



Royal Mail Group plc

Regulatory Financial Statements  
2004-05

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## Summary of results

	2004-05					2003-04				
	USO	Other letter products <sup>2</sup>	Regulatory accounts total	Non letters, excluded and eliminations	Group total <sup>3</sup>	USO	Other letter products <sup>2</sup>	Regulatory accounts total	Non letters, excluded and eliminations	Group total <sup>3</sup>
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Revenue	6,016	660	6,676	2,280	8,956	5,802	635	6,437	2,196	8,633
Operating costs <sup>1</sup>	(5,589)	(552)	(6,141)	(2,278)	(8,419)	(5,480)	(615)	(6,095)	(2,318)	(8,413)
Profit/(loss) from operations <sup>1</sup>	427	108	535	2	537	322	20	342	(122)	220
Pension deficit and operating exceptional items (excluding Share in Success)	(148)	(11)	(159)	(38)	(197)	(176)	(15)	(191)	(5)	(196)
Profit before interest, taxation and Share in Success	279	97	376	(36)	340	146	5	151	(127)	24
Share in Success	(181)	(17)	(198)	(20)	(218)	-	-	-	-	-
Profit before interest and taxation (PBIT)	98	80	178	(56)	122	146	5	151	(127)	24
PBIT Margin (excluding Share in Success)	4.6%	14.7%	5.6%			2.5%	0.8%	2.3%		
PBIT Margin (including Share in Success)	1.6%	12.1%	2.7%			2.5%	0.8%	2.3%		
Operational volumes (millions of items (excluding Door to Door))	20,878	1,361	22,239			20,794	1,275	22,069		

- USO business improved profit from operations by £105m (32.6%) from £322m to £427m. The margin after pension deficit costs and operating exceptional items increased from 2.5% to 4.6% (excluding Share in Success), though it decreased from 2.5% to 1.6% (including Share in Success);
- USO revenues increased by 3.7%, driven by the tariff increase from April 2004 of 1.3% (2003-04 3.0%), increases in underlying volumes (based on revenue derived traffic volumes excluding international products and Door to Door) of 1.4% (2003-04 1.6%) and a favourable product mix variance;
- USO profits mask the fact that the 0-100g Service, which accounts for 83.5% of total volume, recorded a loss before interest and taxation of £462m (2003-04 £292m);
- Stamped mail losses of £235m (2003-04 £247m) continue to be subsidised by business (meter and account) mail; and
- First Class stamped mail loses 5p per item (2003-04 5p), Second Class stamped mail loses 8p per item (2003-04 9p).

<sup>1</sup> Before charges relating to pension deficit and operating exceptional items and after share of operating profit in associates and joint ventures.

<sup>2</sup> Other letter products also includes the Non USO Price Control products and Downstream Access as per the profit and loss statement on page 9.

<sup>3</sup> Group total PBIT numbers exclude non operating exceptional items.

### Introduction

A financial review of the Group is included within Royal Mail Holdings' statutory accounts. This review supplements those statements 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 due to Postcomm's attention on this area of the business.

As in previous years, this section exposes the uniqueness of the Royal Mail business, where once again:

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

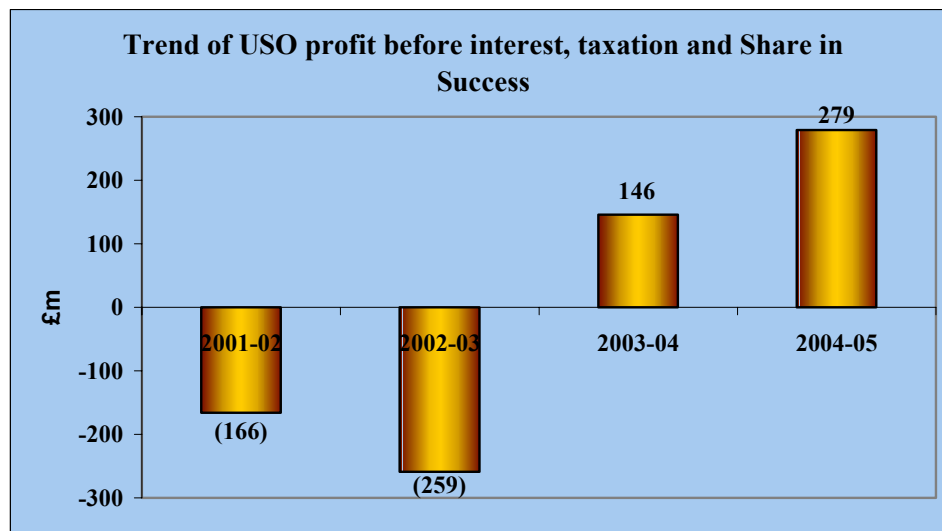
Royal Mail has, in conjunction with Postcomm, started to address these issues, which reflect a misalignment between product price and product cost:

- The launch in April 2005 of Postcomm's consultation process on size based pricing (now known as "Pricing in Proportion") represents the final stage in Royal Mail's drive to introduce a 'size based' dimension to product pricing. It is essential that this process reaches a successful conclusion and is reflected in the updated Price Control arrangement from April 2006.
- From April 2005, the basic 1<sup>st</sup> class stamped mail price is 1p higher than the equivalent business product, at 30p as opposed to 29p.

