

Operating and Financial Review

This Operating and Financial Review describes the main trends and factors underlying the development, performance and position of National Grid during the year ended 31 March 2006 as well as those likely to affect our future development, performance and position. It has been prepared in line with the guidance provided in the Reporting Statement on the Operating and Financial Review issued by the UK Accounting Standards Board in January 2006.

About National Grid

Principal operations

Our principal operations are in regulated networks and comprise the transmission and distribution of electricity and gas and the provision of network infrastructure to the broadcast and telecommunications industries, based mainly in the UK and the US. We also have interests in related markets, including metering services, liquefied natural gas (LNG) facilities and property in the UK, as well as electricity interconnectors in the UK and Australia.

History

National Grid originated from the restructurings of the UK gas industry in 1986 and the UK electricity industry in 1990. We entered the US electricity delivery market in 2000 in New England and expanded into New York in 2002. We substantially increased our UK wireless infrastructure activities in 2004. In 2005, following the sales of four UK regional gas distribution networks, we adopted National Grid as a single name for all our principal businesses. In 2006, we announced agreements to expand our activities in the US with the proposed acquisitions of KeySpan Corporation and of the Rhode Island gas distribution network owned by Southern Union Company.

Key milestones

1986	British Gas incorporated as a public limited company
1990	Electricity transmission network in England and Wales transferred to National Grid on electricity privatisation
1995	National Grid listed on the London Stock Exchange
1997	British Gas (renamed BG) demerged Centrica
1997	National Grid demerged Energis
2000	New England Electric System and Eastern Utilities Associates acquired by National Grid
2000	Lattice Group demerged from BG Group and listed separately
2002	Niagara Mohawk Power Corporation merged with National Grid's US operations
2002	Merger of National Grid and Lattice Group to form National Grid Transco
2004	Acquisition of UK wireless infrastructure network from Crown Castle International Corp.
2005	Sales of four UK regional gas distribution networks
2005	Adoption of National Grid as a single name for our principal businesses
2006	Agreements to acquire KeySpan Corporation and Southern Union Company's Rhode Island gas distribution network

The Operating and Financial Review consists of the following sections:

Section	Page	Section	Page
About National Grid	20	US electricity and gas distribution	48
Key performance indicators	30	US stranded cost recoveries	51
Performance during the year	31	Wireless infrastructure	52
UK electricity and gas transmission	38	Other activities	54
US electricity transmission	43	Financial position and financial management	56
UK gas distribution	45	Accounting policies	62

Businesses and segments

The performances of our businesses are reported by segment, reflecting the management responsibilities and economic characteristics of each activity. Our principal businesses and segments are as follows:

Business	Segment	Description of principal activities
Transmission	UK electricity and gas transmission	Owner and operator of the high-voltage electricity transmission network in England and Wales, the gas transmission network in Great Britain, electricity interconnectors with Scotland and with France, and storage facilities for LNG. Operator of the electricity transmission networks in Scotland.
	US electricity transmission	Owner and operator of high-voltage electricity transmission networks in the northeastern US.
UK Distribution	UK gas distribution	The distribution of gas within England as the owner and operator of four of the UK's eight gas distribution networks.
US Distribution	US electricity and gas distribution	The delivery of electricity and gas in New York and electricity in New England.
	US stranded cost recoveries	Recovery, through charges to electricity customers, of costs mainly incurred prior to divestiture of electricity generation.
Wireless	Wireless infrastructure	Provision of structures and equipment to serve the broadcast and mobile telecommunications industries, principally in the UK, but also in the US.
Other businesses and corporate activities	Other activities	Other businesses, including metering services, property management, an LNG gas import terminal in the UK and an electricity interconnector business in Australia, as well as corporate activities, such as business development.

Acquisitions and disposals

Sales of four regional gas distribution networks

In June 2005, we sold four of our regional gas distribution networks, comprising approximately half of the gas distribution network in Great Britain, for net cash proceeds of £5.8 billion.

The effect of these sales has been to reduce by about half the size of our UK gas distribution segment, which now comprises four retained networks.

The sales have resulted in a significant restructuring of the gas distribution market in the UK, so that four different owners are now responsible for their respective regional networks.

Proposed acquisitions in the northeastern US

We have entered into two agreements to expand significantly our operations in the northeastern US. These comprise the proposed acquisition of KeySpan Corporation for \$7.3 billion (£4.2 billion), together with the assumption of approximately \$4.5 billion (£2.6 billion) of debt and the proposed acquisition from Southern Union Company of its Rhode Island gas distribution network for cash consideration of \$498 million (£286 million) and assumed debt of \$77 million (£44 million).

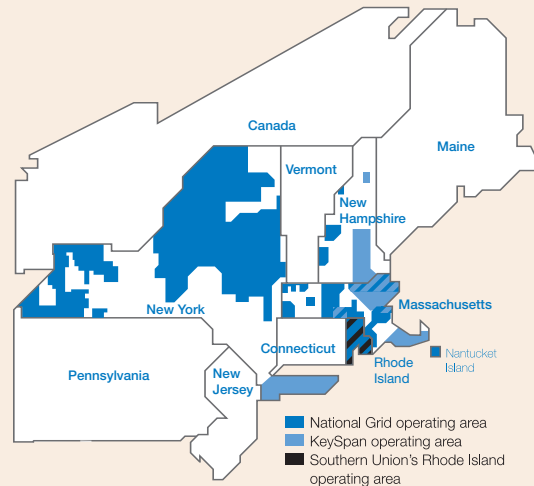
KeySpan is the fifth largest distributor of natural gas in the US and the largest in the northeastern US, serving 2.6 million customers in New York, Massachusetts and New Hampshire. KeySpan also operates an electricity transmission and distribution network serving 1.1 million customers in New York under a long-term contract with the Long Island Power Authority. KeySpan's other interests include 6.7 GW of generation capacity, together with a small portfolio of non-regulated energy-related services and strategic investments in certain gas pipeline, storage and LNG assets.

The Rhode Island gas distribution business serves approximately 245,000 customers through a distribution network of over 3,000 miles of mains. The network substantially overlaps our existing electricity distribution service area in Rhode Island. The rates for the Rhode Island gas distribution business are set by the same state regulators that set our electricity distribution rates in Rhode Island. Both businesses have a history of performing under incentive-based rate plans, which provide substantial benefits to customers and shareholders.

By combining our current US operations with those of KeySpan and the Rhode Island gas distribution business, we expect to become the third largest gas delivery business in the US.

These proposed acquisitions represent an excellent fit with our strategy, building on our core skills of owning and operating network infrastructure, and they are expected to provide additional opportunities for growth.

The proposed acquisition of KeySpan is subject to approvals from federal and state regulatory authorities, our shareholders and KeySpan's shareholders, and is planned to be completed in early 2007. The proposed acquisition of the Rhode Island gas distribution network is subject to approval by state regulatory authorities and is expected to complete this summer.



Other acquisitions and disposals

There were no significant acquisitions completed during the year ended 31 March 2006.

During the year, we sold our interest in a joint venture, Energis Polska. Net proceeds from this disposal amounted to £8 million. In addition, on 22 February 2006, we entered into an agreement to sell our 38.5% interest in Copperbelt Energy Corporation in Zambia. This sale is subject to governmental and regulatory consent by the Zambian authorities.

In 2004/05, we acquired the UK operations of Crown Castle International Corp. for cash consideration of £1,138 million and a telecommunications tower operation in the US for cash consideration of £13 million. Also in 2004/05, we disposed of our investment in a joint venture, Citelec, giving rise to a gain of £13 million.

External market environment

The principal markets in which we operate are the energy markets in the UK and the northeastern US and the wireless infrastructure market in the UK.

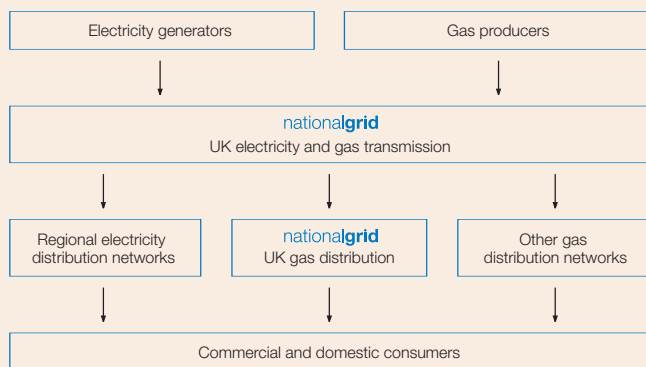
Energy markets in the UK and the US

The generation and supply of electricity and gas in the UK and the northeastern US are competitive in that consumers can contract with different suppliers to obtain the energy they need. Those suppliers are then responsible for sourcing that energy from electricity generators or from gas producers as appropriate, as well as arranging for that energy to be delivered through physical delivery networks.

These networks, including the ones we operate, are monopolies in their local areas as, for the majority of consumers, there are no methods of receiving energy other than through those networks.

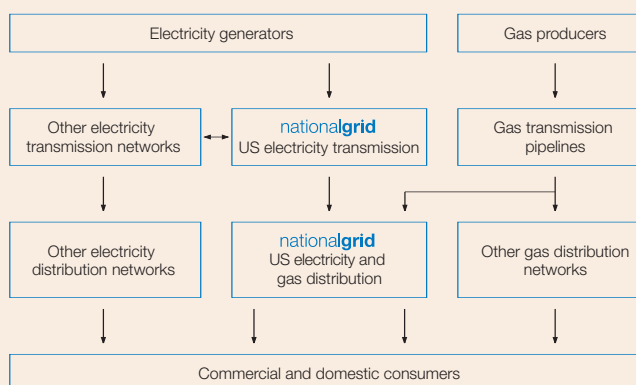
In the UK, both domestic and commercial consumers contract with energy suppliers, which obtain the energy required from electricity generators and gas producers. Energy is transported through electricity or gas transmission networks to regional electricity or gas distribution networks that then deliver that energy to consumers.

We are the owner and operator of the electricity transmission network in England and Wales, operator (but not owner) of the two electricity transmission networks in Scotland and owner and operator of the gas transmission network and of four of the eight regional gas distribution networks in Great Britain.



In the northeastern US, consumers can purchase their energy through independent energy suppliers, but the majority still purchase electricity or gas from their local electricity or gas distribution business. Electricity is transported either direct into local electricity distribution networks or via electricity transmission networks, while gas is produced primarily in the Gulf of Mexico and Canada and transported through interstate gas transmission pipelines into local gas distribution networks. Regional transmission organisations or independent system operators have the responsibility for balancing electricity supply with demand. Gas distribution networks, including our New York gas distribution business, are each responsible for balancing gas supply with demand in their distribution area.

Our US distribution businesses promote competition by encouraging consumers to purchase their energy from independent suppliers.



Energy market developments

The UK and US are entering a period of changing supply patterns for both gas and electricity, as more reliance is placed on imported gas and on new sources of electricity generation, including renewables. In the UK, the decline in UK continental shelf gas reserves and the UK Government's emphasis on combating climate change and encouragement of renewable generation mean that we continue to see a trend toward greater use of imported gas for both consumption and use in power generation. In the US, there is also likely to be an increased reliance on imported gas and significant interest in the development of renewable power generation.

These changes will have an impact on our electricity and gas transmission and gas distribution businesses. In particular, significant investment is likely to be required in our UK gas and electricity transmission and distribution networks to link new power plants and gas import facilities with domestic, business and industrial consumers.

Wireless infrastructure market

The broadcast industry is supported by infrastructure for the transmission of terrestrial, satellite, cable and broadband signals. National Grid Wireless is one of the two providers of infrastructure for terrestrial television and radio in the UK.

Mobile infrastructure is provided by mobile operators and independent wireless infrastructure providers, of which National Grid Wireless is the leading independent provider in the UK.

Regulatory environment

As a result of our position in, and importance to, the economies we serve, our electricity and gas transmission and distribution businesses are subject to UK, European Union and US federal and state laws and regulations.

In the UK, these businesses are regulated under the Gas Act 1986 and Electricity Act 1989 by the Office of Gas and Electricity Markets (Ofgem). Ofgem operates under the direction and governance of the Gas and Electricity Markets Authority, and has established price control mechanisms that restrict the amount of revenue that can be earned by regulated businesses, typically covering five-year price control periods.

In the US, our public utilities are regulated by utility commissions in the states in which we operate and by the Federal Energy Regulatory Commission (FERC). These US regulators set service standards and determine allowable levels of return. We were also regulated under the Public Utility Holding Company Act 1935 until its repeal became effective on 8 February 2006.

