Royal Mail Group plc

Regulatory Financial Statements 2005-06

Contents

Summary of results

	2005-06						2004-05 restated for IFRS					
	USO	Other letter products[2]	Downstream Access	Regulatory accounts total	Non letters, excluded and eliminations	Group total[3]	USO	Other letter products[2]	Downstream Access	Regulatory accounts total	Non letters, excluded and eliminations	Group total[3]
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Revenue	5,870	747	152	6,769	2,287	9,056	6,016	648	12	6,676	2,280	8,956
Operating costs[1]	(5,655)	(657)	(166)	(6,478)	(2,223)	(8,701)	(5,799)	(554)	(12)	(6,365)	(2,289)	(8,654)
Operating profit/ (loss) before exceptional items[1]	215	90	(14)	291	64	355	217	94	-	311	(9)	302
Operating exceptional items (excluding Share in Success)	(55)	(6)	(2)	(63)	(56)	(119)	(34)	(2)	-	(36)	(23)	(59)
Operating profit / (loss) before Share in Success	160	84	(16)	228	8	236	183	92	-	275	(32)	243
Share in Success	(69)	(8)	(2)	(79)	(12)	(91)	(181)	(16)	(1)	(198)	(20)	(218)
Operating profit / (loss)	91	76	(18)	149	(4)	145	2	76	(1)	77	(52)	25
Operating Margin Before Exceptionals	*3.7%*	*12.0%*	*-9.2%*	*4.3%*			*3.6%*	*14.5%*	*0.0%*	*4.7%*		
Operating Margin (including Share in Success)	*1.6%*	*10.2%*	*-11.8%*	*2.2%*			*0.0%*	*11.7%*	*-8.3%*	*1.2%*		
Operational volumes (millions of items (excluding Door to Door))	*19,458*	*1,678*	*1,157*	*22,293*			*20,878*	*1,274*	*87*	*22,239*		

- USO business showed a slight deterioration in operating profit before exceptional items from £217m to £215m, though the USO margin before exceptional items has improved from 3.6% to 3.7%;
- USO revenues decreased by 2.4%, despite the tariff increase from April 2005 of 1.7% (2004-05 1.3%), caused by a 6.8% decrease in volumes. The main component of this decrease was the move from end-to-end processed bulk mail to downstream access;
- USO profits mask the fact that the 0-100g Service, which accounts for 76.2% of total volume (2004-05 83.5%), recorded an operating loss of £250m (2004-05 £543m); and
- Stamped mail losses of £237m (2004-05 £281m) continue to be subsidised by business (meter and account) mail.

[1] Before charges relating to operating exceptional items
[2] Other letter products also includes the Non USO Price Control products as per the income statements on page 9
[3] Group total Operating profit numbers exclude profit/ loss on disposal of businesses and disposal of property, plant and equipment

Introduction

A financial review of the Group is included within the Royal Mail Holdings plc Report and Accounts for the year ended 26 March 2006 (the "RMH Statutory Accounts"). This review supplements those accounts in the context of regulatory reporting. 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 USO results.

The results continue to expose the lack of alignment between product cost and product pricing, where once again:

- Higher weighted items subsidise lower weighted ones; and
- Business users (meter and account customers) subsidise social users (stamps).

These issues are now recognised by Postcomm, and as pricing structures continue to be developed, Royal Mail is seeking to align more appropriately its prices with the costs of delivering the service. Two examples of this shift can be seen in pricing changes during 2006-07:

- Pricing in Proportion is due to go live in August 2006, and this will introduce a 'size based' dimension to product pricing. The size of a mail item has a significant impact on the cost of sortation, transportation and delivery, and as such it will be an important lever in better aligning price with cost; and
- From April 2006, to mirror first class pricing, Royal Mail has introduced a 1p differential on the price of a basic weight second class stamped item as compared to the equivalent business mail product. The basic second class stamp price is now 23p, compared to an account mail price of 22p. A basic first class stamp price is now 32p, as compared with the 31p account mail price.

Whilst these moves are in the right direction, there remains a significant disparity between cost and price. Continued realignment of prices by class, payment method and zone of delivery will be essential if the mails market is not to be distorted by cream skimming activity.

Financial Summary

2005-06 represents a year of consolidation following completion of the renewal plan in 2004-05. The principal drive for the year was to maintain the profit turnaround into the final year of the price control, whilst continuing to improve the quality of the service offered to customers. The financial year has seen the material onset of competition in the mails marketplace, with more than 1.1bn items of business mail migrating to downstream access (DSA). This fundamental change in the market structure is set to continue.