### Financial summary

2004-05 represents the final phase of the Group's three year Renewal Plan. A combination of continued traffic growth, price rises and cost efficiencies has driven significant improvements in profitability (excluding the £1,074 Share in Success payment made to each employee) and cash flow, and this at the same time as delivering a major pay deal to operational staff and improved service to customers.

The completion of the Renewal Plan is only the first step in transforming Royal Mail into a mails operation which is truly commercial and market focused, generating both profits and cash to permit further investments in our people and their pension fund, and in technology and service offerings to satisfy the needs of our customers. Key to achieving this is the continuation of efficiency improvements, and achieving a satisfactory Price Control which allows Royal Mail to change its prices to better reflect its costs and which also provides a medium term solution to the pension funding deficit.



<b>Summary of USO results</b>	<b>2004-05</b>	<b>2003-04</b>
<b>External turnover (£m)</b>	<b>6,016</b>	<b>5,802</b>
Profit from operations (£m)	427	322
Less: Pension deficit (£m)	(114)	(93)
Less: Operating exceptionals (excluding Share in Success) (£m)	(34)	(83)
<b>Profit before interest, taxation and Share in Success (£m)</b>	<b>279</b>	<b>146</b>
Less: Share in Success (£m)	(181)	-
<b>Profit before interest and taxation (£m)</b>	<b>98</b>	<b>146</b>
<i>PBIT margin (excluding Share in Success) (%)</i>	<i>4.6</i>	<i>2.5</i>
<i>PBIT margin (including Share in Success) (%)</i>	<i>1.6</i>	<i>2.5</i>
<i>Traffic – operational measurement (millions of items (excluding Door to Door))</i>	<i>20,878</i>	<i>20,794</i>

At the profit from operations level, performance is significantly improved on prior year. External turnover increased by £214m (3.7%) from £5,802m to £6,016m, and this helped drive USO profit from operations improvement by £105m (32.6%) from £322m to £427m, with the margin from operations improving by 1.6% from 5.5% to 7.1%.

After adjusting for operating exceptional items (excluding Share in Success) and the SSAP 24 pension deficit charge of £114m, profit before interest and taxation has increased by £133m (91.1%), from £146m to £279m.

The pension deficit charge of £114m in the USO, represents 82.6% of the total Group deficit charge of £138m. For the total Mails business as a whole, the share of the total Group deficit charge is 89.1% or £123m, which equates to a pension funding deficit of some £2.2bn which needs to be covered by sufficient regulatory profits. This is a formidable challenge given the existing cross subsidisation between products and the imminent arrival of full blown competition.

## Business review

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After adjusting for operating exceptional items (including Share in Success) and the SSAP 24 pension deficit charge, profit before interest and taxation has decreased by £48m (32.9%), from £146m to £98m.

Operationally counted USO traffic volumes increased by 0.4% (84m items) in the year, from 20,794m to 20,878m. The underlying trend based on revenue derived traffic volumes was an increase of 1.4% (excluding international products and Door to Door).

### USO Revenues

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

	2004-05 £m	2003-04 £m	Variance £m	Variance %
1c stamp/ meter/ PPI	1,700	1,681	19	1.1
2c stamp/ meter/ PPI	1,126	1,108	18	1.6
Bulk Mail*	1,810	1,730	80	4.6
Other	1,380	1,283	97	7.6
<b>Total</b>	<b>6,016</b>	<b>5,802</b>	<b>214</b>	<b>3.7</b>

\*Bulk Mail includes Mailsort, Walksort and Cleanmail

The largest drivers of USO revenue increase were Bulk Mail, which improved by £80m (4.6%) in 2004-05 from £1,730m to £1,810m, and Other revenues (including Packetpost, Government Postage and Special Delivery), which improved by £97m (7.6%).

### USO Prices

Prices were adjusted from April 2004, with the average price increase being 1.3% (under the current Price Control).

The basic weight band price for a 0-60g item remained static at 28p for a 1<sup>st</sup> class letter, with the equivalent 2<sup>nd</sup> class price increasing by 1p from 20p to 21p. This move has seen some 'uptrading' in the year from 2<sup>nd</sup> class to 1<sup>st</sup> class.

### USO Volumes

USO volumes have increased slightly at 0.4%, however to some extent this understates the increase due to improvements in traffic measurement in operations. Underlying volume growth for the USO was 1.4% (2003-04 1.6%), based on revenue derived traffic.

The largest drivers of volume growth have been Bulk Mail and Government Postage, which have been offset by a decrease in 2<sup>nd</sup> class public tariff mail.

### USO Costs from operations

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

	2004-05 £m	2003-04 £m
Staff costs	3,823	3,533
Non staff costs	1,686	1,863
Depreciation, amortisation and impairment	80	84
<b>Total</b>	<b>5,589</b>	<b>5,480</b>

Overall USO costs have increased by £109m. The pay deal in operations has driven an increase in staff costs, though this is partially offset by reduced headcount following the Renewal Plan changes and efficiencies in non staff cost areas.

## Business review

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### USO Profit from operations (before charges relating to pension deficit and operating exceptional items)

#### By product

As set out below, the USO profitability continues to be driven by 1<sup>st</sup> class, Bulk Mail products (Mailsort, Walksort and Cleanmail) and Other products such as Packetpost and Special Delivery.