Certain of the UK activities of our Wireless business are subject to regulation by the Office of Communications (Ofcom), in particular our television and radio transmission infrastructure networks. We operate two digital multiplexes under the terms of licences granted by Ofcom. Ofcom is also responsible for regulating the broadcast and telecommunications industries.

Our businesses are covered by safety legislation which is enforced by the Health and Safety Executive (HSE) in the UK and federal and state safety regulators in the US. Our UK gas operations work under a permissioning regime, whereby our organisation, processes and procedures are documented in safety cases that are subject to acceptance by the HSE.

Our securities are listed on the London Stock Exchange and on the New York Stock Exchange. We are regulated by the Financial Services Authority in the UK and by the Securities and Exchange Commission in the US.

More information on the regulatory environment in which we operate is provided in the segmental discussions on pages 38 to 55.

Regulatory developments

Regulatory developments in the UK during the year included:

- on 1 April 2005, in our role as Great Britain System operator, we took responsibility for operating the Scottish electricity transmission networks in addition to the England and Wales network;
- on 1 May 2005, our UK gas transmission and distribution businesses (and each of the networks that we subsequently sold) were each granted a gas transporter licence, replacing the single integrated transmission and distribution licence that we held previously. A new Uniform Network Code was introduced by Ofgem, establishing the mechanisms for the operation of the UK gas delivery market participants;

- to align the price control periods for electricity transmission with that of gas transmission in the UK, Ofgem extended the electricity transmission price control period due to end on 31 March 2006 by a further year, extending the current period to 31 March 2007;
- Ofgem also intends to extend the current gas distribution price control period originally scheduled to end on 31 March 2007 to 31 March 2008. The next five-year price control review period will commence on 1 April 2008; and
- following their review of the broadcasting transmission services market, Ofcom introduced a new regulatory regime in April 2005 that required broadcast network access providers, including National Grid Wireless, to publish reference offer terms and conditions for new contracts with effect from 30 December 2005.

Regulatory developments in the US during the year included the enactment of the Energy Policy Act 2005, which is not expected to have any immediate effect on the Group's business, but certain provisions, including transmission pricing incentives and the creation of National Interest Electric Transmission Corridors, may benefit our long-term strategy.

The repeal of the Public Utility Holding Company Act 1935 removed certain regulations imposed on us by the Securities and Exchange Commission and replaced them with new regulations by the FERC.

Price controls and rate plans

Our principal price controls and rate plans relate to electricity and gas transmission and gas distribution in the UK and electricity distribution in the US. They can be summarised as follows:

		Current price control					Extension	Future price control					
UK electricity transmission													
UK gas transmission													
UK gas distribution													
US electricity distribution	Massachusetts	Current rate plan (until 2019)											
	Rhode Island	Current rate plan (until 2019)											
	New York	Current rate plan											
		2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13

Business drivers

Our principal activities include the operation of highly complex energy and other infrastructure networks. As a consequence, there are many factors that influence the financial returns we obtain. We consider the following to be our main business drivers:

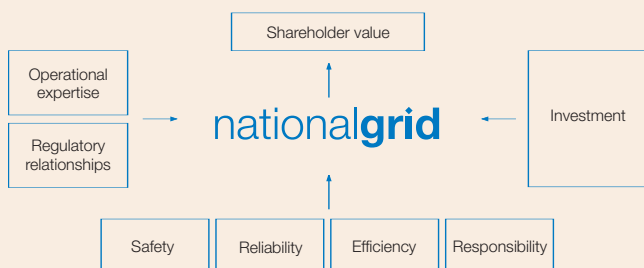
Price controls and rate plans	<p>The prices we charge for use of our energy transmission and distribution networks are determined in accordance with regulator-approved price controls in the UK and rate plans in the US. The negotiation of these arrangements has a significant impact on the revenue we obtain from our operations.</p> <p>In addition, these arrangements may include incentives that permit us to earn additional revenues based on our performance or penalise us if we do not meet various targets.</p> <p>The length of these arrangements is significant to us in that they provide stability to our operations and allow us to plan ahead and invest with confidence that we will obtain financial returns. In the UK, our price controls typically cover periods of five years, while in the US our electricity rate plans usually cover periods of 10 to 20 years.</p> <p>Our wireless infrastructure network in the UK is also subject in part to regulatory price controls.</p>
Multi-year contractual arrangements	<p>Revenues in our Wireless infrastructure business and several of our other businesses, including metering services, our LNG import terminal in the UK and our electricity interconnector in Australia, are determined by contractual arrangements, usually long-term and with 'blue chip' customers.</p>
Safety and reliability	<p>Our ability to operate safely and reliably is very important to us, our employees, our customers, the public and our regulators. Our financial performance is affected by our performance in these areas.</p>
Efficiency	<p>Our objective, and that of our regulators, is to deliver services as efficiently as possible. This allows us to limit price increases or to reduce prices to our customers and improve our own financial performance to the benefit of our shareholders.</p>
Capital investment	<p>Capital investment is a significant driver for organic growth.</p> <p>In our regulated energy networks, the prices we charge include an allowed return for capital investment determined in accordance with our price controls and rate plans. These provide incentives for us to enhance the quality and reach of our networks through capital improvements.</p> <p>For other businesses, our capital investment in new assets allows us to develop new revenue streams or to increase revenue from existing assets.</p>
Acquisitions and disposals	<p>We consider investing in energy and other network infrastructure businesses where we believe we can create value through operational improvements, synergies and financial benefits.</p> <p>We consider disposals where we believe that the price on offer is better than the long-term return we can obtain ourselves or where a business does not fit with our long-term strategy.</p>
Responsibility	<p>Our reputation is important to us. Delivering sustainable value depends on the trust and confidence of our stakeholders and this can only be earned by conducting our business in a responsible manner.</p>

A number of other factors also affect our financial performance, but are less significant than the principal business drivers above, or are mitigated by the way our operations are structured:

Volumes	<p>Changes in the quantities of electricity and gas delivered through our transmission and distribution networks may result in an increase or decrease in our revenue. Volumes are affected by weather, consumer demand and network availability as well as other factors. The impact of changing volumes may sometimes be offset by changes in costs or may sometimes result in an under- or over-recovery against our allowable revenue, with a corresponding increase or decrease in revenue in future periods.</p>
Exchange rates	<p>The reported results, cash flows and financial position of our US operations are affected by movements in the US dollar to sterling exchange rate. However, the effect of these movements is partially hedged through the use of US dollar denominated debt and derivative financial instruments.</p>
Commodity and other pass-through costs	<p>We are allowed to recover certain costs, including commodity costs in the US and other direct costs in both the UK and the US, through charges to customers. The timing of recovery of these costs can vary between financial periods leading to an under- or over-recovery within any particular financial period. We are affected by movements in commodity prices to the extent that they affect our own energy requirements, the most significant of which relates to gas purchases required for the operation of our gas transmission and gas distribution networks in the UK. Certain US commodity contracts are recorded in our balance sheet at their fair values, which are affected by movements in commodity prices. Although remeasurements in the carrying values of these contracts are reflected in our income statement, under our rate plans we expect to recover the net costs incurred under these contracts from customers in future periods.</p>
Inflation	<p>Without action to improve efficiency, our operating costs will increase each year as a result of wage increases and inflation in external costs. In general, our revenues also increase each year, although not necessarily at the same rate, depending on our regulatory or contractual arrangements. As a consequence, our ability to control costs and improve efficiency is important to our ability to increase operating profits.</p> <p>Our price controls in the UK are linked to retail price inflation, while our regulatory settlements in Rhode Island and New York allow us to recover additional distribution revenue from customers if there is a significant change in the rate of inflation.</p>
Seasonality	<p>Revenues from our gas distribution networks in the UK and the US and our gas transmission network in the UK are weighted towards the end of the financial year, as gas demand is typically higher during the winter months. Otherwise, seasonality does not have a significant impact on revenues.</p> <p>With the exception of commodity and other volume-related costs passed through to customers, our operating costs are generally not seasonal.</p>
Interest rates	<p>The costs of financing our operations are affected by changes in prevailing interest rates, as some of our debt is at floating rates. We hedge some of our exposure to interest rates with fixed rate debt and derivative financial instruments to maintain a proportion of our debt at fixed interest rates.</p>

Objectives and strategy

Our principal objective is to create value for our shareholders, through our goal of being the world's premier network utility.



To achieve our principal objective we have committed ourselves to operating our businesses to the highest standards of safety, reliability and efficiency and to acting in a responsible way that contributes to society. We have established operating objectives in the following areas:

Safety	Safety is paramount. Our most important goals are to ensure that members of the public are not injured as a direct result of our operations and to deliver a working environment where there are zero work-related injuries and illnesses wherever we operate in the world. Our goals also include reducing the risks of transporting gas and improving the health of our staff so they are fit for work every day.
Reliability	Our principal operations are critical to the functioning of the economies we serve. The reliability of our energy and wireless infrastructure networks, and the quality of our service to our customers, are therefore our next highest priorities after safety.
Efficiency	By improving efficiency we can constrain the cost of our operations borne by customers and improve returns to shareholders. We continually seek improvements in efficiency throughout our businesses. This includes enhancing the performance of our staff through their development and training.
Responsibility	We are committed to operating in a responsible way and we have adopted high ethical and governance standards. We take actions to minimise the environmental impact of our operations and to remediate contaminated land, promote inclusion and diversity in our workforce, and invest in the communities in which we operate.

We use our skills and assets to create value for shareholders through investing for growth in our existing businesses, investing in energy and selected other network assets and businesses and improving the efficiency of our existing and acquired businesses.

To achieve our objectives, our strategy is to focus on the ownership and operation of large complex networks by:

- using our operational expertise to outperform benchmarks and regulatory targets;
- managing regulatory relationships to benefit customers and shareholders; and
- using a disciplined approach to investment to maximise returns.

Key performance indicators

We measure the achievement of our objectives through the use of qualitative assessments and through the monitoring of quantitative indicators, termed key performance indicators (KPIs). In line with our operating objectives, we use both financial and non-financial KPIs.

KPIs are used as our primary measures of whether we have achieved our principal operating objectives. The scale and size of our operations means that we use many other detailed performance measures in addition to the KPIs listed below. We use qualitative assessments to judge progress against our objectives in areas where numerical measures are less relevant.

Value	Objective	Key performance indicator
Safety	Zero public injuries	Members of the public injured as a direct result of our operations
	Zero work-related injuries	Employee lost time injury frequency rate
	Reduce risks from transporting gas	Standards of service for responding to gas escapes Length of UK gas distribution mains replaced
	Zero work-related ill health	Sickness absence rate
Reliability	Operational reliability	Business-specific reliability and service quality measures
Efficiency	Operate efficiently	Adjusted operating profit* Achieve real reduction of 35% in UK gas distribution controllable costs by 31 March 2007
	Responsibility	Reduce environmental impact
Employ an inclusive and diverse workforce		Percentage of female employees
		Percentage of ethnic minority employees
Shareholder value	Improve financial performance	Adjusted earnings per share* Operating cash flows Total shareholder return
	Invest for future growth	Capital expenditure
		Investments in acquisitions

* Adjusted operating profit and adjusted earnings per share are equal to operating profit and earnings per share excluding exceptional items and remeasurements in each case.

Details of KPIs for the year ended 31 March 2006 are included on page 30, while segment-specific KPIs are reflected in the business segment sections on pages 38 to 55.

Resources

Our key strengths and resources include:

- the skills and expertise of our people;
- our processes and techniques for managing large complex networks;
- our relationships with customers, regulators and other stakeholders;
- our ability to work together to achieve our objectives;
- the control and/or ownership of the assets used in our networks; and
- our financial position, together with the committed and uncommitted borrowing facilities available to us.

Our strategy for developing our people is discussed below. The principal assets of each of our businesses are described in the segmental sections of this Operating and Financial Review on pages 38 to 55 and our financial position is described on pages 56 to 61.

Developing our people

We continue to invest in the development of our people.

Throughout National Grid, people development forums provide the opportunity for management teams to discuss the performance and potential of their teams. This allows for the identification of individual development needs and business skill requirements.

Our UK engineering foundation programme has recently been launched and is designed to facilitate the entrance, training and progression of young people into key engineering roles, initially with UK electricity transmission. We intend to provide opportunities for the young people on this programme to obtain a new vocational qualification, being an employer-led, UK Government-backed, foundation degree.

A new career development programme was launched in April 2005 for operations engineers to develop their skills as line managers. In addition, our flagship leadership development programme is to be extended to middle management in 2006. Further development is under way through an emerging leaders programme.