During the year Royal Mail has developed the next stage of its business investment strategy. This provides for significant investment in customer service, infrastructure and people, to be financed through a combination of efficiency improvements, the new Price Control and an appropriate new commercial financing package from the Shareholder.

At the heart of the strategy is a desire to be allowed to compete appropriately on price in the rapidly changing marketplace, whilst offering improved service in a more efficient manner. Also critical to the long term success of the business is to generate sufficient funds to support the increased funding requirement of the pension plans.

USO Performance Summary

The financial analysis in the remainder of the Business Review section focuses on Operating profit before exceptional items. A summary of operating profit performance before exceptional items is shown below:

	2005-06			2004-05		
	Revenue	**Profit**	**Margin**	**Revenue**	**Profit**	**Margin**
	£m	**£m**	**%**	**£m**	**£m**	**%**
1c stamp/ meter/ PPI	1,738	125	7.2	1,700	50	2.9
2c stamp/ meter/ PPI	1,084	(77)	(7.1)	1,126	(162)	(14.4)
Bulk Mail*	1,582	38	2.4	1,810	69	3.8
Other	1,466	129	8.8	1,380	260	18.8
Total	**5,870**	**215**	**3.7**	**6,016**	**217**	**3.6**

**Bulk Mail includes Mailsort, Walksort and Cleanmail*

Royal Mail continues to classify Business Collections as Other letter products. Should this product have been classified as USO, the net effect would be to increase the 2005-06 operating profit in the USO by £25m (2004-05 £21m).

USO Revenues

USO revenues decreased by £146m (2.4%) to £5,870m in 2005-06, driven principally by a reduction in bulk mail revenues as traffic has migrated to DSA. Customers have also taken action to downtrade to cheaper product alternatives, both in terms of class of service and presortation level, which has also contributed to the dilution in revenue. This has been partially offset by the impact of price increases on 1st Class mail and growth in Special Delivery.

USO Operational volumes

USO volumes have decreased by 6.8% from 20,878m to 19,458m due to the migration of traffic to DSA and continued volume decline in social mail. It is worth noting, however, that the total volume of bulk mail traffic (including DSA) has continued to grow at 3.4%.

USO Costs from operations

The following table highlights the breakdown of costs in the USO:

	2005-06	2004-05
	£m	£m
People costs	(3,881)	(3,971)
Depreciation, amortisation and impairment	(83)	(80)
Net operating charges	(1,691)	(1,748)
Total	(5,655)	(5,799)

Overall USO operating costs have decreased by £144m (2.5%). Whilst total costs in the mails business have continued to rise by 1.8%, the growth in DSA has switched costs from the USO to DSA. People costs represent 68.6% (2004-05 68.5%) of total costs, which remains an extremely high proportion when compared to many other regulated industries.

USO Operating profit (before operating exceptionals and Share in Success)

By Product

As set out above, the USO operating profit before exceptional items of £215m continues to be driven by 1st Class, Bulk Mail products (Mailsort, Walksort and Cleanmail) and other products such as Packetpost and Special Delivery.

This continues to mask the fact that stamped products generate losses of £237m (2004-05 £281m), which are more than offset by profitable meter and account products.

From April 2005, Royal Mail started to address this discrepancy by introducing a higher price for 1st Class stamped mail than for metered or account products. This change has helped to reduce losses in stamped products in the year.

By Service

Whilst USO traffic volumes have declined by 1.4bn items, the profitability of the USO has reduced by only £2m to £215m (2004-05 £217m).

The impact of the increased tariff on basic weight 1st Class items has increased contribution within the USO significantly, though this has been offset by the migration of traffic to DSA and a material increase in redirections traffic (driven by improved traffic measurement).

During the year, as part of the refresh of cost driver information, Royal Mail updated its statistical data on the average size of mail items. This has led to changes in the relative weighting factors used to differentiate the assignment of costs between formats of mail (letters, flats, packets and parcels) in the costing system, and has consequently impacted on the distribution of costs between the USO Services. In summary, this has reduced costs allocated to the 0-100g Service, and increased costs in the other Services.

The 0-100g Service is still loss making at £163m (2004-05 £380m loss), representing a negative margin on revenue of 4.5% (2004-05 9.8%). Operational volumes in the service have declined by 1.6 billion items, with items lost not only from Mailsort as traffic migrates to DSA, but also from 1st and 2nd Class as customers chose cheaper product alternatives such as Cleanmail Plus. This loss has been mitigated by the basic weight step price increase on 1st Class products and by changes in the relative weighting factors used to assign costs between letters and the larger format products, a move that has switched costs to larger mail formats and therefore to the heavier weightstep Services.