	2004-05			2003-04		
	Revenue £m	Profit £m	Margin %	Revenue £m	Profit £m	Margin %
1c stamp/ meter/ PPI	1,700	108	6.4	1,681	163	9.7
2c stamp/ meter/ PPI	1,126	(111)	(9.9)	1,108	(148)	(13.4)
Bulk Mail*	1,810	143	7.9	1,730	124	7.2
Other	1,380	287	20.8	1,283	183	14.3
<b>Total</b>	<b>6,016</b>	<b>427</b>	<b>7.1</b>	<b>5,802</b>	<b>322</b>	<b>5.5</b>

\*Bulk Mail includes Mailsort, Walksort and Cleanmail

As in previous years, these figures mask the fact that stamped products generate losses of £235m (2003-04 £247m), which are offset by profitability in meters and PPI products.

From April 2005, Royal Mail has started to address this discrepancy by introducing a higher price for stamped than for metered and PPI products, with 1<sup>st</sup> class stamps for the basic weight step now priced at 30p as opposed to 29p for the equivalent meter and PPI products. This higher price is more than justified by the additional costs involved in handling and processing stamped mail.

#### By Service

There has been an overall improvement in the contribution and margin of the USO, driven largely by aforementioned price and traffic increases, which have more than covered the additional costs incurred inclusive of the pay deal.

The 0-100g weight step is still loss making at £212m, representing a negative margin on revenue of 5.5% (2003-04 4.3%). Operational volumes in this Service have improved by 315m items (1.7%).

The 101-350g segment is profitable at £112m and the Non Licensed, 350g+ Service continues to be the most profitable part of the USO, with profits of £527m. Operational volumes have declined in both of these Services, by 152m items (9.0%) and 79m items (9.5%) respectively.

The differences in profitability arise because pricing is driven by weight, whilst cost is driven primarily 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.

During 2004-05, work with Postcomm has focused in three main areas:

- Working towards the criteria that will define the next Price Control period, which commences in April 2006. Royal Mail believes that the next Price Control will determine the ultimate success or failure of liberalising the postal sector, and

## Business review

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therefore considers it vital that Postcomm builds in sufficient scope for pricing flexibility to facilitate the introduction of fair and efficient competition.

- On 5 April 2005, Postcomm published a consultation document - "Royal Mail's revised proposals for size based pricing (pricing in proportion)" - which Royal Mail hopes will lead to it being able to introduce a 'size based' dimension to prices from April 2006. Whilst any new prices have still to be defined, such a move would facilitate a migration to a structure where prices better reflect the underlying costs of delivering products.
- Following consultation with Postcomm, in April 2005 Royal Mail has introduced a different, higher price to customers who access the postal network using 1<sup>st</sup> class stamps as a payment channel. Stamped mail is not only more expensive for Royal Mail to operationally handle, but also the unit costs of stamp production and sale are higher than for other channels. It is hoped that this will start to address the large losses currently experienced in social mail traffic.

### Moving forward

In the coming year, Royal Mail will seek to consolidate the recent turnaround in financial performance, whilst continuing to improve its quality of service to customers. The opening of the mails market to full competition in January 2006, together with the continuing migration of traffic to Downstream Access, both offer major challenges. It is essential that the new Price Control, due to commence in April 2006, allows Royal Mail the flexibility to respond sensibly to the impacts of competition.

Royal Mail looks forward to bringing the new "Pricing in Proportion" proposals to fruition in April 2006, subject to a successful conclusion in the consultation process. This will allow, over time, Royal Mail to better align its product prices with costs.

However, the recent initial proposals from Postcomm relating to the third Price Control raise considerable concerns for the future of the USO. These proposals not only significantly understate the value of the regulated business and the level of the profits that it will be allowed to earn, but do not allow the necessary investment which is required to further improve efficiency and allow Royal Mail to compete on a level playing field. The proposals do not allow the pricing flexibility that is required to rectify the inherent problem of stamp prices not reflecting underlying costs. Royal Mail will be responding to these proposals by the end of August 2005.

## Profit and loss statements

For the years ended 27 March 2005 and 28 March 2004

### Profit and loss statement – 2004-05

All figures in £m or stated otherwise										
2004-05										
	USO				Less	Add	Sub total	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 <sup>1</sup> £m	Total Price Control products £m	Other letter products £m	Downstream Access £m	Total Mails <sup>2</sup> £m
Revenue	3,867	775	1,374	6,016	204	219	6,031	429	12	6,676
Operating costs	(4,079)	(663)	(847)	(5,589)	(193)	(194)	(5,590)	(346)	(12)	(6,141)
Staff costs	(2,897)	(485)	(441)	(3,823)	(148)	(144)	(3,819)	(183)	(11)	(4,161)
Depreciation, amortisation and impairment	(64)	(5)	(11)	(80)	(3)	(2)	(79)	(4)	-	(86)
Net operating charges	(1,118)	(173)	(395)	(1,686)	(42)	(48)	(1,692)	(159)	(1)	(1,894)
<b>Profit / (Loss) from operations</b>	<b>(212)</b>	<b>112</b>	<b>527</b>	<b>427</b>	<b>11</b>	<b>25</b>	<b>441</b>	<b>83</b>	<b>-</b>	<b>535</b>
Pension deficit charge	(87)	(14)	(13)	(114)	(4)	(4)	(114)	(5)	-	(123)
Operating exceptional items:										
Share in Success	(137)	(23)	(21)	(181)	(7)	(7)	(181)	(9)	(1)	(198)
Other	(26)	(4)	(4)	(34)	(1)	(1)	(34)	(1)	-	(36)
<b>Profit / (Loss) before interest and taxation</b>	<b>(462)</b>	<b>71</b>	<b>489</b>	<b>98</b>	<b>(1)</b>	<b>13</b>	<b>112</b>	<b>68</b>	<b>(1)</b>	<b>178</b>
Operational Volumes (excluding Door to Door) (millions)	18,578	1,544	756	20,878	730	707	20,855	567	87	22,239