Our recruitment processes for apprentices, graduates and university placements in the UK and the intern programme in the US, continue to build on the previous successes of developing our talent from within and addressing the decline in the number of graduates in technical engineering subjects.

Employee engagement

Following our first Group-wide employee opinion survey in 2004, we identified a number of areas for improvement. These included improving opportunities for dialogue across the Group, developing a better understanding of Group strategy among employees, managing change better, improving performance management, demonstrating our values in all that we do and continuing to progress inclusion and diversity.

We have established a core set of three behavioural values that apply across all our operations: Respect, Integrity and Ownership.

Across the Group, we have also refined our employee briefing processes and publications. We have re-launched our Group, UK and US intranet sites and our UK and US employee newspapers. We have also introduced a Group-wide publication, 'National Grid World', to provide employees with a broader view of Group activities.

Inclusion and diversity

In January 2005, we launched our Inclusion and Diversity programme, setting out how we intend to develop and operate our business in a way that results in a more inclusive and diverse culture. We aim to ensure that our employees, regardless of race, gender, nationality, age, disability, sexual orientation, religion or background, have the opportunity to develop to their full potential.

We have taken a number of steps to make this vision a reality. We have established a number of employee groups, including networks for women, and ethnic minority employees. We hope these will help us to identify and remove any barriers that exist for these groups of employees. In particular, we are committed to increasing the number of women in senior management from the existing 18.3% through a variety of measures including mentoring, development programmes and our continued commitment to flexible working.

Employee development is extremely important to us and we have begun a programme of training for all our managers about the knowledge and behaviour required to manage a diverse workforce such that all our employees feel included and able to contribute effectively.

Capital investment

The Group's total annual capital expenditure is expected to be approximately £2.5 billion per year over the next five years and was £2,062 million in 2005/06 in our continuing businesses, compared with £1,518 million in 2004/05.

This reflects changing energy infrastructure requirements as the UK's dependency on gas imports and its focus on renewable energy sources both increase. There is also a need to increase the rate of asset replacement in UK electricity transmission as the condition of assets built in the 1960s and 1970s necessitates their replacement.

Investment is being made in New England to deliver the regional system plan and in New York to address asset replacement requirements and to maintain the safety and reliability of the network.

Isle of Grain

In July 2005, commercial operations for the first phase of the Isle of Grain LNG import terminal commenced, and work on Phase II is now under way. Cumulative investment has now reached £249 million out of an expected £500 million total spend, all of which is underpinned by long-term contracts signed with BP, Centrica, Gaz de France and Sonatrach. Market appetite for further expansion at the Isle of Grain is currently being explored.

National Grid Australia

We completed the construction of the Basslink project in Australia, an electricity interconnector linking Victoria and Tasmania, during the year and it became operational in April 2006.

Basslink can provide up to 600 MW of hydro electricity to mainland Australia and over 300 MW of electricity into Tasmania.

Digital switchover

In our Wireless infrastructure business, we expect to invest over £200 million in new common digital television broadcast infrastructure over the next six years to 2012, and around £50 million on our own digital broadcast transmission assets.

Safety

Our approach to safety and occupational health is set out in our Group Vision for Safety. This is underpinned by Group-wide policies and strategy statements that are available on our website. Our objective is to achieve zero work-related injuries, zero work-related ill health and zero injuries to the public. While this objective is demanding, we believe it is achievable.

This year we have reported a 27% reduction in the number of lost time injuries to our employees and an 18.5% reduction in lost time injuries to our contractors. We continue to develop initiatives and safety awareness campaigns to protect both the public and our employees and contractors who are affected by, or involved with, our operations. We also continue to exceed our safety standards for uncontrolled and controlled gas escapes in the UK and to deliver our increased long-term iron mains replacement programme as agreed with the Health and Safety Executive.

Overall, our aim is to develop a culture in which acting safely becomes second nature.

Reliability

Our approach to maintaining and improving reliability involves:

- investing in infrastructure and systems to provide the operational tools and techniques necessary to manage our assets and operations to high standards and investing in the renewal of assets;
- investing in the skills and capabilities of our people to give them the ability to operate our networks to a high degree of service excellence; and
- maintaining a constant focus on reliability as one of our principal objectives, ensuring we are proactive about planning to ensure reliability and that we react quickly to factors that could compromise reliability.

Efficiency

We continually review our operations to identify opportunities to improve the productivity of our assets and our people, and to identify areas in which we can reduce costs or restrict cost increases. Planning ahead is essential in our approach to maintaining and improving efficiency. For example, in November 2005 we decided to establish a multi-function shared services organisation for our businesses in the UK, comprising supply chain management and significant parts of human resources and finance. This is similar in nature to our existing shared services organisation in the US.

Responsibility

Our Framework for Responsible Business defines the principles by which we manage our business and our day-to-day dealings with our customers, employees, shareholders, suppliers and local communities. It is underpinned by Group-wide policies and position statements that are also available on our website.

We believe strong corporate governance is essential to operating responsibly and achieving our goals. We describe our approach to corporate governance on pages 68 to 76.

Ethics

We have set out the ethical standards we expect each employee to meet while conducting business for the Group in our Standards of Conduct applicable to our US employees and our Code of Business Conduct applicable to all our UK and other employees.

Allegations of misconduct are investigated and reported to our Ethics Office in the US or to our Business Conduct Committee in the UK. We aim to ensure that reported breaches are thoroughly and promptly investigated and, where appropriate, acted upon and any necessary improvements implemented. The Board Risk & Responsibility Committee receives a twice-yearly report on the number and type of inquiries and allegations.

Environmental management

We are committed to a year-by-year improvement in our environmental performance. Our Group-wide environmental policy sets out the key areas we are addressing, and we continue to implement environmental management systems certified to the international standard ISO 14001 to help us deliver improvements in these areas.

Approximately 86% of our employees work to systems certified to ISO 14001. Later this year, National Grid Wireless will become the latest of our businesses to seek external certification.

Climate change

We are committed to making a contribution towards minimising climate change and our public position statement, Energy Delivery and Climate Change, sets out how we propose to address the issue of greenhouse gas emissions in particular. Following its publication, we established a Group-wide Climate Change Strategy Group, which has established a long-term strategy that maps out how we will achieve a 60% reduction in emissions well in advance of the target date of 2050 set by the UK Government.

We have already achieved the UK Kyoto obligation and what would have been the US obligation. We are seeking means of reducing our impact further, taking into account the planned acquisitions described on page 21.

Contaminated land

We manage a portfolio of contaminated land including former manufactured gas plants, industrial landfills, former gas holders and older substations on our distribution and transmission networks. Sites can sometimes have a complex mix of contamination dating back over 100 years.

In the UK, the main focus of our remediation programme is on managing the environmental risk and returning land to beneficial use, while in the US, our highest priority sites for remediation are those with the highest environmental risk profile and those we are required to remediate by regulatory agencies. Our goal is to return these sites to productive public or private use.

Electric and magnetic fields (EMFs)

National Grid recognises that there is some scientific evidence suggesting certain adverse health effects are linked to electric and magnetic fields. There is also evidence linking an increased risk of certain diseases to proximity to powerlines, though the cause of this is not clear. As a consequence, there is public concern and we take these issues very seriously. The balance of evidence remains against both power-frequency and radio-frequency electric and magnetic fields causing ill health.

The World Health Organization has classified power-frequency magnetic fields as 'possibly' carcinogenic. Our recently updated Public Position Statement on EMFs helps set the framework within which we continually assess the scientific evidence in this area, determine any implications for the way in which we conduct our business and explain to society what the science is telling us.

In all our operations, as a minimum we aim to comply with regulations, guidelines or practices relating to EMFs in force in the different jurisdictions in which we operate. Where other companies, such as telecommunications operators, use our assets, we expect them similarly to comply with the relevant regulations, guidelines or practices.

Human rights

Human rights are primarily the responsibility of governments. However, we believe we can make a valuable contribution within the context of our own operations to support and respect the observance of human rights.

We do not have operations in countries that are considered to have poor human rights. We have therefore focused on extending our existing risk management processes by identifying and understanding the areas where the Group might be exposed to human rights risks and opportunities, should we develop new business in such countries. We have also started to assess the human rights risks associated with our global supply chain and have worked with other UK utilities to extend the screening of potential suppliers to include labour-related issues.

We continue our work with the Business Leaders Initiative on Human Rights, an international business-led initiative aimed at developing practical business tools to incorporate human rights into day-to-day business decision-making. As part of this work, we addressed the informal interactive hearings of the General Assembly of the United Nations in June 2005 on how responsible business practices can help promote and fulfil the rights of everyone.

Community investment

The role of National Grid as a good corporate citizen is one that complements and adds value to our strategic ambitions and as such must be delivered through a consistent and integrated approach.

The Group's Community Investment Policy provides a framework for ensuring that investment delivers benefits for our business and the communities involved. All community investment must develop our business, support our employees, support communities and enhance our reputation. To achieve these benefits, we focus our investment on three key themes to ensure that we maximise the impact of our investment: Skills and Education; Environment and Energy; and Community Development.

Through our Social Policy Committee, successful projects are being reviewed to determine whether they can be adopted in other parts of the business: for example, opportunities to transfer the successful 'Young Offender Into Work Programme' to the US, a wider implementation of the US Syracuse Recycling Centre model, and a sharing of best practice for fuel poverty initiatives across the UK and the US.

Stakeholder engagement

National Grid has a diverse range of external stakeholders including customers, regulators, government and local communities. We adopt an open and constructive approach in our dealings with external audiences.

Stakeholder management includes coordinated activity ensuring appropriate engagement with the UK Government and Parliament, US Federal and State authorities and legislators, devolved assemblies, regulators and other key stakeholders. This is supplemented by business-specific stakeholder planning, enabling appropriate engagement mechanisms and agreements to be put in place in the context of the Group and the wider objectives of stakeholders.

Each of our businesses engages with relevant stakeholders, including customers, employees, contractors and the community, both in terms of the services we provide, the way that we operate and the impact that our activities have on each of our stakeholders.

Risk and uncertainties

As well as the opportunities we have to grow and develop our business, we face a number of risks and uncertainties in obtaining our objectives.

The most significant risk factors we have identified relate to:

- changes in laws or regulation;
- breaches in environmental or health and safety law or regulation;
- network failure or inability to carry out critical non-network operations;
- achievement of business performance objectives;
- regulatory treatment of commodity costs passed through to consumers;
- reputation damage from disruptions to supply, even if outside our control;
- business development activities;
- fluctuations in the US dollar or movements in interest rates, restrictions in borrowings and debt arrangements or changes in credit ratings;
- pension scheme funding requirements;
- changes in tax rates; and
- changes in accounting standards.

These are described in more detail on pages 74 to 76. We also comment on financial risks and risk management 'Financial position and financial management' on pages 56 to 61.

Legal and related matters

In June 2005, Ofgem announced that certain aspects of the domestic gas metering business were to be investigated by it under the Competition Act 1998. Information requested as part of this investigation was provided to Ofgem in September 2005. On 17 May 2006, Ofgem issued a statement of objections detailing why it believes National Grid's conduct is in breach of the Competition Act. We shall be responding to the statement of objections in due course.

Other developments

Other developments during the year that may affect us include the European Union Electricity Regulation, which requires a mandatory inter-operator compensation scheme to be established in respect of electricity transfers between member states. The scheme may be introduced in the course of 2006, although this is by no means certain. Any receipts from, or payments to, the scheme will have to be set against transmission charges and so the overall impact is expected to be neutral. The scheme could also have an impact on charging arrangements for the interconnector with France. The Regulation allows for other changes to be made to transmission tariffs and congestion management across member state borders, although details of these areas will only be developed over the coming year.

A European Union Directive concerning measures to safeguard security of natural gas supply is due for implementation in May 2006. This will ensure that member states have in place, and publish, policies and standards on gas security of supply. In addition, the Gas Regulation on conditions for access to gas networks was adopted by the European Union in September 2005 and will apply from 1 July 2006.

There are also a number of European Directives and Regulations in development covering many issues including electricity security of supply, harmonisation of access to gas systems and infrastructure development, where the precise impact on our businesses in the future is currently uncertain.

We expect the impact of these regulations on our businesses to be minimal.