The 101-350g Service is profitable at £10m (2004-05 £88m profit), the worsening performance driven by the migration to DSA of profitable volume in Mailsort combined with traffic growth in loss making 1st Class stamped items. The weighting factor refresh on average mail size has also contributed to the reduction in profitability.

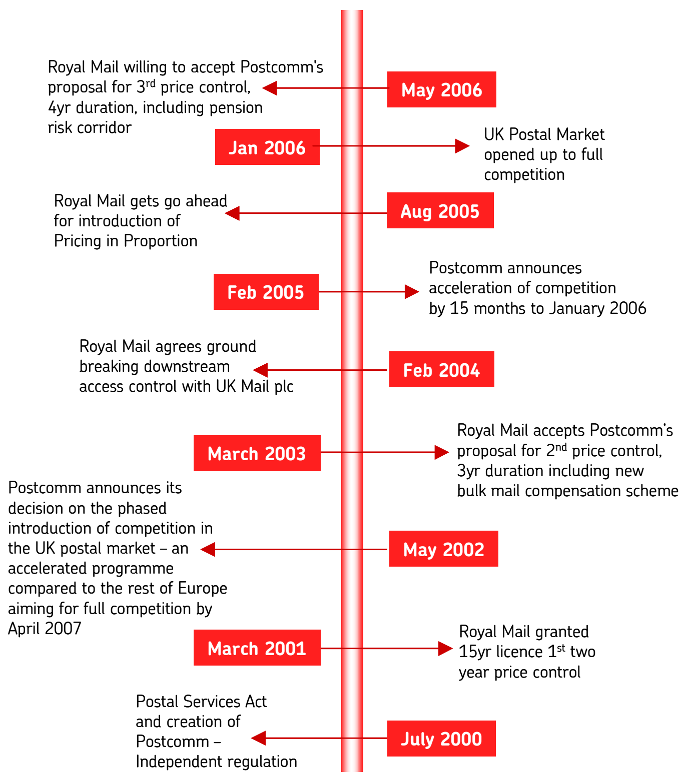
Profits in the Non Licensed and 350g+ Service have declined by £141m to £368m (2004-05 £509m), driven principally by additional traffic and costs identified against the Redirections product (an additional 155m items attracting £66m of cost into this Service), DSA migration, higher costs of Special Delivery driven by the new internal trading contract with Post Office Ltd and the weighting factor refresh.

The differences in profitability by Service arise because pricing is driven by weight, whilst cost is driven principally by format and size.

Regulatory Review

The Postal Services Commission (Postcomm) was created as the Independent Regulator for the UK postal sector in 2000. Subsequently, 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:



During 2005-06, work with Postcomm has focused in the following areas:

- Price Control: Postcomm has now set a Price Control for the four-year period commencing in April 2006. The main components of the new control include:

  - The price controlled products have been allocated into one of two baskets. One of these is for captive products (i.e. effective monopoly products such as 1st and 2nd Class Standard Tariff Letters), the other for non captive products. Price control restrictions have been set specific to each basket.
  - There is increased focus on non price related factors, with some restrictions on commercial activity and increased Quality of Service monitoring.
  - An initial price increase of 4% was allowed from April 2006 specifically to help fund the pension deficit.

- Pricing in Proportion: Following consultation, a fundamental change in the way Royal Mail prices its products and services has been agreed with Postcomm. In August 2006 Royal Mail will, for the first time, introduce a more cost reflective size based dimension to prices. This move should start to address the disparity in profits between different Service categories within the USO.