### Profit and loss statement – 2003-04

All figures in £m or stated otherwise										
2003-04 Restated Format										
	USO				Less	Add	Sub total	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 <sup>1</sup> £m	Total Price Control products £m	Other letter products £m	Downstream Access £m	Total Mails <sup>2</sup> £m
Revenue	3,687	812	1,303	5,802	167	215	5,850	420	-	6,437
Operating costs	(3,845)	(717)	(918)	(5,480)	(179)	(201)	(5,502)	(414)	-	(6,095)
Staff costs	(2,635)	(471)	(427)	(3,533)	(125)	(141)	(3,549)	(178)	-	(3,852)
Depreciation, amortisation and impairment	(71)	(5)	(8)	(84)	(3)	(1)	(82)	(5)	-	(90)
Net operating charges	(1,139)	(241)	(483)	(1,863)	(51)	(59)	(1,871)	(231)	-	(2,153)
<b>Profit / (Loss) from operations</b>	<b>(158)</b>	<b>95</b>	<b>385</b>	<b>322</b>	<b>(12)</b>	<b>14</b>	<b>348</b>	<b>6</b>	<b>-</b>	<b>342</b>
Pension deficit charge	(70)	(12)	(11)	(93)	(4)	(4)	(93)	(5)	-	(102)
Operating exceptional items	(64)	(12)	(7)	(83)	(4)	(3)	(82)	(3)	-	(89)
<b>Profit / (Loss) before interest and taxation</b>	<b>(292)</b>	<b>71</b>	<b>367</b>	<b>146</b>	<b>(20)</b>	<b>7</b>	<b>173</b>	<b>(2)</b>	<b>-</b>	<b>151</b>
Operational Volumes (excluding Door to Door) (millions)	18,263	1,696	835	20,794	644	721	20,871	554	-	22,069

<sup>1</sup> Non USO Price Control products are Other letter products which are subject to Price Control

<sup>2</sup> Total Mails is the aggregation of total Price Control products, Other letter products, USO Non Price Control products and Downstream Access

**Balance sheet statements**  
At 27 March 2005 and 28 March 2004

**Royal Mail Group plc balance sheet \***

	2004-05 £m	2003-04 £m
<b>Fixed assets</b>		
Tangible assets	1,464	1,444
Investments	107	182
<b>Total fixed assets</b>	<b>1,571</b>	<b>1,626</b>
<b>Current assets</b>		
Stocks	15	15
Debtors - receivable within one year	919	807
Debtors - receivable beyond one year	1,458	1,473
Investments	1,056	952
Cash at bank and in hand	12	8
	<b>3,460</b>	<b>3,255</b>
<b>Creditors - amounts falling due within one year</b>	<b>(1,548)</b>	<b>(1,304)</b>
<b>Net current assets</b>	<b>1,912</b>	<b>1,951</b>
<b>Total assets less current liabilities</b>	<b>3,483</b>	<b>3,577</b>
<b>Creditors - amounts falling due after more than one year</b>	<b>(898)</b>	<b>(892)</b>
<b>Provisions for liabilities and charges</b>	<b>(256)</b>	<b>(539)</b>
<b>Net assets</b>	<b>2,329</b>	<b>2,146</b>
<b>Capital and reserves</b>		
Called up share capital	-	-
Share premium	3,784	3,784
Revaluation reserve	65	141
Profit and loss account	(2,321)	(2,544)
Mails Reserve	801	765
<b>Shareholders' funds</b>	<b>2,329</b>	<b>2,146</b>

\* Royal Mail Group plc is a wholly owned subsidiary of Royal Mail Holdings plc and immediate parent undertaking of Post Office Ltd (POL) and General Logistics Systems International Holdings B.V. (GLS). Therefore, this balance sheet excludes the assets of POL and GLS, but includes the assets recorded within those business units of Royal Mail Group plc which do not form part of the regulatory asset base (such as Property Holdings and Parcelforce Worldwide). Therefore it does not specifically represent the assets of the regulated Services.

This balance sheet has been extracted from the audited statutory accounts of Royal Mail Group plc for the year ended 27 March 2005, and has been prepared in accordance with the accounting policies set out in those financial statements.