Key performance indicators

Value	KPI	Description	Target	Results
Safety	Injuries to the public	Members of the public injured as a direct result of our operations [†]	Zero	2005/06: 20 2004/05: 52
	Employee lost time injury frequency rate	Injuries resulting in employees taking time off work (per 100,000 hours worked)	Zero	2005/06: 0.28 2004/05: 0.37
	Gas safety-related service standards	Proportion of uncontrolled gas escapes attended within one hour in the UK	97%	2005/06: 97.97% 2004/05: 98.46%
	UK gas distribution mains replacement	Length of gas main decommissioned	2005/06: 1,724 km 2004/05: 1,492 km	2005/06: in excess of 1,710 km 2004/05: 1,458 km
	Sickness absence rate	Proportion of available work days which are lost due to sickness	Zero work-related sickness [‡]	2005/06: 2.38% 2004/05: 2.69%
Reliability	Business-specific reliability and service quality measures are discussed in the business segment sections on pages 41, 44, 46, 50, 53 and 55.			
Efficiency	Adjusted operating profit*	Operating profit from continuing operations excluding exceptional items and remeasurements	To increase each year	2005/06: £2,527 million 2004/05: £2,443 million
	UK gas distribution controllable costs	Operating costs over which we have direct control	Reduce controllable costs by 35% in real terms of their 2002 level by 31 March 2007	Achieved by 31 March 2006
Responsibility	Significant direct environmental incidents	Category 1 environmental incidents	Zero	2005/06: 22 2004/05: 23
	Greenhouse gas emissions tonnes per £m of revenue	CO ₂ equivalent emissions estimated to be directly or indirectly caused by our operations	60% reduction by 2050	2005/06: 1,110 2004/05: 1,680
	Fines from environmental citations and prosecutions	Financial quantity of fines imposed	Zero	2005/06: Zero 2004/05: US\$3,000 and A\$1,000
	Percentage of female employees	Proportion of employees who are female	We do not have specific targets – our aim is to ensure that we recruit the best candidates regardless of sex, race, disability, sexual orientation, age, religion or belief	2005/06: 23.4% 2004/05: 21.0%
	Percentage of ethnic minority employees	Proportion of employees who are from ethnic minorities		2005/06: 6.7% 2004/05: 6.0%
Shareholder value	Adjusted earnings per share**	Earnings per share from continuing operations excluding exceptional items and remeasurements	To increase sufficiently to support 7% dividend growth through to March 2008	2005/06: 46.7p 2004/05: 42.3p
	Operating cash flows	Cash generated from continuing operations	To increase each year	2005/06: £3,131 million 2004/05: £2,911 million
	Total shareholder return	Growth in share price, assuming reinvestment of dividends and returns of capital	To increase	2005/06: 22.9% 2004/05: 19.0%
	Capital expenditure	Additions to property, plant and equipment and to intangible assets	There is no numerical target for capital expenditure or for acquisitions, as each investment is different and is considered on its merits	2005/06: £2,062 million 2004/05: £1,518 million
	Investments in acquisitions	Consideration in respect of acquired businesses		2005/06: No acquisitions 2004/05: £1,151 million

[†] Major injuries comprise fatalities and other injuries that require the person to receive hospital treatment or, in the UK, injuries reported under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations.

[‡] The sickness absence rate includes absences resulting from both work-related and not work-related illnesses.

* Operating profit from continuing operations including exceptional items and remeasurements increased from £2,142 million in 2004/05 to £2,439 million in 2005/06. See page 33.

** Earnings per share from continuing operations including exceptional items and remeasurements increased from 36.3p in 2004/05 to 42.8p in 2005/06. See pages 35 and 36.

Performance during the year

Operating performance

Safety performance

Against the significant safety improvements we have seen over the past three years, it is with great sadness that we record that there were six fatalities directly associated with our operations during 2005/06.

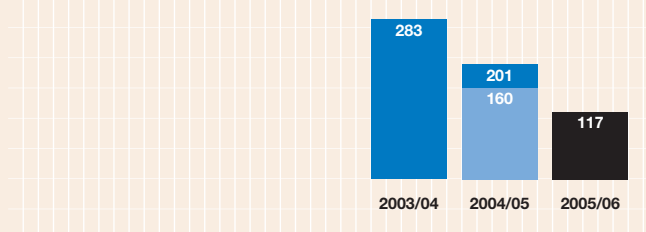
In October 2005, an employee died while working on our London gas distribution network. There is an investigation into the incident and we are working closely with the Health and Safety Executive. We have reviewed our procedures and equipment for use while working in gaseous environments and we are currently implementing an action plan under the management of a member of the UK gas distribution leadership team.

Two contractors died in a helicopter crash in Scotland while carrying out an aerial survey of our gas transmission network. There have also been three public fatalities resulting directly from our operations: an elderly person died after being hit by a vehicle from our UK gas distribution operations; in Zambia, a cyclist died in a collision with a car driven by an employee of our joint venture, Copperbelt Electricity Corporation; and, in the UK, a man died after parachuting illegally from an electricity pylon.

These were tragic events and our thoughts and deepest sympathies are with all those affected.

Employee lost time injuries

Number



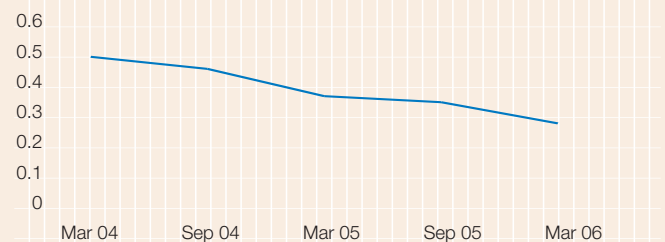
2004/05 lost time injuries were 160 excluding and 201 including the sold networks respectively. 2005/06 excludes three lost time injuries that occurred in the sold networks while still owned by National Grid.

Over the past 12 months, we have continued to see an encouraging improvement in our safety performance across the Group. Excluding the sold networks, 117 of our employees received injuries that resulted in them taking time off work during 2005/06 compared with 160 in 2004/05, a 27% reduction.

The lost time injury frequency rate provides a more accurate indicator of year-on-year performance than an absolute measure because it takes into account changing employee numbers resulting from acquisitions and disposals, such as the sales of the four UK gas distribution networks in 2005/06. The number of employee lost time injuries per 100,000 hours worked in 2005/06 fell to 0.28, a 24% improvement when compared with the previous year.

Employee lost time injury frequency rate

Per 100,000 hours worked



There has also been a significant reduction in the number of contractor lost time injuries across the Group, falling from 146 in 2004/05 to 119 in 2005/06, a 18.5% decrease.

In December 2005, the safety management aspects of National Grid Wireless's integrated management system were certified to the international occupational health and safety management standard, OHSAS 18001.

In our UK Transmission and Distribution operations, we have reinforced our existing safety procedures by focusing on areas of our activities where there is most risk of serious injuries. We believe these procedures will help drive continual improvements in key areas.

In the US, we have unified our employee safety rules into an Employee Safety Handbook that incorporates the best practices from the New York and New England operations.

We have continued to focus on our employees' health by promoting physical well-being, and highlighting mental health issues such as stress. In the UK, we published a stress management standard and implemented a drugs and alcohol policy, complementing those already in place for our US employees. In the US, we have promoted employee health and well-being by offering wellness programmes.

Around 2.38% of available work days were lost due to sickness absence compared with 2.69% for the previous year.

Responsibility

This year has again seen external endorsement of our responsible business approach. We continue to feature in the Dow Jones Sustainability World and FTSE4Good indices. We are one of only two multi-utilities listed in the Dow Jones Sustainability World Index, confirming that our approach to responsible business is indeed world-class.

In May 2006, we were placed equal fourth in Business in the Community's fourth Corporate Responsibility Index, a leading UK benchmark of responsible business, the only company to be ranked in the top five for three years running.

Ethics

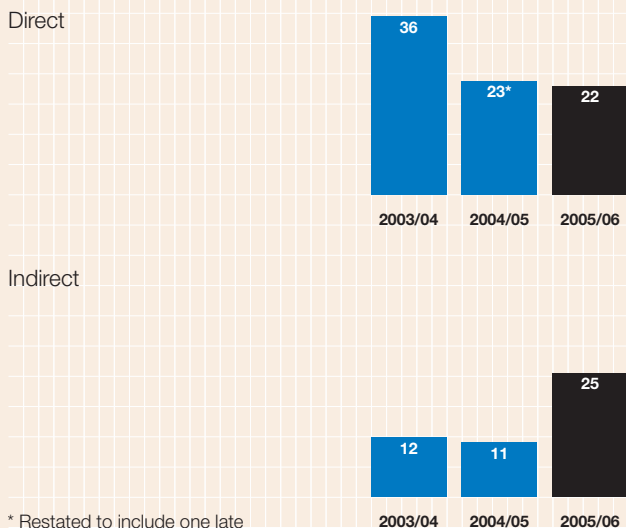
In 2004/05, we reported on our website for the first time the number of substantiated breaches of our employee codes of business conduct. In 2005/06, there were 4.76 substantiated breaches per 1,000 employees compared with 8.04 in 2004/05. Offences include such things as internet and email abuse, misuse of company vehicles and other assets and climbing electricity pylons unattached. Disciplinary actions can range from a verbal warning to dismissal.

Environmental management

The number of significant environmental incidents in 2005/06 arising directly from our operations was 22, compared with 23 in the previous year. Incidents out of our control resulting from third party or weather-related damage to our networks was 25 compared with 11 for 2004/05.

There were no prosecutions by enforcing bodies resulting from these incidents. We received 10 environmental citations in 2005/06 compared with 14 in the previous year, although none attracted fines.

Significant environmental incidents



Contaminated land

In the UK, National Grid Property manages 382 contaminated sites. This compares with 470 sites in 2004/05, the reduction principally reflecting the transfer of sites as part of the sales of the four UK gas distribution networks in 2005. In the US, we have responsibility for approximately 190 contaminated sites, the vast majority of which are formerly owned manufactured gas plants.

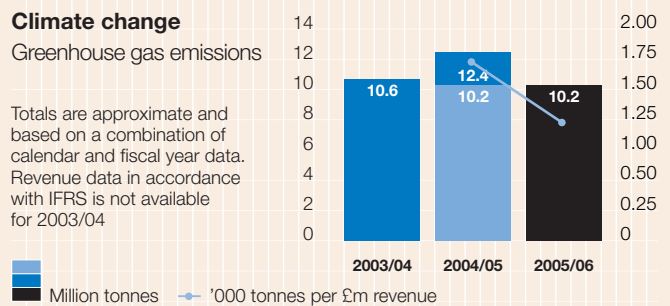
During 2005/06, 35 sites in the UK and four sites in the US were remediated.

Together with the Environment Agency, we have sought judicial review to clarify the legal position with regard to the remediation of a site in Bawtry, Yorkshire following a decision by the Environment Agency that National Grid Gas plc was an appropriate party to be involved in the clean up of the land. The site has a long and complex history of ownership. On 17 May 2006, the High Court ruled in the Environment Agency's favour. We intend to appeal this decision, which we believe is incorrect in law.

Climate change

The largest sources of direct emissions continue to be methane leakage and venting from our UK gas networks, while the largest source of indirect emissions is caused by losses across our electricity networks. Together these account for some 79% of our total emissions.

During 2005/06, our direct and indirect emissions of greenhouse gas amounted to some 10.2 million tonnes CO₂ equivalent, the same as 2004/05 excluding the sold networks.



In 2005/06, emissions per £million of revenue amounted to some 1,110 tonnes CO₂ equivalent compared with 1,680 tonnes for the previous year.

Inclusion and diversity

At 31 March 2006, of our 19,783 employees across the Group, 23.4% were females and 6.7% were from ethnic minority groups compared with 21.0% and 6.0% at 31 March 2005.

Community investment

The London Benchmarking Group model has been adopted to provide a framework for measuring and reporting the Group's community investment contributions. Processes are now in place so that community investment spend across the Group can be captured and categorised according to the model, and spend against our agreed themes can be reported as described on page 28. During 2005/06, we invested some £7.7 million in support of community initiatives and relationships across Group operations.

During 2005/06, we contributed £912 million (2004/05: £1 billion) to the communities we operate in, comprising employment, property and corporate taxes.

Business segment performance

The operating performance of each business segment is described in the business segment reviews on pages 38 to 55.

Financial performance

We report our financial results and position in accordance with International Financial Reporting Standards (IFRS) as adopted in the European Union. A summary of the effects of implementing IFRS and the principal differences from our results for the year ended 31 March 2005 previously reported under UK GAAP is on pages 62 and 63.

Continuing and discontinued operations

The financial results of our business segments (as described on page 20) and of other activities are presented within continuing operations.

The results of the four gas distribution networks sold on 1 June 2005 are no longer included within the UK gas distribution segment, but are instead presented as discontinued operations.