Income statements

For the years ended 26 March 2006 and 27 March 2005

Income statement – 2005-06

All figures in £m or stated otherwise	2005-06										
	USO				Less	Add	Sub total	Add	Add	Add	Total
	0-100g £m	101-350g £m	Non Licensed, 350g+ £m	Total USO £m	USO Non Price Control products £m	Non USO Price Control products[1] £m	Total Price Control products £m	Other letter products £m	Downstream Access £m	USO Non Price Control products £m	Total Mails[2] £m
Revenue	3,641	758	1,471	5,870	204	286	5,952	461	152	204	6,769
Operating costs	(3,804)	(748)	(1,103)	(5,655)	(233)	(292)	(5,714)	(365)	(166)	(233)	(6,478)
People costs	(2,747)	(535)	(599)	(3,881)	(168)	(219)	(3,932)	(221)	(136)	(168)	(4,457)
Depreciation, amortisation and impairment	(59)	(6)	(18)	(83)	(6)	(2)	(79)	(5)	(3)	(6)	(93)
Net operating charges	(998)	(207)	(486)	(1,691)	(59)	(71)	(1,703)	(139)	(27)	(59)	(1,928)
Operating profit/ (loss) before exceptional items	(163)	10	368	215	(29)	(6)	238	96	(14)	(29)	291
Operating exceptional items:											
Share in Success	(49)	(9)	(11)	(69)	(3)	(4)	(70)	(4)	(2)	(3)	(79)
Other	(38)	(8)	(9)	(55)	(3)	(3)	(55)	(3)	(2)	(3)	(63)
Operating profit/ (loss)	(250)	(7)	348	91	(35)	(13)	113	89	(18)	(35)	149
Operational Volumes (excluding Door to Door) (millions)	16,995	1,485	978	19,458	707	1,028	19,779	650	1,157	707	22,293

Income statement – 2004-05

All figures in £m or stated otherwise	2004-05 Restated for IFRS										
	USO				Less	Add	Sub total	Add	Add	Add	Total
	0-100g £m	101-350g £m	Non Licensed, 350g+ £m	Total USO £m	USO Non Price Control products £m	Non USO Price Control products[1] £m	Total Price Control products £m	Other letter products £m	Downstream Access £m	USO Non Price Control products £m	Total Mails[2] £m
Revenue	3,867	775	1,374	6,016	204	219	6,031	429	12	204	6,676
Operating costs	(4,247)	(687)	(865)	(5,799)	(200)	(202)	(5,801)	(352)	(12)	(200)	(6,365)
People costs	(3,009)	(504)	(458)	(3,971)	(154)	(150)	(3,967)	(188)	(11)	(154)	(4,320)
Depreciation, amortisation and impairment	(64)	(5)	(11)	(80)	(3)	(2)	(79)	(4)	-	(3)	(86)
Net operating charges	(1,174)	(178)	(396)	(1,748)	(43)	(50)	(1,755)	(160)	(1)	(43)	(1,959)
Operating profit/ (loss) before exceptional items	(380)	88	509	217	4	17	230	77	-	4	311
Operating exceptional items:											
Share in Success	(137)	(23)	(21)	(181)	(7)	(7)	(181)	(9)	(1)	(7)	(198)
Other	(26)	(4)	(4)	(34)	(1)	(1)	(34)	(1)	-	(1)	(36)
Operating profit/ (loss)	(543)	61	484	2	(4)	9	15	67	(1)	(4)	77
Operational Volumes (excluding Door to Door) (millions)	18,578	1,544	756	20,878	730	707	20,855	567	87	730	22,239

[1] Non USO Price Control products are Other letter products which are subject to Price Control

[2] Total Mails is the aggregation of total Price Control products, Other letter products, USO Non Price Control products and Downstream Access

Royal Mail Group plc is required, under Condition 14 of the Licence granted by Postcomm on 23 March 2001, to provide regulatory financial statements.

The regulatory financial statements are based on the statutory accounts of Royal Mail Holdings for the 52 week period ending 26 March 2006, on which the auditors have expressed an unqualified opinion. The statutory accounts comply with IFRS, the Companies Act and the accounts disclosure requirements of chapter 12, paragraphs 43 and 43A of the Listing Rules of the Financial Services Authority.

Previously, the accounts of Royal Mail have been prepared under UK Generally Accepted Accounting Practice (UK GAAP). The current financial year sees Royal Mail produce its accounts for the first time in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. Comparative numbers have been restated to take account of the IFRS adjustments, which are detailed in the IFRS preliminary financial statements that were published on 17 November 2005.

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 UK operations of the Group mails operations, particularly those that form the USO.

For the first time, in line with the EU Directive, Royal Mail has included an analysis of the 0-100g Service, split between 0-50g and 51-100g. This disclosure has been agreed with Postcomm and is unaudited. It is included as note 5.

The following Services are applicable to the regulatory income statement for 2005-06 and 2004-05:

Service	Service provision
Licensed USO - 0 to 100g	Postal products that form part of the USO, and are below or equal to a 100g weight threshold e.g. first and second class mail below or equal to the weight threshold.
Licensed USO - 101g to 350g	Postal products that form part of the USO, and are between a weight threshold of 101g and 350g.
Non Licensed USO, 350g+	Postal products that form part of the USO, and are Non Licensed or 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	Postal products that do not form part of the USO but are included within the Price Control e.g. Presstream.
Other letter products	Postal products outside of the USO and the Price Control, except for Downstream Access e.g. Door to Door.