## Cash flow statements

For the years ended 27 March 2005 and 28 March 2004

### Royal Mail Group plc cash flow statement \*

	2004-05	2003-04
	£m	£m
<b>Reconciliation of operating profit to net cash inflow from operating activities</b>		
<b>Royal Mail Group plc operating profit before exceptional items</b>	<b>436</b>	<b>86</b>
Depreciation and amortisation	135	169
<b>Changes in working capital and other non cash items:</b>	<b>(151)</b>	<b>294</b>
Decrease in stock	-	2
(Increase) / decrease in debtors	(89)	247
Decrease / (increase) in creditors	9	(4)
(Increase) / decrease in provisions	(71)	49
Cash payments in respect of operating exceptional items	(244)	(375)
<b>Net cash inflow from operating activities</b>	<b>176</b>	<b>174</b>
<b>Royal Mail Group plc cash flow statement</b>		
<b>Net cash inflow from operating activities</b>	<b>176</b>	<b>174</b>
<b>Returns on investments and servicing of finance</b>	<b>26</b>	<b>31</b>
Equity dividends received	3	9
Interest received	52	52
Interest paid	(29)	(30)
<b>Taxation</b>		
Corporation tax paid	(4)	-
<b>Capital expenditure and financial investment</b>	<b>(102)</b>	<b>(41)</b>
Purchase of tangible fixed assets	(195)	(139)
Sale of tangible fixed assets	93	97
Sale of fixed asset investments	-	1
<b>Acquisitions and disposals</b>	<b>(2)</b>	<b>26</b>
Purchase of subsidiary undertakings	(2)	-
Disposal of subsidiary undertakings	-	26
<b>Cash inflow before use of liquid resources and financing</b>	<b>94</b>	<b>190</b>
<b>Management of liquid resources</b>		
Net movement in current asset investments	(104)	(152)
<b>Net cash (outflow) / inflow before financing</b>	<b>(10)</b>	<b>38</b>
<b>Financing</b>	<b>14</b>	<b>(50)</b>
New loans	14	-
Repayment of loans	-	(50)
<b>Increase / (decrease) in cash in the period</b>	<b>4</b>	<b>(12)</b>

\* Royal Mail Group plc is a wholly owned subsidiary of Royal Mail Holdings plc and immediate parent undertaking of Post Office Ltd (POL) and General Logistics Systems International Holdings B.V. (GLS). Therefore, this cash flow statement excludes the cash flows of POL and GLS, but includes the cash flows recorded within those business units of Royal Mail Group plc which do not form part of the regulatory asset base (such as Property Holdings and Parcelforce Worldwide). Therefore it does not specifically represent the cash flows of the regulated Services.

## Licence requirements

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Royal Mail Group plc is required, under Condition 14 of the Licence granted by Postcomm on 23 March 2001, to provide regulatory financial statements. Postcomm was created under the Postal Services Act 2000 and established in November 2000 as an independent regulator for the UK postal industry.

The regulatory financial statements are based on the statutory accounts of Royal Mail Holdings for the 52 week period ending 27 March 2005, on which the auditors have expressed an unqualified opinion. The statutory accounts comply with UK GAAP, the Companies Act and the accounts disclosure requirements of chapter 12, paragraphs 43 and 43A of the Listing Rules of the Financial Services Authority.

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 accounts is on the UK operations of the Group mails operations, particularly those which form the USO (primarily the mails business).

The format of the regulatory financial statements for 2004-05 has been revised to provide more information on the underlying costs of the business, in terms of operational pipeline costs, long run marginal costs and the revenues and costs associated with Downstream Access. The regulatory balance sheet and cash flow statement have been replaced with the statutory balance sheet and cash flow statement of Royal Mail Group plc. All of these changes have been agreed with Postcomm.

The following Services are applicable to the regulatory profit and loss statement for 2004-05:

<b>Service</b>	<b>Service provision</b>
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.
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 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.

For 2004-05 the USO has not been formally defined 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

## **Licence requirements**

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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 interest and taxation in the Royal Mail Holdings statutory accounts (see note 1). All items below profit before interest and tax ("PBIT") are as stated in the 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;
- be prepared consistently with UK GAAP in so far as those principles may be reasonably applied, or with such other accounting principles as Postcomm may approve in writing;
- be subject to audit;
- be prepared and submitted before 31 July 2005; and
- meet requirements of European Directive 97/67/EC Article 14.

The focus is on Royal Mail's UK mails operational activities as the effects 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 15 to 19. The following statements are prepared after agreeing formats with Postcomm:

- a profit and loss statement to show profit before interest and taxation for 2004-05 and 2003-04 using the revised format for 2004-05;
- a balance sheet statement as at 27 March 2005 and the prior year as at 28 March 2004 for Royal Mail Group plc; and
- a cash flow statement for 2004-05 and 2003-04 for Royal Mail Group plc.

All items below PBIT are as stated in the 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

## **Licence requirements**

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incorporated under the Companies Act 1985 each of those companies would comply with subsections 221(1) and (2) of that Act.

### **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 which are set using a basis of charges reached through a negotiation between the respective businesses. The total charge from Post Office Ltd to Royal Mail Letters for 2004-05 was £306m.

### **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 2005". 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.