Use of adjusted profit measures

We separately disclose items of income and expenditure that are material, either by their nature or their size, and are relevant to an understanding of the Group's financial performance. These include exceptional income or charges that do not relate to the underlying financial performance of the Group and remeasurement gains or losses arising from changes in the value of commodity contracts and of derivative financial instruments, recorded at fair value in the balance sheet.

In considering the financial performance of our businesses and segments, we use 'business performance' or 'adjusted' profit measures. References to 'adjusted operating profit', 'adjusted profit before taxation', 'adjusted earnings' and 'adjusted earnings per share' are stated before exceptional items and mark-to-market remeasurements of financial instruments and commodity contracts.

The Directors believe that the use of these adjusted measures best illustrates the underlying business performance of the Group. Excluding exceptional items and mark-to-market remeasurements of derivative financial instruments and commodity contracts removes their distorting impact in order to provide a clearer comparison from year to year.

Remeasurements arise on commodity contracts (other than normal sale and purchase contracts) and on financial instruments as these are recorded in the balance sheet at their fair values. Remeasurements included in operating profit relate to changes in the fair value of those commodity contracts resulting from movements in electricity and gas prices. Financial remeasurements relate to changes in the fair values of derivative financial instruments and in the fair value of commodity contracts resulting from changes in interest rates.

Operating financial performance

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Revenue	9,193	7,382
Other operating income	80	70
Operating costs excluding exceptional items and remeasurements	(6,746)	(5,009)
Adjusted operating profit	2,527	2,443
Exceptional items	(39)	(263)
Remeasurements	(49)	(38)
Total operating profit	2,439	2,142

The following tables set out the revenue, adjusted operating profit and operating profit of the Group by business segment.

Revenue by business segment

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
UK electricity and gas transmission	2,710	1,995
US electricity transmission	310	284
UK gas distribution	1,222	1,113
US electricity and gas distribution	3,711	3,087
US stranded cost recoveries	511	409
Wireless infrastructure	325	208
Other activities	701	734
Total segmental revenues	9,490	7,830
Less: sales between business segments	(297)	(448)
Revenue	9,193	7,382

Segmental operating profit before exceptional items and remeasurements

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
UK electricity and gas transmission	844	859
US electricity transmission	127	126
UK gas distribution	483	424
US electricity and gas distribution	364	375
US stranded cost recoveries	489	465
Wireless infrastructure	75	42
Other activities	145	152
Adjusted operating profit	2,527	2,443

Segmental operating profit after exceptional items and remeasurements

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
UK electricity and gas transmission	843	857
US electricity transmission	127	119
UK gas distribution	432	333
US electricity and gas distribution	364	258
US stranded cost recoveries	440	427
Wireless infrastructure	70	29
Other activities	163	119
Operating profit	2,439	2,142

Details of the financial performance of business segments, including information on exceptional items and remeasurements, are included in the business segment reviews on pages 38 to 55.

Revenue, operating costs and operating profit

The movements in the year in revenue and other operating income, operating costs and operating profit can be summarised as follows:

	Revenue and other operating income £m	Operating costs £m	Operating profit £m
2004/05 results	7,452	(5,310)	2,142
Add back 2004/05 exceptional items and remeasurements	–	301	301
2004/05 adjusted results	7,452	(5,009)	2,443
Exchange on US operations	169	(125)	44
2004/05 constant currency results	7,621	(5,134)	2,487
UK electricity and gas transmission	715	(730)	(15)
US electricity transmission	13	(18)	(5)
UK gas distribution	113	(54)	59
US electricity and gas distribution	488	(516)	(28)
US stranded cost recoveries	84	(81)	3
Wireless infrastructure	114	(81)	33
Other activities	(26)	19	(7)
Sales between businesses	151	(151)	–
2005/06 adjusted results	9,273	(6,746)	2,527
2005/06 exceptional items and remeasurements	–	(88)	(88)
2005/06 results	9,273	(6,834)	2,439

The increases in revenue, operating costs and operating profit from 2004/05 to 2005/06 from exchange on US operations reflected the movement in the average US dollar to sterling exchange rate from \$1.87:£1 in 2004/05 to \$1.79:£1 in 2005/06.

Other operating income relates primarily to gains on the sales of property, which were £10 million higher in 2005/06 than in 2004/05.

The most significant increases in revenue and operating costs arose in UK electricity and gas transmission, including increased revenues and operating costs in respect of operating the Scottish electricity transmission networks following the introduction of the British Electricity Trading and Transmission Arrangements (BETTA), increased pass-through costs in US electricity and gas distribution and US stranded cost recoveries, and a full-year contribution from the Wireless infrastructure business. Revenue and costs also increased in UK gas distribution, with savings in controllable costs resulting in increased operating profit.

Adjusted operating profit increased by £40 million on a constant currency basis. This was driven by favourable results from UK capacity auctions in LNG storage and the French Interconnector, a continued focus on efficiencies, particularly in UK gas distribution, sustained volume growth in the US and a full-year contribution from the enlarged and growing Wireless infrastructure business.

These factors more than offset an increase in depreciation charges in UK electricity and gas transmission, lower system operator incentive profits also in UK electricity and gas transmission and the timing of the recovery of certain pass-through costs in the US.

Net operating exceptional charges of £39 million for 2005/06 consisted of £60 million of restructuring costs, primarily cost reduction programmes in UK gas distribution, and £21 million of gains relating to the disposals of joint venture investments. This compared with £263 million in 2004/05, comprising £121 million in restructuring costs (£82 million in UK gas distribution, £23 million in our US businesses and £16 million in other businesses), £41 million in exceptional pension charges in the US and £101 million of increases in environmental provisions.

Operating remeasurements of £49 million (2004/05: £38 million) relate to changes in the value of commodity contracts in the US carried in the balance sheet at fair value arising from movements in energy prices.

Total operating profit rose by £297 million from 2004/05 to 2005/06, resulting from an increase in adjusted operating profit of £84 million and a decrease in operating exceptional charges and remeasurements of £213 million as compared with 2004/05.

Earnings from continuing operations

Adjusted earnings

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Adjusted operating profit	2,527	2,443
Net finance costs excluding exceptional items and remeasurements	(606)	(706)
Share of post-tax results of joint ventures	3	3
Adjusted profit before taxation	1,924	1,740
Taxation excluding tax on exceptional items and remeasurements	(597)	(437)
Adjusted profit from continuing operations	1,327	1,303
Adjusted earnings per share from continuing operations	46.7p	42.3p

Earnings

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Total operating profit	2,439	2,142
Net finance costs	(663)	(706)
Share of post-tax results of joint ventures	3	3
Profit before taxation	1,779	1,439
Taxation	(562)	(319)
Profit from continuing operations	1,217	1,120
Earnings per share from continuing operations	42.8p	36.3p

Net finance costs

Net interest excluding exceptional finance costs and remeasurements decreased by £100 million from 2004/05 to 2005/06. This was primarily explained by the reduction in our net debt following the sales of the four UK gas distribution networks and a reduction in the interest charge related to pensions. This decrease is partially offset by the impact of a stronger US dollar.

Exceptional finance costs and remeasurements

Exceptional finance costs of £49 million in 2005/06 related to £39 million on the early repayment of debt and £10 million relating to the issue of B shares, as part of the return of capital to shareholders. The issue of the B shares was accounted for as debt, and the associated issue costs recorded as an exceptional finance cost.

Financial remeasurements of £8 million relate to net gains on derivative financial instruments and the financial element of commodity contract revaluations.

Taxation

A net charge of £562 million arose in 2005/06, compared with £319 million in 2004/05. This reflects net tax credits amounting to £35 million and £118 million in respect of exceptional items and remeasurements in 2005/06 and 2004/05 respectively. The effective tax rate was 32% for 2005/06 and 22% for 2004/05.

Excluding the effect of net tax credits on exceptional items and remeasurements, the effective tax rate for 2005/06 and 2004/05 was 31% and 25% respectively, compared with a standard UK corporation tax rate of 30% for both years.

A reconciliation of the main components giving rise to the difference between the relevant effective tax rate and the UK standard corporation tax rate is shown in note 11 to the accounts.

Exchange rates

The weighted average exchange rate used to translate all US dollar results into sterling for 2005/06 and 2004/05, being \$1.79:£1 and \$1.87:£1 for each year respectively. The balance sheets at 31 March 2006 and 31 March 2005 have been translated at \$1.74:£1 and \$1.89:£1 respectively.

Exchange rate movements impacted the translation of US dollar denominated adjusted operating profit and operating profit for 2005/06 compared with 2004/05. If 2004/05 was translated on a comparable basis, using the 2005/06 average exchange rate of \$1.79:£1, adjusted operating profit and operating profit for 2004/05 would have been £44 million and £37 million higher respectively.

The effect of movements in the US dollar exchange rate on adjusted operating profit and operating profit was largely offset by the increased sterling cost of US dollar debt taken out to finance US dollar denominated investments and the reduced sterling cost of US taxes. As a result, adjusted profit for the year and profit for the year from continuing operations for 2004/05 would have been £23 million and £19 million higher respectively if translated at the 2005/06 average exchange rate of \$1.79:£1.

Profit for the year from continuing operations

Profit for the year from continuing operations increased from £1,120 million in 2004/05 to £1,217 million in 2005/06 as a consequence of the changes in operating profit, net finance costs and taxation.

Adjusted profit measures

The following tables reconcile the adjusted profit measure to the corresponding total profit measure in accordance with IFRS.

a) Reconciliation of adjusted operating profit to total operating profit

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Adjusted operating profit	2,527	2,443
Exceptional operating items	(39)	(263)
Operating remeasurements	(49)	(38)
Total operating profit	2,439	2,142

Adjusted operating profit is presented on the face of the income statement under the heading 'Operating profit – before exceptional items and remeasurements'.

b) Reconciliation of adjusted profit before taxation to profit before taxation

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Adjusted profit before taxation	1,924	1,740
Exceptional operating items	(39)	(263)
Operating remeasurements	(49)	(38)
Exceptional finance costs	(49)	–
Financial remeasurements	(8)	–
Total profit before taxation	1,779	1,439

Adjusted profit before taxation is presented in note 11 to the accounts under the heading 'Profit before taxation before exceptional items and remeasurements'.

c) Reconciliation of adjusted earnings to earnings (profit for the year)

	Years ended 31 March	
	2006 £m	2005 £m
Continuing operations		
Adjusted earnings	1,327	1,303
Exceptional operating items	(39)	(263)
Operating remeasurements	(49)	(38)
Exceptional finance costs	(49)	–
Financial remeasurements	(8)	–
Tax on exceptional items and remeasurements	35	118
Earnings	1,217	1,120

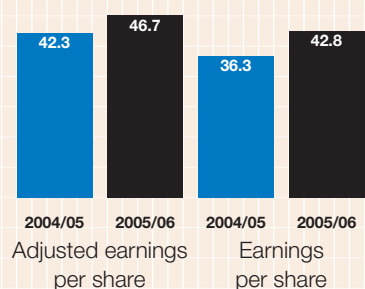
Adjusted earnings is presented on the face of the income statement under the heading 'Profit from continuing operations after taxation before exceptional items and remeasurements'.

Earnings per share from continuing operations

The following table sets out the adjusted basic earnings per share and basic earnings per share from continuing operations for 2005/06 and 2004/05 and reconciles the differences between them.

Earnings per share

pence



	Years ended 31 March	
	2006 pence	2005 pence
Continuing operations		
Adjusted basic earnings per share	46.7	42.3
Exceptional operating items	(1.4)	(8.5)
Exceptional finance costs	(1.7)	–
Tax on exceptional items	0.9	3.3
Remeasurements	(2.0)	(1.2)
Tax on remeasurements	0.3	0.4
Earnings per share	42.8	36.3

Adjusted basic earnings per share for 2005/06 increased by 4.4 pence, an increase of 10% compared with 2004/05.

This reflected the increase in adjusted profit for the year from continuing operations and the share consolidation in August 2005 following the £2 billion return of value to shareholders.

Earnings per share from continuing operations increased from 36.3 pence in 2004/05 to 42.8 pence in 2005/06, reflecting the increase in adjusted earnings, combined with lower exceptional items and remeasurements, and the impact of the share consolidation.

Diluted earnings per share from continuing operations was 42.6 pence in 2005/06, 0.2 pence lower than basic earnings per share, compared with 36.2 pence per share in 2004/05 (0.1 pence lower). The principal reason for the dilution in 2005/06 and 2004/05 relates to employee share option schemes.