Service	Service provision
Downstream Access	Postal products outside of the USO, the Price Control and Other letter products. This relates to customer and other licensed postal operators' mail, which enters the Royal Mail pipeline after the outward sortation and distribution processes.

The USO

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

The USO is not formally defined in the Licence at product level. The products categorised as USO represent the range of products that Royal Mail currently offers to fulfil its statutory duty to provide services that meet the needs of all customers. Hence in classifying products as USO, management has considered carefully the nature of the products and has made appropriate judgements.

Other specific items, for which the separation across the Service areas is not appropriate, have been excluded but are shown within the reconciliations to the profit before financing and taxation in the Royal Mail Holdings statutory accounts (see note 1). All items below profit before financing and taxation are as stated in the RMH Statutory Accounts and have not been repeated within the reconciliation.

The obligation to produce the regulatory financial statements

The obligation to prepare regulatory financial statements for Royal Mail Group plc is placed on Royal Mail Group plc by Condition 14 of the Licence. The principal requirements of the Licence, as agreed with Postcomm, are that regulatory financial statements must:

- 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 statement, Royal Mail Group plc 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 Holdings. Postcomm has agreed by exception that no balance sheet and cashflow should be submitted in 2005-06;
- 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. During the year, 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 2006; and
- meet requirements of European Directive 97/67/EC Article 14.

The focus is on Royal Mail's UK mails operational activities as the performance of non letters services and subsidiaries, associates and other undertakings (primarily operating outside the UK), have been agreed with Postcomm as being outside the scope of regulation.

Financial statements

The basis of preparation of these regulatory financial statements is disclosed in notes A to G on pages 14 to 19. The following statement is prepared after agreeing formats with Postcomm:

- An income statement under IFRS to show operating profit for 2005-06 and 2004-05.

- In 2004-05, Royal Mail included the balance sheet and cash flow statement for Royal Mail Group plc. In 2005-06, RMH Statutory Accounts have been prepared under IFRS, whereas the individual statutory accounts of Royal Mail Group plc will be prepared under UK GAAP. The Directors consider that to include a balance sheet and cashflow in the regulatory financial statements in 2005-06 would be inconsistent with the underlying preparation of the financial data in the income statement, and Royal Mail has agreed with Postcomm that they should be excluded. In order to monitor the new price control effectively, Royal Mail and Postcomm will discuss appropriate disclosures for future years.

All items below operating profit are as stated in the RMH Statutory Accounts and have not been repeated within the reconciliation.

Accounting records

The organisation, management and accounting structures of Royal Mail do not align with the Services defined in Condition 14(2)(a) of the Licence. 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 14 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

In the absence of industry specific regulatory accounting guidelines, the methodology adopted has been documented in "An overview of the principles and methodologies used in preparing regulatory financial statements for 2006". This methodology was developed following consultation 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 costing methodology.

A. General

These regulatory financial statements are based on the financial records of the business and reconciled to operating profit within the RMH 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 51 to 57 of the RMH 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 26 March 2006.

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.

In the absence of regulatory accounting guidelines, 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 2006”; and
- Accounting Policies for the income statement consistent with IFRS as applied in the RMH Statutory Accounts.

In cases of conflict the principles as documented in “An overview of the principles and methodologies used in preparing regulatory financial statements for 2006” prevail.

B. 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

Levels of activity have been measured over the entire UK Letters operational network.

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.

In particular, a high level analysis performed by management using industrial engineering based planning standards illustrated a potential change in regulatory profits if the total hours worked are aligned to the most recent operational standards for handling traffic (rather than on the current allocation of hours between mail centre activities as captured in the time recording system).

In response to this finding, Royal Mail has introduced a data quality improvement programme, targeted specifically at operational hours analysis, for deployment during 2006-07. The programme aims to streamline the recording process, and in so doing improve the accuracy of the information collected from operational sites.

Royal Mail has prepared its accounts on a consistent basis 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.

Royal Mail refreshes these underlying assumptions when appropriate. Of particular note during 2005-06, the weighting factors were updated to reflect the latest statistical data relating to the average size of mail items. This change has had the impact of assigning a higher proportion of size related costs to larger formats of mail (flats and packets) - and a lower proportion of costs to letters - than in 2004-05.

2004-05 regulatory financial statements were prepared using the statistical data relating to the mail item average sizes in existence at that time. For illustrative purposes, applying 2005-06 average size data to 2004-05 reduces USO costs by £43m and therefore improves profitability by £43m.