## **Regulatory accounting principles and basis of preparation**

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### **A. General**

These regulatory financial statements are based on the financial records of the business and reconciled to the profit before interest and taxation within Royal Mail Holdings' 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 39 to 41 of the Royal Mail Holdings' 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 27 March 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 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 2005"; and
- Accounting Policies consistent with UK GAAP as applied in the Royal Mail Holdings 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 2005" prevail.

### **B. Key drivers**

#### **(i) Profit and loss statement**

Revenues are primarily driven directly to products by sales 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 costs to sales products. 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 have ongoing initiatives to improve the processes.

Non stamp and meter traffic volumes i.e. "account traffic" 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.

## **Regulatory accounting principles and basis of preparation**

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### **(iii) Activity analysis**

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

Staff 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, and ongoing initiatives aim to further improve the quality of the data.

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

### **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 (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 exception to this is Post Office Ltd charges which are set using a basis of charges reached through a negotiation between the respective businesses. The total charge from Post Office Ltd to Royal Mail Letters for 2004-05 was £306m.

### **D. Profit and loss statements**

#### **(i) General principles**

The profit and loss 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.

## **Regulatory accounting principles and basis of preparation**

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### **(iii) Other operating charges**

Agency labour costs relating to the operational postal activities have been included within staff costs in the regulatory financial statements. For the purposes of the statutory accounts, agency labour costs are included within other net operating charges (note 2).

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

### **(iv) Pension costs**

Pension costs are accounted for under SSAP 24 in Royal Mail Holdings' statutory accounts. In the regulatory financial statements, the charges associated with the pension fund deficit are disclosed separately, as agreed with Postcomm.

In 2003-04 the pension deficit charge was shown in the Total Mails column on the face of the regulatory profit and loss statement.

For 2004-05 the pension deficit charge relating to the mails operations is spread across the regulatory Service columns on the face of the regulatory profit and loss statement. The figures for 2003-04 are also disclosed.

### **(v) Operating exceptional items**

In 2003-04 the total operating exceptional items were shown in the Total Mails column on the face of the regulatory profit and loss statement.

For 2004-05 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 profit and loss statement. The figures for 2003-04 are also disclosed.

### **(vi) Share of operating profit in associates / joint ventures**

The share of the results of associated undertakings and joint ventures has been assigned to non letters services (excluded from the regulatory accounts total) and forms part of the reconciliation statement on page 20.

### **(vii) Net profit on disposal of tangible fixed assets**

Profits and losses on sale of properties have been assigned to non letters services (excluded from the regulatory accounts total) and forms part of the reconciliation statement on page 20.

### **(viii) Profit / (loss) on disposal of subsidiary undertakings**

The profit / (loss) on disposal of subsidiary undertakings has been assigned to overseas subsidiaries or non letter services as appropriate (excluded from the regulatory accounts total) and forms part of the reconciliation statement on page 20.

### **(ix) Excluded items**

Postcomm have agreed the items below PBIT are excluded from the regulatory financial statements. These items include:

- Interest;
- Taxation;
- Share of joint ventures' interest and taxation;

## **Regulatory accounting principles and basis of preparation**

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- Equity minority interests; and
- Transfer to dividend reserve.

### **(x) Prior year comparatives**

Royal Mail continues to develop its information quality review processes and analytical procedures. The accuracy of information has continued to improve during the year and further improvements will be made in future years.

The additional transparency provided by Royal Mail's new financial systems environment has also allowed significant improvements to be made to review processes. One result of this detailed review has been to identify areas where the presentation of information in prior years could be further improved.

Prior year information has not been restated to reflect the better presentation, which relates to more accurate and consistent mapping of detailed product revenues and costs to the regulatory Services. The net effect of the improved presentation would have been to decrease the 2003-04 profit from operations in the USO by £22m and increase the 2003-04 profit from operations in the Other letter products by £22m.

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 2004-05 profit from operations in the USO by £21m (2003-04 £22m).

## **E. Balance sheet**

### **(i) General principles**

For 2004-05 the regulatory balance sheet has been replaced with:

- The balance sheets for Royal Mail Group plc at 27 March 2005 and 28 March 2004; and
- An unaudited analysis of tangible fixed assets by pipeline area at 27 March 2005 and 28 March 2004, which is included as note 6.

### **(ii) Tangible fixed asset information by pipeline**

The tangible fixed asset analysis is based on the historic net book values of the tangible fixed assets for Royal Mail Group plc.

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 tangible fixed assets across the pipeline areas is based on the costs incurred in operating and maintaining the assets within each pipeline area.

### **(iii) Tangible fixed assets - average asset lives**

Tangible fixed assets are recognised at cost, including directly attributable costs in bringing the asset into working condition for its intended use.

Depreciation of tangible fixed assets 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.

## **Regulatory accounting principles and basis of preparation**

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The lives assigned to major categories of tangible fixed assets and remaining lives in Royal Mail Holdings 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

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### **F. Cash flow statement**

For 2004-05 the regulatory cash flow statement has been replaced with the cash flow statements of Royal Mail Group plc for 2004-05 and 2003-04.

### **G. Costs by pipeline**

An unaudited analysis has been added to the regulatory financial statements detailing the costs by pipeline area for 2004-05 and 2003-04 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.

