amortisation and impairment	(38)	(11)	(6)	(23)	(78)	(14)	(11)	(5)	(1)	(13)	(44)
Net operating charges	(352)	(181)	(185)	(439)	(1,157)	(157)	(145)	(105)	(20)	(152)	(579)
Operating profit/(loss) before exceptional items	41	(62)	(119)	32	(108)	105	99	(175)	14	(68)	(25)
Volumes (excluding door to door)	5,343	1,036	250	756	7,385	3,951	1,828	242	128	5,280	11,429

As discussed in more detail on page 9, 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
2008-09										
Bulk	(438)	(1,816)	(450)	(330)	(3,034)	(335)	(1,065)	(174)	(114)	(1,688)
Non-bulk	(1,123)	(1,151)	(727)	(581)	(3,582)	(917)	(697)	(295)	(218)	(2,127)
Total	(1,561)	(2,967)	(1,177)	(911)	(6,616)	(1,252)	(1,762)	(469)	(332)	(3,815)
2007-08 (Restated)										
Bulk	(413)	(1,863)	(482)	(380)	(3,138)	(325)	(1,111)	(191)	(134)	(1,761)
Non-bulk	(1,093)	(1,199)	(693)	(670)	(3,655)	(906)	(738)	(187)	(245)	(2,076)
Total	(1,506)	(3,062)	(1,175)	(1,050)	(6,793)	(1,231)	(1,849)	(378)	(379)	(3,837)

Bulk products defined as Mailsort, Cleanmail, PPI, Response Services, Presstream, Packetpost, Packetsort, Walksort and Access (i.e. 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

2008-09

	Processing £m	Access, National and Local Distribution £m	Delivery £m	Other £m	Total Mails £m	Non Mails assets £m	Total Royal Mail Group Ltd £m
Property	-	-	-	-	-	60	60
Property fit out	148	37	174	5	364	15	379
Vehicles	-	96	70	1	167	11	178
Plant and machinery	376	10	7	3	396	3	399
Fixtures and equipment	29	9	35	1	74	7	81
Total	553	152	286	10	1,001	96	1,097

2007-08 (Restated)

	Processing £m	Access, National and Local Distribution £m	Delivery £m	Other £m	Total Mails £m	Non Mails assets £m	Total Royal Mail Group Ltd £m
Property	-	-	-	-	-	74	74
Property fit out	147	36	172	5	360	9	369
Vehicles	-	83	60	1	144	12	156
Plant and machinery	284	7	5	2	298	2	300
Fixtures and equipment	16	5	19	1	41	9	50
Total	447	131	256	9	843	106	949

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 Limited. The properties are leased at market rates to the business units that deliver the regulatory Services. Property fit out costs are those incurred in order 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 2008-09 property, plant, vehicles and equipment profiles across pipeline areas have been applied to both 2007-08 and 2008-09, and as such the comparative values have been restated.

Unaudited notes to the financial statements

4. Disclosure of performance of specific products

	2008-09		Operating Profit/(loss) before exceptional items (£m)
	Revenue (£m)	Fully Allocated Cost (£m)	
International Bulk Mail	111	(98)	13
Branch Direct	7	(19)	(12)
Special Delivery Account	118	(80)	38

5. Postcode Address File Proforma Income Statement 2008-09

	£m
Revenue	25.0
Operating Costs	(22.0)
Operating Profit	<u>3.0</u>