C. 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 statutory accounts.

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 is Post Office Ltd charges that are set using a basis of charges reached through a negotiation between the respective businesses.

D. 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.

(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 forms part of the reconciliation statement on page 20.

(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 form part of the reconciliation statement on page 20.

(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 forms part of the reconciliation statement on page 20.

(viii) Excluded items

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

- Finance costs and income; and
- Taxation.

(ix) Prior year comparatives

Comparative numbers have been restated to take account of the IFRS adjustments, which are detailed in the IFRS preliminary financial statements that were published on 17 November 2005. The adjustments relevant to the regulatory financial statements relate to additional pension and annual leave costs, and where possible have been apportioned across the Services in line with payroll costs.

E. Balance sheet

(i) General principles

As set out on page 12, Royal Mail has agreed with Postcomm that it is not appropriate to include a balance sheet for 2005-06. Some unaudited supplementary balance sheet information has been included, and this is detailed below.

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

The property, plant, vehicles and equipment analysis is based on the historic net book values of the property, plant and equipment for Royal Mail Group plc. This analysis is included for information, but is unaudited.

The property assets are recorded as non-Mails assets as they belong to the Property Holdings business unit and 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.

(iii) 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 RMH 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

F. Cash flow statement

As set out on page 12, Royal Mail has agreed with Postcomm that it is not appropriate to include a cash flow statement for 2005-06.

G. Costs by pipeline

An unaudited analysis has been added to the regulatory financial statements detailing the costs by pipeline area for 2005-06 and 2004-05 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.

1. Reconciliations the RMH Statutory Accounts – income statement reconciliations for 2005-06 and 2004-05

2005-06	Revenue	People costs	Depreciation, amortisation and impairment	Net operating charges	Share of profit from associates and joint ventures	Operating exceptional items	Share in Success	Operating profit / (loss)	Other items	Profit / (loss) before financing and taxation
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Regulatory accounts total	6,769	(4,457)	(93)	(1,928)	-	(63)	(79)	149	-	149
Adjustments										
Non letters services	1,279	(1,105)	(2)	(289)	32	(56)	(12)	(153)	67	(86)
Overseas subsidiaries	1,037	(202)	(24)	(711)	-	-	-	100	-	100
Reclassification (note 2)	5	(204)	(55)	254	-	-	-	-	-	-
Interbusiness eliminations	(34)	-	-	83	-	-	-	49	-	49
RMH Statutory Accounts total	9,056	(5,968)	(174)	(2,591)	32	(119)	(91)	145	67	212

2004-05 Restated for IFRS

Regulatory accounts total	6,676	(4,320)	(86)	(1,959)	-	(36)	(198)	77	-	77
Adjustments										
Non letters services	1,394	(1,081)	3	(480)	28	(23)	(20)	(179)	67	(112)
Overseas subsidiaries	913	(181)	(16)	(643)	-	-	-	73	-	73
Reclassification (note 2)	6	(257)	(49)	300	-	-	-	-	-	-
Interbusiness eliminations	(33)	-	-	87	-	-	-	54	-	54
RMH Statutory Accounts total	8,956	(5,839)	(148)	(2,695)	28	(59)	(218)	25	67	92

Below is a reconciliation of the restated 2004-05 IFRS results for the Group's regulatory operating profit shown above back to the results reported in the 2004-05 regulatory financial statements.

	£m
Operating profit under IFRS	77
Add back IFRS adjustments	
IAS 19 Pension deficit	99
IAS 19 Holiday pay accrual	2
Profit before interest and taxation as originally reported under UK GAAP	178

2. Reclassification and elimination of costs

An analysis of the reclassification included in the income statement reconciliations (note 1) is detailed below:

	2005-06			
	People costs	Depreciation, amortisation and impairment	Net operating charges	Other Items
	£m	£m	£m	£m
Operational labour	-	-	-	-
Centrally held costs and income	(204)	(55)	254	-
Total	(204)	(55)	254	-

	2004-05 Restated for IFRS			
	People costs	Depreciation, amortisation and impairment	Net operating charges	Other Items
	£m	£m	£m	£m
Operational labour	3	-	(3)	-
Centrally held costs and income	(260)	(49)	303	-
Total	(257)	(49)	300	-

Reclassifications reflect the different treatment of costs between the RMH Statutory Accounts and the regulatory financial statements. This note details the reclassification of costs from the regulatory financial statements to the Statutory Accounts.