Discontinued operations

Years ended 31 March	2006 £m	2005 £m
Revenue	168	1,102
Operating costs before exceptional items	(107)	(592)
Adjusted operating profit	61	510
Exceptional items	(15)	(74)
Operating profit	46	436
Share of post-tax results of joint ventures	–	(5)
Taxation	(18)	(140)
Profit from discontinued operations	28	291
Gain on disposal of discontinued operations	2,605	13
Profit for the year	2,633	304

Discontinued operations primarily comprise the four regional gas distribution networks we sold on 1 June 2005. Revenues, operating costs before exceptional items and adjusted operating profit in 2005/06 are substantially lower than 2004/05 as they relate to a two-month period rather than a full year. In addition, revenue for those two months is proportionally lower due to seasonality.

The exceptional charge of £15 million in 2005/06 arose from the payment of a fine relating to one of the sold networks. The exceptional items in 2004/05 related to costs incurred in preparation for the disposal of the networks and to reorganisations, primarily due to cost reduction programmes.

The Group's share of post-tax results of joint ventures in 2004/05 relates to Citelec, which was sold in August 2004.

The gain on disposal of discontinued operations in 2005/06 relates to the sales of gas distribution networks and in 2004/05 to Citelec.

Earnings per share from discontinued operations in 2005/06 was 92.8 pence, which includes 91.8 pence relating to the gain on disposal of four regional gas distribution networks. This compares with 9.9 pence in 2004/05.

Net profit and total earnings per share for the year

Net profit from both continuing and discontinued operations was £3,850 million in 2005/06 (£1,424 million in 2004/05).

Total earnings per share from both continuing and discontinued operations was 135.6 pence in 2005/06 (46.2 pence in 2004/05).

Cash flows

Cash flows from operating activities

Cash generated from continuing operations was £3,131 million in 2005/06, compared with £2,911 million in 2004/05. This included cash outflows relating to exceptional items of £118 million and £120 million respectively. After reflecting cash flows relating to discontinued operations and tax paid, net cash inflow from operating activities was £2,971 million, compared with £3,308 million in 2004/05.

Net corporate tax payments amounted to £140 million in 2005/06, compared with £150 million in 2004/05.

Cash flows from investing activities

Cash outflows from continuing operations investing activities fell from £2,652 million in 2004/05 to £1,713 million in 2005/06, as 2004/05 included £1,122 million in respect of the acquisition of the UK operations of Crown Castle International Corp. (£1,109 million) and a US telecommunications tower operation (£13 million). Cash flows relating to discontinued operations included £5,750 million of disposal proceeds and £115 million of cash outflows from investing activities, compared with £323 million in 2004/05.

Purchases of tangible and intangible fixed assets net of disposal proceeds absorbed cash of £1,748 million compared with £1,484 million in 2004/05.

Cash flows from financing activities

Net cash used in financing activities of £5,712 million in 2005/06 (compared with £325 million in 2004/05) included £1,957 million in respect of the £2 billion return of value to shareholders.

Payments to providers of finance, in the form of net interest and dividends, totalled £1,449 million in 2005/06 compared with £1,390 million in 2004/05.

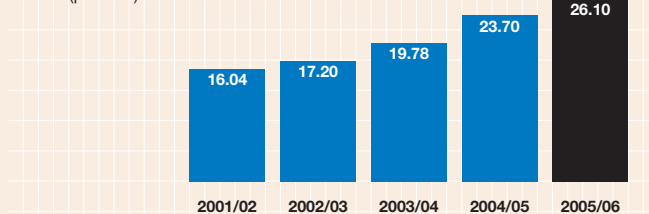
Net interest cash outflows fell from £762 million in 2004/05 to £704 million in 2005/06. The reduction reflected the beneficial impact of refinancing debt, lower short-term interest rates, the stronger US dollar and receipt of £5.8 billion proceeds from the four network sales.

£2 billion return to shareholders

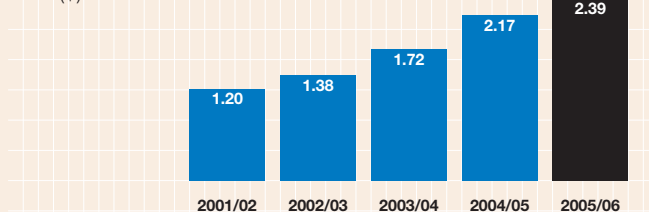
Following the successful completion of the sales of four regional gas distribution networks for proceeds of £5.8 billion, we implemented a B share scheme to return £2 billion to shareholders in a tax efficient manner.

Dividends

Total ordinary dividends per share (pence)



Total ordinary dividends per ADS (\$)



Dividends in respect of the financial year

Dividends	2006 pence	2005 pence	2004 pence	2003 pence	2002 pence
Interim	10.2	8.5	7.91	6.86	6.46
Final	15.9	15.2	11.87	10.34	9.58
Total	26.1	23.7	19.78	17.20	16.04

Dividends per ADS	\$	\$	\$	\$	\$
Interim	0.88	0.79	0.67	0.54	0.47
Final	1.51	1.38	1.05	0.84	0.73
Total	2.39	2.17	1.72	1.38	1.20

The proposed total ordinary dividend for 2005/06 amounts to £709 million or 26.1 pence per ordinary share. This represents an increase of 10% over the previous year's ordinary dividend per share of 23.7 pence (£731 million).

The above amounts exclude the return of £2 billion to shareholders through the B share scheme.

The total ordinary dividend per share was covered 1.8 times by adjusted earnings per ordinary share (2004/05 covered 1.8 times) and covered 1.6 times by earnings per ordinary share from continuing operations (2004/05 covered 1.5 times).

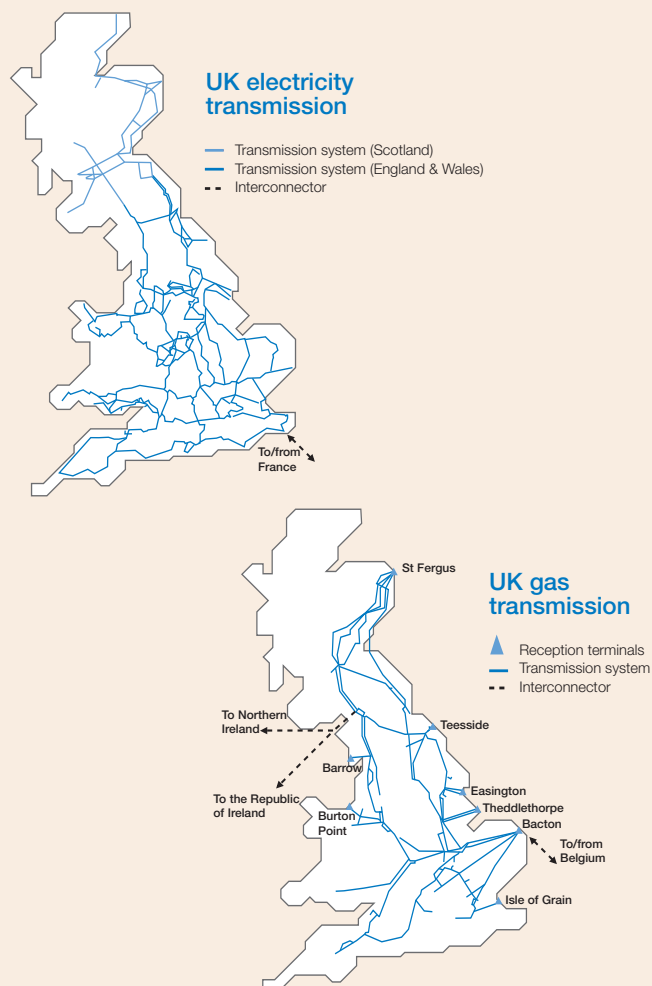
The table above shows the ordinary dividends paid or payable by National Grid for the past five financial years. These dividends do not include any associated UK tax credit in respect of such dividends. The table excludes dividends paid or payable by Lattice Group prior to the merger with National Grid Group on 21 October 2002.

Dividends expressed in US dollars per ADS in the table above reflect the actual amount paid to ADS holders, expressed to two decimal places, with respect to all amounts with the exception of the final ordinary dividend for 2005/06. The final ordinary dividend per ADS for 2004/05 reflects the declared US dollar amount expressed to two decimal places.

In accordance with IFRS, the final dividend proposed in respect of each financial year is now reported in the financial statements for the subsequent year. As a consequence, the final dividend proposed to shareholders for 2005/06 of 15.9 pence per share, amounting to £433 million, will be reported in the financial statements for the year ending 31 March 2007.

UK electricity and gas transmission

About the segment



Principal activities

Our UK electricity and gas transmission segment has the following principal activities:

Electricity transmission owner	We own the electricity transmission system in England and Wales. Our electricity assets comprise approximately 4,500 miles of overhead line, about 415 miles of underground cable and 337 substations at 240 sites.
Electricity system operator	We are the Great Britain System Operator, responsible for managing the operations of both the England and Wales transmission system that we own and also the two high-voltage electricity transmission networks in Scotland. Day-to-day operation of the Great Britain electricity transmission system involves the continuous real-time matching of demand and generation output, ensuring the stability and security of the power system and the maintenance of satisfactory voltage and frequency.
Gas transmission owner	We own the gas transmission network in Great Britain. This comprises approximately 4,300 miles of high pressure pipe and 26 compressor stations, connecting to eight distribution networks and to third party independent systems for onward transportation of gas to end consumers.

Gas system operator	We operate the gas transmission network. Day-to-day operation includes balancing supply and demand, maintaining satisfactory system pressures and ensuring gas quality standards are met.
French interconnector	We own and operate the UK assets, and a portion of the subsea cables, that comprise the electricity interconnector between England and France as part of a joint arrangement with the French transmission operator, RTE.
LNG storage	We own and operate four liquefied natural gas (LNG) storage facilities in the UK.

External and regulatory environment

The electricity network infrastructure in the UK primarily comprises three electricity transmission networks (one in England and Wales and two in Scotland) and twelve regional electricity distribution networks. In general, electricity generated is transmitted over the electricity transmission networks to the twelve regional electricity distribution companies, which distribute electricity to end consumers on behalf of electricity suppliers.

The energy markets in the UK are regulated by Ofgem, which has the responsibility for promoting competition, wherever appropriate, and for regulating the companies that own and operate the infrastructure through which electricity and gas are delivered.

The functioning of the electricity market in Great Britain is governed by the British Electricity Trading and Transmission Arrangements (BETTA), which became effective on 1 April 2005.

The gas infrastructure in the UK primarily comprises the gas transmission network and eight regional gas distribution networks. Gas is input into the gas transmission network, which connects with each of the eight regional gas distribution networks, which in turn distribute gas to consumers. Detailed arrangements for the gas industry are provided through the Uniform Network Code issued by Ofgem, which defines the obligations, responsibilities and roles of the industry participants.

Certain consumers, primarily large industrial users, receive electricity or gas direct from the relevant transmission network.

Through our subsidiary, National Grid Electricity Transmission plc, we are the sole holder of an electricity transmission licence for England and Wales. This licence also covers our role as the Great Britain System Operator. We have a duty under the Electricity Act 1989 to develop and maintain an efficient, coordinated and economical system of electricity transmission and to facilitate competition in the supply and generation of electricity. Charges to users of the transmission networks comprise two principal elements: Transmission Network Use of System charges in respect of the electricity transmission owner activity and Balancing Services Use of System charges in respect of the electricity system operator activity. We collect these charges from all Great Britain transmission network users and make payments to the owners of the Scottish transmission networks for the element of the Transmission Network Use of System charges that relate to their networks.

Through our subsidiary National Grid Gas plc, we hold a gas transporter licence in respect of the gas transmission network. We have a duty under the Gas Act 1986 to develop and maintain an efficient and economical pipeline system for the conveyance of gas. Under the terms of our licence, we receive income through charges to shippers for entry and exit capacity (gas transmission owner and gas system operator activity) and commodity charges (gas system operator activity).

Ofgem sets price controls in respect of the amounts that can be charged by the owners and operators of electricity and gas infrastructure in the UK. The current price controls in respect of our electricity transmission owner activities commenced on 1 April 2001 and were originally intended to continue until 31 March 2006, but have been extended to 31 March 2007. The current price controls in respect of our gas transmission owner and gas system operator activities commenced on 1 April 2002 and are due to continue until 31 March 2007. The next five-year price control periods for both electricity and gas transmission activities are due to commence on 1 April 2007.

The electricity interconnector between England and France and our LNG storage facilities do not form part of our electricity and gas transmission networks respectively and are each separately regulated via a financial ring-fencing arrangement. A portion of the LNG storage capacity is set aside to support network operating requirements, with remaining capacity sold to gas shippers.