## Notes to the statements

### 1. Reconciliations to statutory accounts

#### Profit and loss statement reconciliations for 2004-05 and 2003-04

	Revenue	Staff costs	Depreciation, amortisation and impairment	Net operating charges	Operating exceptional items	Share in Success	Pension deficit charge	Operating profit / (loss)	Other items	Profit / (loss) before interest and taxation
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
<b>2004-05</b>										
<b>Regulatory accounts total</b>	<b>6,676</b>	<b>(4,161)</b>	<b>(86)</b>	<b>(1,894)</b>	<b>(36)</b>	<b>(198)</b>	<b>(123)</b>	<b>178</b>	<b>-</b>	<b>178</b>
<b>Adjustments</b>										
Non letters services	1,392	(1,013)	3	(532)	(23)	(20)	(15)	(208)	104	(104)
SSAP 24 pension deficit charge	-	(138)	-	-	-	-	138	-	-	-
Overseas subsidiaries	915	(181)	(24)	(646)	-	-	-	64	(3)	61
Reclassification (note 2)	6	455	(49)	(412)	-	-	-	-	-	-
Interbusiness eliminations	(33)	-	-	87	-	-	-	54	-	54
<b>Statutory accounts total</b>	<b>8,956</b>	<b>(5,038)</b>	<b>(156)</b>	<b>(3,397)</b>	<b>(59)</b>	<b>(218)</b>	<b>-</b>	<b>88</b>	<b>101</b>	<b>189</b>
<b>2003-04</b>										
<b>Regulatory accounts total</b>	<b>6,437</b>	<b>(3,852)</b>	<b>(90)</b>	<b>(2,153)</b>	<b>(89)</b>	<b>-</b>	<b>(102)</b>	<b>151</b>	<b>-</b>	<b>151</b>
<b>Adjustments</b>										
Non letters services	1,381	(1,113)	(18)	(555)	40	-	(30)	(295)	83	(212)
SSAP 24 pension deficit charge	-	(132)	-	-	-	-	132	-	-	-
Overseas subsidiaries	836	(166)	(25)	(617)	(15)	-	-	13	3	16
Reclassification (note 2)	9	375	(62)	(337)	-	-	-	(15)	15	-
Interbusiness eliminations	(30)	-	-	163	-	-	-	133	-	133
<b>Statutory accounts total</b>	<b>8,633</b>	<b>(4,888)</b>	<b>(195)</b>	<b>(3,499)</b>	<b>(64)</b>	<b>-</b>	<b>-</b>	<b>(13)</b>	<b>101</b>	<b>88</b>

## Notes to the statements

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### 2. Reclassification and elimination of costs

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

	2004-05				
	Staff costs	Pension deficit charge	Depreciation, amortisation and impairment	Net operating charges	Other Items
	£m	£m	£m	£m	£m
Operational labour	704	-	-	(704)	-
Centrally held costs and income	(249)	-	(49)	292	-
<b>Total</b>	<b>455</b>	<b>-</b>	<b>(49)</b>	<b>(412)</b>	<b>-</b>

	2003-04				
	Staff costs	Pension deficit charge	Depreciation, amortisation and impairment	Net operating charges	Other Items
	£m	£m	£m	£m	£m
Operational labour	649	-	-	(649)	-
Centrally held costs and income	(274)	-	(62)	312	15
<b>Total</b>	<b>375</b>	<b>-</b>	<b>(62)</b>	<b>(337)</b>	<b>15</b>

Reclassifications reflect the different treatment of costs between the statutory accounts and the regulatory accounts. This note details the reclassification of costs from the regulatory accounts to the statutory accounts.

## Notes to the statements

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### 3. Royal Mail Holdings exceptional items included in operating charges

	2004-05	2003-04
	£m	£m
Share in Success	(218)	-
Impairment of tangible fixed assets	(23)	(17)
Impairment of goodwill relating to subsidiaries	-	(24)
Provision for surplus properties	-	(17)
Provision for Renewal Plan restructuring	(36)	(6)
<b>Total</b>	<b>(277)</b>	<b>(64)</b>

The £277m of operating exceptional costs comprises the Share in Success incentive scheme costs of £218m (2003-04 £nil), impairment of tangible fixed assets of £23m (2003-04 tangible fixed assets of £17m and intangible fixed assets of £24m), £nil costs relating to onerous contracts for surplus leasehold properties (2003-04 £17m) and £36m charges relating to the Group wide Renewal Plan restructuring (2003-04 £6m). The £36m charges comprise £34m in respect of employee related redundancy costs and £2m in respect of other, mainly overseas, operating costs.

The net figure of £59m (excluding Share in Success of £218m) comprises a charge of £36m for total Mails services and a £23m charge for the other business areas. The £218m Share in Success comprises a charge of £198m for Mails services and £20m for other business areas.

Of the £277m (2003-04 £64m) operating exceptional costs, £43m (2003-04 (£25m) credit) relates to non Mails services business areas.

## Notes to the statements

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### 4. Royal Mail Holdings provisions for liabilities and charges

	2004-05 £m	2003-04 £m
Mails and Parcels	159	429
Counter Services	12	50
<b>Total*</b>	<b>171</b>	<b>479</b>

\* excludes deferred tax

The Mails and Parcels provision includes amounts relating to redundancy and other non redundancy items for the Heathrow Worldwide Distribution Centre and other restructuring programmes. During the year £36m was charged to exceptional items and £11m to other operating costs. £117m was transferred to creditors due within one year, mainly relating to amounts due to the pension scheme for redundancies with early retirement. £111m of this provision is expected to be utilised in 2005-06 and the remainder over the following two to three years, except for £12m relating to decommissioning costs and £20m relating to onerous property contracts, which are expected to be utilised over a longer period.