3. Royal Mail Holdings Group wide exceptional items included in operating charges

	2005-06	2004-05
	£m	£m
Share in Success	(91)	(218)
Provision for restructuring	(75)	(36)
Impairment of property plant and equipment	(17)	(23)
Impairment of intangible assets	(15)	-
Impairment of goodwill relating to associates	(9)	-
Impairment of property subsequent to categorisation as non current assets held for sale	(3)	-
Total	(210)	(277)

The £75m restructuring charge is all in respect of employee related costs (2004-05 £34m employee related and £2m other operating costs). Of the above impairments, £31m (2004-05 £19m) relates to Post Office Ltd. Due to ongoing losses, the carrying value of asset purchases made by Post Office Ltd during the year have been impaired to recoverable amount. The £9m impairment of goodwill relating to associates comprises £8m for G3 Worldwide Mail N.V. (Spring) and £1m for Camelot International Services Limited.

The net figure of £119m (excluding Share in Success of £91m) comprises a charge of £63m for total Mails services and a £56m charge for the other business areas. The £91m Share in Success comprises a charge of £79m for Mails services and £12m for the other business areas.

4. Royal Mail Holdings Group wide provisions for liabilities and charges

	2005-06	2004-05
	£m	£m
Mails and Parcels	109	160
Post Office Counter Services	2	12
Total*	111	172

* excludes deferred tax

The Mails and Parcels provision includes amounts relating to redundancy and other non redundancy items (onerous property contracts and decommissioning costs), which relate to restructuring programmes. During the year £60m was charged to exceptional items and £11m to other operating costs. £39m was transferred to creditors due within one year, mainly relating to amounts due to the pension scheme for redundancies with early retirement. £58m of this provision is expected to be utilised in 2006-07 and the remainder over the following two to three years, except for £12m relating to decommissioning costs and £31m relating to onerous property contracts, which are expected to be utilised over a longer period.

Post Office Counter Services provisions relate to Post Office Ltd.

5. Split of 0-100g weight step for 2005-06 (unaudited)

	0-50g	51-100g	0-100g
Revenue	3,035	606	3,641
Operating costs	(3,125)	(679)	(3,804)
Operating loss before exceptional items	(90)	(73)	(163)
Operating exceptional items			
Share in Success	(40)	(9)	(49)
Other	(31)	(7)	(38)
Operating loss	(161)	(89)	(250)

Under EU Directive 2002/39/EC, as from 1 January 2006 the weight limit for the reserved area falls to 50g (from 100g previously). All national USO providers must separately state their results (unaudited) for the reserved area. Consequently, the above addresses the requirement of this Directive.

6. Analysis of Costs by Pipeline (unaudited)

	FAC					LRMC				
Costs by pipeline	Processing	Delivery	Other operational costs	Overheads	**Total**	Processing	Delivery	Other operational costs	Overheads	**Total**
	£m	£m	£m	£m	**£m**	£m	£m	£m	£m	**£m**
2005-06	(1,354)	(2,862)	(1,345)	(917)	**(6,478)**	(1,131)	(1,836)	(565)	(543)	**(4,075)**
2004-05	(1,376)	(2,689)	(1,380)	(920)	**(6,365)**	(1,181)	(1,704)	(581)	(560)	**(4,026)**

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).

7. Property, Plant, Vehicles and Equipment – information by pipeline (unaudited)

2005-06 unaudited							
	Processing	Access, National and Local Distribution	Delivery	Other	Total Mails	Non Mails assets	Total Royal Mail Group plc
	£m	£m	£m	£m	£m	£m	£m
Property	-	-	-	-	-	617	617
Property fit out	143	29	205	15	392	9	401
Vehicles	1	56	40	4	101	10	111
Plant and machinery	223	20	4	51	298	-	298
Fixtures and equipment	4	1	7	-	12	4	16
Total	371	106	256	70	803	640	1,443

2004-05 unaudited							
	Processing	Access, National and Local Distribution	Delivery	Other	Total Mails	Non Mails assets	Total Royal Mail Group plc
	£m	£m	£m	£m	£m	£m	£m
Property	-	-	-	-	-	655	655
Property fit out	148	29	212	15	404	7	411
Vehicles	1	46	21	4	72	12	84
Plant and machinery	223	22	4	51	300	-	300
Fixtures and equipment	4	1	6	-	11	3	14
Total	376	98	243	70	787	677	1,464

As these accounts have been published before the statutory accounts of Royal Mail Group plc have been finalised, the above information is based upon management accounts. The property assets are recorded as Non Mails assets as they belong to the Property Holdings business unit and 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 2005-06 property, plant, vehicles and equipment profiles across pipeline areas have been applied to both 2004-05 and 2005-06, and as such the comparative values have been restated.