Business drivers

As electricity transmission owner and gas transmission owner, we own and maintain the physical assets, develop the networks to accommodate new connections and disconnections, and manage a programme of asset replacement and investment to ensure the long-term reliability of the respective networks.

As electricity system operator and gas system operator, we undertake a range of activities necessary for the successful delivery in real-time of secure, reliable and efficient energy. In the case of electricity this involves the continuous real-time balancing of supply and demand, involving balancing services that include commercial arrangements with market participants that enable electricity demand or generation output to be varied. In the case of gas we ensure the system is balanced with supply and demand at the end of each day and we are required to maintain levels of short-term gas reserves to ensure that domestic and other non-daily metered gas supplies can be maintained during prolonged cold conditions.

The principal business drivers for our UK electricity and gas transmission activities include:

- the price controls set by Ofgem, which determine the prices that can be charged to users of the electricity and gas transmission networks;
- capital investment, which drives the regulatory asset value, a key component in determining our allowed revenues under our price controls;
- our ability to operate reliably, and so to earn incentives for good performance and avoid penalties for poor performance;
- meeting regulatory targets for management of the electricity and gas systems, generating incentives for good performance; and
- our ability to operate efficiently.

Our principal business drivers are considered to be the following:

Business driver	Description
Price controls	The charges that we can make for access to our electricity and gas transmission systems are currently determined by a formula linked to retail price inflation (RPI). For electricity this is set at RPI -1.5% and for gas RPI -2%. These formulae are based upon Ofgem's estimates of operating expenditure, capital expenditure and asset replacement, together with an allowed rate of return. The current rate of return is set at a real pre-tax rate of 6.25% on our regulatory asset value for both our electricity and gas networks. Our electricity regulatory asset value as of 31 March 2006 is estimated at approximately £5.6 billion (£5.3 billion March 2005) and for gas £2.8 billion (£2.5 billion March 2005).
Reliability	We are subject to an incentive scheme based on the reliability of the electricity transmission network in England and Wales. This is based on achieving reliability in excess of 99.9999%. For 2006/07 there is the potential to earn additional revenue up to 1% if loss of supply is less than 248 MWh. For loss of supply in excess of 274 MWh up to a collar of 635 MWh we can potentially lose up to 1.5% of revenue.
Efficiency	Both of our gas and electricity system operations (SO) have incentive schemes where, if we operate our networks more efficiently than Ofgem's forecasts, we can increase our revenues. Our electricity SO external incentive, the Balancing Services Incentive Scheme (BSIS), has historically been agreed on an annual basis. For the 2006/07 scheme, we decided not to accept Ofgem's proposals for the BSIS target. We considered that neither of Ofgem's external proposals offered an appropriate balance of risk and reward. Normal arrangements for the operation of the system and management of payments will continue, but without a financial incentive. We are at all times obligated under our transmission licence to operate the system in an economic and efficient manner. For gas we have seven incentive schemes covering activities such as cost of investment for additional capacity, managing constraints, the cost of purchasing shrinkage gas (gas used in operating the system or lost during transport) and other gas system operation costs.

Current and future developments

British Electricity Trading and Transmission Arrangements (BETTA)

On 1 April 2005 we became responsible for operating the Great Britain transmission system, setting charges and maintaining the charging statements for all transmission users in Great Britain. As a consequence, under the regulatory arrangements for BETTA, the Anglo-Scottish interconnector (previously subject to separate commercial agreements outside the regulated business) is now subject to price control in the same manner as other network infrastructure in the regulated businesses of Scottish Power and National Grid.

On 28 October 2005, the judicial review sought by Scottish Power of the Gas and Electricity Markets Authority's decision to approve the Great Britain Electricity Transmission Network Use of System charging methodology developed and proposed by National Grid and Ofgem was dismissed.

Gas transporter licence

On 1 May 2005 our gas transporter licence specific to our gas transmission network was amended to facilitate the distribution network sales. The five gas transporter licenses relevant to the gas distribution networks were amended at the same time, four of which were subsequently transferred to the four sold distribution networks on 1 June 2005.

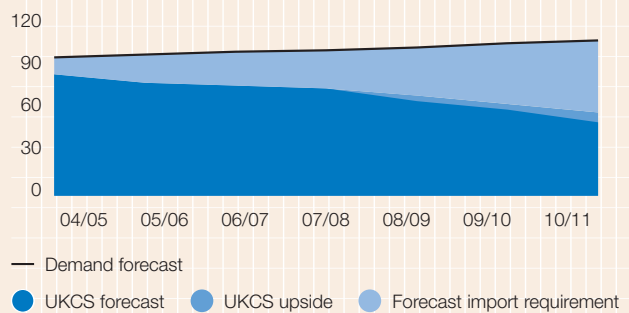
UK energy market developments

The UK is entering a period of changing supply patterns for both gas and electricity. The sources of gas and electricity are shifting, with the decline in UK continental shelf (UKCS) gas reserves and the Government's emphasis on combating climate change and encouragement of renewable generation. We also continue to see trends towards greater use of gas in power generation with the UK moving towards a low carbon economy.

We continue to work with the UK Government and Ofgem to make possible the necessary investments in the electricity transmission network to support the development of renewable energy projects. The final Transmission Investment for Renewable Generation proposals from Ofgem recognised the need to invest in networks to accommodate renewables. Funding costs for £108 million of investment will be allocated to our electricity transmission owner activity allowable revenue for the upgrade of the Anglo-Scottish interconnector (conditional on the satisfactory outcome of key planning consent issues in Scotland). At this time access has been sought by over 13 GW of renewable generation consisting of over 200 offers in Scotland. For England and Wales offers have been made to 5 GW of renewable generation.

Gas supply projections

bcm per annum



As a consequence of the decline in gas production from the UK continental shelf, our latest forecast is that the UK will import around 50% of its gas requirements by the end of the decade.

Activity to increase import capability has involved the development of gas interconnectors and LNG importation facilities by National Grid and other market participants. These include the Norwegian interconnector and the LNG import facility at Milford Haven in addition to our LNG import facility on the Isle of Grain.

A number of gas pipeline and compressor projects are being progressed to meet these developments. Around 90 miles of gas pipeline is being constructed from Ganstead to Asselby in the region of Humberside and from Pannal in North Yorkshire to Nether Kellet in Lancashire to enable increased imports at Easington. Around 206 miles of new pipeline is being built in South Wales and Gloucestershire to cater for the Milford Haven importation facility, which is to be connected during the 2007/08 gas supply year. These projects, responding to meet the changing supply sources, require over £1,000 million in capital expenditure on the gas transmission network in the period up to 2008/09.

Gas supply

In 2004 our gas transporter safety case was amended to include a system of 'safety monitors'. These monitor levels define minimum levels of gas storage required to ensure continued and safe delivery of gas to all domestic and other non-daily metered customers under prolonged Winter conditions.

For winter 2005/06 we worked with Ofgem and the industry to enhance the level of information that is available to the market to further promote industry participant response to the gas supply/demand position. Of particular note is the introduction of the Daily Summary Report, available on the National Grid website and the introduction of the Gas Balancing Alert. This system is designed to highlight to the market that a reduction in demand might be required when the supply and demand balance is very tight.

Emissions trading

The European Union emissions trading scheme commenced on 1 January 2005. Its purpose is to reduce the level of carbon dioxide emitted by placing a financial incentive on participants to reduce their emissions of this greenhouse gas. Allowances are granted to participants in accordance with a national allocation plan and any shortfall or surplus can be traded with other participants.

Our carbon dioxide emissions between 1 January and 31 December 2005 in the UK were broadly in line with our allocation, and so the scheme did not have a material financial effect on our results in 2005/06. We similarly do not expect the scheme to have a significant impact on our results in 2006 or 2007. Phase 2 of the emissions trading scheme, covering the period from 1 January 2008 to 31 December 2012, is in the process of being negotiated.

Capital investment

Investment in electricity and gas transmission networks is, by its nature, variable and is largely driven by changing sources of supply and asset replacement requirements. The gas transporter and electricity transmission licences oblige us to provide connections and capacity upon request.

The bulk of the current electricity transmission network was installed during the 1960s and 1970s, with main plant asset lives typically of between 40 and 50 years. Over the next few years, we anticipate substantially increasing investment on replacing parts of our UK electricity network as these assets become due for renewal.

In addition, parts of the gas transmission network are reaching the end of their lives. These are mainly compressor stations, control systems and valves (ie above ground assets and not the high pressure pipes). This, together with work required to meet changing supply sources, means that the UK electricity and gas transmission business will be embarking on a significant increase in investment and network renewal.

To meet the increasing programme of work, we have been exploring ways to work more efficiently and collaboratively with major suppliers and contractors to manage the increase in workload effectively.

Performance during the year

Operating performance

The winter of 2005/06 saw demand from the electricity transmission network in England and Wales hit a peak of 53.73 GW. This compares with the previous year's peak of 53.29 GW.

The total amount of electricity transmitted for 2005/06 was 312,399 GWh compared with 308,305 GWh for 2004/05.

2005/06 saw a maximum gas demand of 411 mcm on 1 February 2006. This decrease on the previous year's peak of 418 mcm was partly due to increased demand-side response reflecting the high gas prices that have been experienced this winter.

Our progress against our operating performance objectives during the year included the following:

Objective	Performance
Safety	During 2005/06 there were 14 lost time injuries compared with 8 in 2004/05. The lost time injury frequency rate increased to 0.28 in 2005/06 from 0.17 in 2004/05.
Reliability	Electricity transmission network reliability in 2005/06 was 99.99990%. This compared with 99.99998% in 2004/05. Our target reliability is 99.99990%. Average annual availability of our electricity network in 2005/06 was 95.09%. This compared with 95.3% in 2004/05. This reflects the increased amount of asset replacement activity to ensure the reliability of the network for years to come. System availability at winter peak demand was 97.9% in 2005/06 compared with 97.6% in 2004/05. Compressor fleet performance during 2005/06 improved with the average time between compressor failures at 10% above our five-year average.

Financial performance

The results for the UK transmission segment for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 £m
Revenue	2,710	1,995
Operating costs excluding exceptional items	(1,866)	(1,136)
Adjusted operating profit	844	859
Exceptional items	(1)	(2)
Operating profit	843	857

The principal movements between 2004/05 and 2005/06 can be summarised as follows:

	Revenue £m	Operating costs £m	Operating profit £m
2004/05 results	1,995	(1,138)	857
Add back 2004/05 exceptional items	–	2	2
2004/05 adjusted results	1,995	(1,136)	859
LNG storage	34	(4)	30
French interconnector	43	(3)	40
Balancing Services Incentive Scheme	214	(235)	(21)
Scottish networks pass-through	259	(259)	–
Transmission owner depreciation and amortisation	–	(83)	(83)
Other	165	(146)	19
2005/06 adjusted results	2,710	(1,866)	844
2005/06 exceptional items	–	(1)	(1)
2005/06 results	2,710	(1,867)	843

The £715 million increase in UK electricity and gas transmission revenue comparing 2005/06 with 2004/05 was mainly due to higher incentivised costs associated with the Balancing Services Incentive Scheme (BSIS), which flow through to revenue, and the collection of Transmission Network Use of System charges under BETTA on behalf of the Scottish network owners. Beneficial outcomes from the capacity auctions in the LNG and electricity interconnector markets have resulted in higher revenues compared to 2004/05. Other higher revenues reflect favourable timing and inflationary impacts, and higher pass through of costs partly reduced by the transfer of the Scottish Interconnector into the electricity transmission regulated business under BETTA.

Operating costs, excluding exceptional items, increased by £730 million in 2005/06 compared to 2004/05. This is due to higher incentivised BSIS costs resulting from higher constraint, margin and energy balancing costs, and Transmission Network Use of System charges owed to the Scottish networks owners under BETTA which became effective from 1 April 2005. Transmission owner depreciation and amortisation has increased by £83 million largely due to higher accelerated depreciation associated with early asset write-offs and an increase in core depreciation reflecting the ramp up in the capital programme. Higher other operating costs reflected higher pass through costs partly offset by the transfer of the Scottish Interconnector as referred to above.

The £15 million decrease in UK electricity and gas transmission adjusted operating profit comparing 2005/06 with 2004/05 reflected the movement in revenue and operating costs as described above.

The £1 million exceptional charge in 2005/06 relates to pension-related elements of the Way Ahead programme in UK gas distribution that have affected UK electricity and gas transmission.