Counter Services provisions relate to Post Office Ltd.

Of the total provisions for liabilities and provisions of £171m, £133m relates to total Mails services.

## Notes to the statements

### 5. Analysis of costs by pipeline (unaudited)

Costs by pipeline	FAC					LRMC				
	Processing	Delivery	Other operational costs	Overheads	Total	Processing	Delivery	Other operational costs	Overheads	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
2004-05	(1,362)	(2,773)	(1,152)	(854)	<b>(6,141)</b>	(1,161)	(1,744)	(459)	(494)	<b>(3,858)</b>
2003-04	(1,357)	(2,676)	(1,085)	(977)	<b>(6,095)</b>	(1,173)	(1,679)	(413)	(379)	<b>(3,644)</b>

Royal Mail operations manage a pipeline of activities, whereby letters are collected from the customer 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).

## Notes to the statements

### 6. Tangible fixed asset information by pipeline (unaudited)

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
<b>Fixed Assets</b>							
Property	-	-	-	-	-	655	655
Property fit out	180	23	192	9	404	7	411
Vehicles	-	45	25	2	72	12	84
Plant and machinery	256	22	4	18	300	-	300
Fixtures and equipment	5	1	5	-	11	3	14
<b>Total</b>	<b>441</b>	<b>91</b>	<b>226</b>	<b>29</b>	<b>787</b>	<b>677</b>	<b>1,464</b>

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 tangible fixed assets across the pipeline areas is based on the costs incurred in operating and maintaining the assets within each pipeline area.

The 2004-05 tangible fixed asset profiles across pipeline areas have been applied to the 2003-04 and 2004-05 tangible fixed assets.

2003-04 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
<b>Fixed Assets</b>							
Property	-	-	-	-	-	705	705
Property fit out	169	19	181	9	378	4	382
Vehicles	-	28	18	1	47	4	51
Plant and machinery	253	25	4	17	299	-	299
Fixtures and equipment	3	-	3	-	6	1	7
<b>Total</b>	<b>425</b>	<b>72</b>	<b>206</b>	<b>27</b>	<b>730</b>	<b>714</b>	<b>1,444</b>

## Statement of responsibilities

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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 2005"; and
  - Accounting Policies consistent with UK GAAP as applied in the Royal Mail Holdings 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 2005" 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 2005". 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 Royal Mail Group plc Board

Adam Crozier  
Chief Executive  
14 June 2005

Marisa Cassoni  
Group Finance Director  
14 June 2005

## **Independent auditors' report**

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### **Independent auditors' report**

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 examined the regulatory financial statements on pages 9 and 20 to 23. The regulatory financial statements, which have been prepared by the Company, comprise separate statements for the year ended 27 March 2005 for each of the services described on page 12 ("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 15 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 Generally Accepted Accounting Practice in the United Kingdom ("UK GAAP"). Financial information other than that prepared on the basis of UK GAAP 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 15 to 19, as agreed with Postcomm to meet the requirements of paragraph 2 of Condition 14 of 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 27 March 2005 and 28 March 2004 ("the Statutory Financial Statements").

As explained on pages 15 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 of 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 in presentation of information have been made in the current year and these are described in the "Regulatory accounting principles and basis of preparation".

### **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.

## **Independent auditors' report**

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We report our opinion as to whether each of the regulatory financial statements for the year ended 27 March 2005 fairly presents the financial situation of the Services and has been properly prepared in accordance with the requirements of paragraph 4(a) of Condition 14 of the Licence, and the "Regulatory accounting principles and basis of preparation" set out on pages 15 to 19.

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

We also read the Business review, Royal Mail Group plc balance sheet statements, Royal Mail Group plc cash flow statements, Licence requirements, Analysis of costs by pipeline and Tangible fixed asset information 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 Auditing Standards 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 Auditing Standards.

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 16 May 2005, 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 formed 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 records are sufficient to comply with the requirements of paragraph 2 of Condition 14 of the Licence, amended as agreed with Postcomm; and

## **Independent auditors' report**

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In our opinion the regulatory financial statements of the Services for the year ended 27 March 2005, fairly present the results attributable to the Services, in accordance with the "Regulatory accounting principles and basis of preparation" on pages 15 to 19, and have been prepared in accordance with the requirements of paragraph 4(a) of Condition 14 of the Licence.

Ernst & Young LLP  
London  
14 June 2005

## **Glossary and explanation of terms**

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### **£m**

Million pounds sterling.

### **2003-04**

Year ending 28 March 2004.

### **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 the Royal Mail Holdings plc.

### **Downstream Access**

Customer and other licensed postal operators’ mail, which enters the Royal Mail pipeline after the outward 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**

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

### **Long run marginal costs**

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.

### **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](http://www.royalmail.com) and select Product A-Z.

## **Glossary and explanation of terms**

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### **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 27 March 2005 and comparable 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.