Statement of responsibilities

Royal Mail Group plc is required, as agreed with Postcomm and under Condition 14 of the Licence, to provide regulatory financial statements in respect of each regulatory Service.

Royal Mail Group plc confirms that the regulatory financial statements have been prepared 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 2006"; and
    - Accounting Policies consistent with IFRS as applied in the Royal Mail Holdings plc Report and Accounts for the year ended 26 March 2006.

    In cases of conflict the principles as documented in "An overview of the principles and methodologies used in preparing regulatory financial statements for 2006" prevail; and

4. The regulatory financial statements are based on the financial records of the business and have been reconciled to the audited Royal Mail Holdings statutory accounts.

No specific regulatory accounting guidelines exist for the UK postal industry and accordingly the methodology adopted has been documented in "An overview of the principles and methodologies used in preparing regulatory financial statements for 2006" and in notes A to G on pages 14 to 19. 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 plc.

Adam Crozier	Allan Leighton
Chief Executive	Chairman
18 July 2006	18 July 2006

Independent auditors' report to the Directors of Royal Mail Holdings plc ("the Company") issued as required by Condition 14 of the Licence dated 23 March 2001 granted by the Postal Services Commission ("Postcomm")

We have audited the Regulatory Financial Statements on page 9 and pages 20 to 22. The Regulatory Financial Statements, which have been prepared by the Company, comprise separate statements for the year ended 26 March 2006 for each of the services described on pages 10 and 11 ("the Services").

This report is made solely to the Company's directors, as a body, in accordance with the requirements of Condition 14 of the Licence and the terms of our engagement. Our audit work has been undertaken so that we might state to the Company's directors 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

The Regulatory Financial Statements have been prepared using the "Regulatory accounting principles and basis of preparation" set out on pages 14 to 19, as agreed with Postcomm to meet Condition 14 of the Licence.

The Regulatory Financial Statements are separate from the Statutory Financial Statements of the Company and have 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 14 to 19, as agreed with Postcomm to meet the requirements of paragraph 2 of Condition 14 to the Licence, the Regulatory Financial Statements are prepared by disaggregating balances recorded in the general ledgers and other accounting records of the Company and its subsidiaries ("the group") maintained in accordance with the Companies Act 1985 and used, in accordance with that Act, for the preparation of the statutory consolidated financial statements of Royal Mail Holdings plc for the years ended 26 March 2006 and 27 March 2005 ("the Statutory Financial Statements").

As explained on pages 14 to 19 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 the Regulatory Financial Statements, the Company has had to make certain estimates and exercise its judgement, having regard to the terms of Condition 14 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 the Regulatory Financial Statements.

Respective responsibilities of the Directors and independent auditors

The Company's responsibilities for preparing the Regulatory Financial Statements as agreed with Postcomm to meet the requirements of Condition 14 of the Licence are set out in the Statement of responsibilities on page 26.

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 each of the Regulatory Financial Statements for the year ended 26 March 2006 have been properly prepared, in all material respects, in accordance with the "Regulatory accounting principles and basis of preparation" on pages 14 to 19 and with the requirements of paragraph 4(a) of Condition 14 of the Licence.

We also report our opinion as to whether the records maintained pursuant to paragraph 1 of Condition 14 to the Licence comply with the requirements of paragraph 2 of Condition 14 to the Licence, amended as agreed with Postcomm.

We also read the Business Review, Licence Requirements, Split of 0-100g weight step, Property, Plant, Vehicles and Equipment Information by Pipeline and Analysis of Costs by Pipeline sections 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 the Regulatory Financial Statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the 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 the Regulatory Financial Statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of the Regulatory Financial Statements are 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 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 17 May 2006, 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 Company's members, 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 Company's members 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 Company's members 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 group'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 14 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 14 to the Licence, amended as agreed with Postcomm; and

In our opinion the Regulatory Financial Statements of the Services for the year ended 26 March 2006, have been properly prepared, in all material respects, in accordance with the "Regulatory accounting principles and basis of preparation" on pages 14 to 19 and with the requirements of paragraph 4(a) of Condition 14 of the Licence.

Ernst & Young LLP

London

£m
Million pounds sterling.

2005-06
Year ending 26 March 2006.

2004-05
Year ending 27 March 2005.

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.

IFRS
International Financial Reporting Standards.

Long run marginal costs ("LRMC")
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 26 March 2006 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 plc
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.

The Licence
The Licence granted to Royal Mail Group plc, by the Postal Services Commission on 23 March 2001.

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.