Capital expenditure

Capital investment in the replacement, reinforcement and extension of the UK electricity and gas transmission networks in 2005/06 was £890 million compared with £529 million in 2004/05.

In 2005/06, 50% or £265 million (2004/05: 41% or £163 million) of electricity transmission capital expenditure was related to asset replacement, reflecting the increasing need to replace transmission network assets, many of which were commissioned in the 1960s.

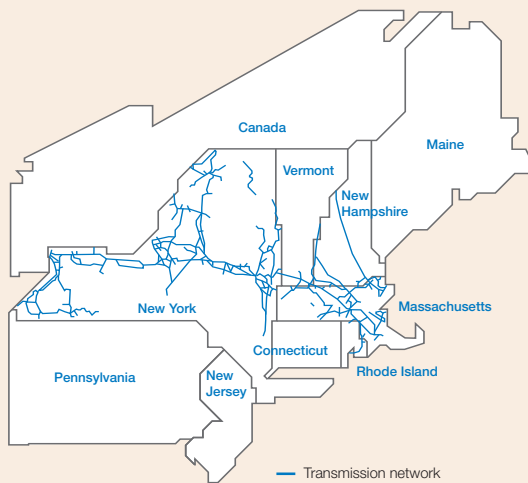
In addition, 2005/06 has seen a substantial increase in the level of capital investment in gas pipeline projects, some £156 million higher than 2004/05.

	2006 £m	2005 £m
Property, plant & equipment	799	464
Intangible assets	91	65
Capital investment	890	529

This includes £41 million of additions relating to emissions allowances received during 2005/06.

US electricity transmission

About the segment



Principal activities

In the US, we own and operate an electricity transmission network of approximately 9,000 miles spanning upstate New York, Massachusetts, Rhode Island, New Hampshire and Vermont. Our US electricity transmission facilities operate at voltages ranging from 69 kV to 345 kV, utilising nearly 8,900 miles of overhead lines, 94 miles of underground cable and 496 substations. We are the largest electricity transmission service provider in the northeastern US by reference to the length of these high-voltage transmission lines. In addition, we own and operate a 139-mile direct current transmission line rated at 450 kV that is a key section of an interconnector between New England and Canada.

External and regulatory environment

In New England and New York, our transmission business operates within two independent organisations, ISO New England, a regional transmission organisation (RTO), and New York ISO, an independent system operator (ISO). These non-profit entities are the system operators for the New England and New York networks. As system operators, the ISOs are responsible for operating wholesale markets for energy, operating reserves and capacity, maintaining the operating reliability of the New England and New York networks, coordinating the activities of the transmission owners, and managing transparent transmission expansion planning processes.

We are one of several transmission owners operating within each of these ISOs. The transmission owners are responsible for certain aspects of the operation of the facilities they each own, such as maintenance, equipment restoration and switching operations. National Grid works closely with ISO New England and New York ISO to support efficient market and network operations and transmission investment.

Business drivers

The revenue for our transmission business in New England and New York is collected from transmission customers, including our US electricity distribution network businesses, pursuant to tariffs approved by state utility commissions and by the Federal Energy Regulatory Commission (FERC).

In New York, efficient and reliable operations within our long-term rate plan are our primary business drivers.

In New England, efficient operations are also key; however, the rate structure is such that network availability, energy deliveries and operational expenditure spend are all 'pass-through' items. We neither gain nor lose from variability of any of these. The tariff allows for recovery of, and a return on, new investment entering service.

Current and future developments

Energy Policy Act

The Energy Policy Act of 2005 was enacted in August 2005 and contained several important provisions that affect our transmission business. Among other things, the federal legislation called for FERC to finalise its transmission pricing policy, providing incentives for transmission investment and independence, the establishment of an electric reliability organisation for new mandated reliability standards and federal backstop siting authority for transmission facilities located within to-be-designated national interest electricity transmission corridors. The focus of the legislation is to further the reliability and economic efficiency of the US electricity transmission network.

Regulation

Consistent with the FERC's proposed pricing policy and the financial incentives for joining a RTO, following ISO New England's filing to become a RTO, we have applied for an increased rate of return for our New England assets. This application is still under review by the FERC.

We have been pursuing a regional planning process with the New York ISO to identify regional transmission needs. Progress has been made and the New York ISO is in the first year of its reliability planning process implementation. The New York ISO has identified reliability needs and is in the process of evaluating both regulated and market solutions to meet those needs.

Capital investment

We expect a significant level of investment in New England to deliver our regional system expansion planning process projects. There will also be an increase in investment in New York in order to address asset replacement requirements and maintain the safety and reliability of the network.

Performance during the year

Operating performance

Our progress against our objectives during the year included the following:

Objective	Performance
Safety	US electricity transmission had a lost time injury frequency rate of zero during 2005/06, extending the time since the last lost time injury to 35 months.
Reliability	Average annual network availability in 2005/06 was 98.7%. This compared with 98.55% in 2004/05. Overall average network availability was similar in New England and New York, for both summer and winter.

Financial performance

Years ended 31 March	2006 £m	2005 constant currency £m	2005 £m
Revenue	310	297	284
Operating costs excluding exceptional items	(183)	(165)	(158)
Adjusted operating profit	127	132	126
Exceptional items	-	(8)	(7)
Operating profit	127	124	119

The principal movements between 2004/05 and 2005/06 can be summarised as follows:

	Revenue £m	Operating costs £m	Operating profit £m
2004/05 results	284	(165)	119
Add back 2004/05 exceptional items	-	7	7
2004/05 adjusted results	284	(158)	126
Exchange rate movements	13	(7)	6
2004/05 constant currency results	297	(165)	132
Tariff adjustment	7	(7)	-
Other	6	(11)	(5)
2005/06 results	310	(183)	127

The average exchange rates used to translate the results of US operations during 2005/06 and 2004/05 were \$1.79:£1 and \$1.87:£1 respectively. To illustrate underlying performance, the impact of exchange rate movements has been separated from other changes by also presenting the operating results for 2004/05 on a constant currency basis, using the average exchange rate for 2005/06 of \$1.79:£1.

The £13 million increase in revenue comparing 2005/06 with 2004/05 on a constant currency basis was due to a one-off adjustment of £7 million to revenues collected from US electricity distribution affiliates under the RTO tariff (there is a corresponding adjustment in operating costs) and generally higher returns in New England, the beneficial timing impact of revenue collection in New York and higher pass-through costs in New England and the interconnector between New England and Canada. Partly offsetting these increases was lower revenue from GridAmerica, following cessation of its operations with effect from 1 November 2005, and a one-off refund associated with a prior period billing error in New England.

Operating costs, excluding exceptional items, increased by £18 million in 2005/06 compared to 2004/05. This is due to the £7 million operating cost adjustment referred to above; higher payroll and associated benefits costs in New York; a one-off write-off of interconnection related costs; and generally higher costs to address reliability issues; partly offset by lower operating costs in GridAmerica following its cessation of operations.

The £1 million overall increase in adjusted operating profit and operating profit reflects a favourable exchange rate impact of £6 million, largely offset by the net £5 million movement in revenue and operating costs as described above.

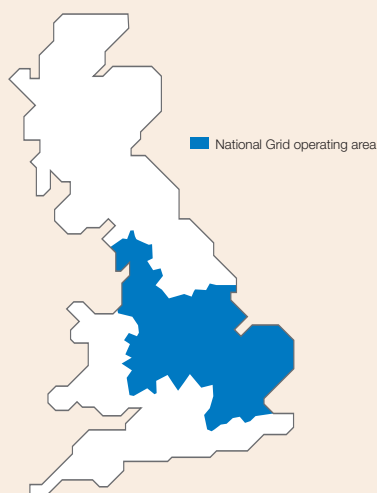
Capital expenditure

Capital investment in the replacement, reinforcement and extension of the US electricity transmission networks in 2005/06 was £91 million compared with £74 million in 2004/05.

This increase in capital expenditure principally reflects additional planned asset replacement in New England to increase reliability and system security as well as facilitating an increase in transfer capability into Boston.

UK gas distribution

About the segment



Principal activities

Our UK gas distribution segment comprises almost half of Great Britain's gas distribution network, and remains the largest gas distribution network in the country, consisting of approximately 82,000 miles of distribution pipelines.

We transport gas on behalf of approximately 70 active gas shippers from the gas transmission network through our four retained regional distribution networks to around 11 million consumers.

We continue to be responsible for the safety, development, maintenance and daily operation of our UK gas distribution networks.

We also continue to manage the national emergency number (0800 111 999) for our networks, the sold networks and the other gas transporters. During 2005/06 we handled around 2.5 million calls to the national emergency number.

External and regulatory environment

Gas is piped from the gas transmission network into each of the eight regional gas distribution networks, which in turn distribute gas to consumers.

Detailed arrangements for the gas industry are provided through the Uniform Network Code (as approved by Ofgem, from time to time), which defines the obligations, responsibilities and roles of the industry participants.

We hold a single gas distribution transporter licence, which authorises us to operate the four gas distribution networks we own. However, each of our four networks has its own separate price control, which establishes the prices we can charge for the services provided by each network.

Each network's separate regulatory asset value associated with its distribution assets was originally allocated to it using an estimate of the UK gas distribution business's regulatory asset value as at 1 April 2002. The allocation was aimed at minimising unnecessary regional differentials in transportation charges.

Business drivers

Our principal business drivers are considered to be the following:

Business driver	Description
Gas distribution price control	The price controls that apply to UK gas distribution take into account Ofgem's estimates of operating expenditure, capital expenditure, replacement expenditure and allowed rate of return. The current rate of return is set at a real pre-tax rate of 6.25% on our regulatory asset value. As at 31 March 2006, our regulatory asset value is estimated at approximately £5.9 billion.
Factors driving revenue	The networks' price control formulae specify a maximum allowed revenue assigned to each network. Each formula retains a 65% fixed, 35% variable revenue associated with transportation volume changes, a mains replacement incentive mechanism and the pass-through of prescribed rates and gas transporter licence fees. In any year, revenue can be more or less than is allowed under the price control formula, although charges should be set to recover allowed revenue. Any difference is carried forward and our charges are adjusted accordingly.
Replacement expenditure	Replacement expenditure improves the future safety and reliability of the network, through the replacement of older gas pipes with modern pipes. Ofgem treats 50% of projected replacement expenditure as recoverable during the year and 50% as recoverable over future years. Each network is subject to its own mains replacement incentive mechanism and retains 33% of any outperformance against Ofgem's annual cost targets as additional return or, alternatively, bears 50% of any overspend if it underperforms.
Capital expenditure	Capital expenditure ensures supply security and meets growing customer demand. Central coordination ensures capital investment is effective and efficient.

Standards of service

Ofgem has established standards of service we are required to meet that apply to our operations.

These include:

- overall standards of service, for example answering 90% of all calls to the national gas emergency number within 30 seconds of the call being connected and informing 97% of all customers when they are due to be reconnected after an unplanned interruption;
- connections standards of service that require us to provide connections to customers to agreed timescales; and
- guaranteed standards of service for our other transportation services.

Compensation is paid to customers for any failures to meet both the guaranteed and the connections standards of service.

Current and future developments

Network sales

On 1 June 2005, we successfully completed the planned sales of four of our eight gas distribution networks (Scotland, Wales and West, North of England and South of England), at a price of £5.8 billion, a considerable premium to the regulatory asset value. From the cash sale proceeds we returned £2 billion to shareholders and repaid around £2.3 billion of debt.

During the coming year, we will be working with the sold networks in their exit from the existing transitional agreements. These agreements came into effect prior to completion of the network sales and, among those put in place, we currently provide a front office systems managed service and a system operation service to the sold networks.

Regulatory price control reviews

Ofgem intends to extend the current five-year gas distribution price control for a further year through an extension price control to cover the year ending 31 March 2008. Discussions have commenced with Ofgem in relation to this extension period. The next full price control period will now cover the period from 1 April 2008 to 31 March 2013.

Business improvements

Following completion of the Way Ahead restructuring programme, a series of strategic development initiatives has been delivered in support of our aim to be the most efficient UK gas distribution network. Centralisation of many key processes has enabled us to place increased emphasis on safety and efficiency, while sharing best practice across the organisation and delivering our office rationalisation programme. This has resulted in the consolidation of 14 regional office locations into three key centres – Warwick, Hinckley and Northampton.

Centralising our asset management, job scheduling and dispatch processes has exploited our economies of scale, while also maintaining alignment of our operational workforce across the network to satisfy consumer requirements.

Control of the gas distribution network for Great Britain has been integrated into the business during the year. New connections work associated with domestic premises has also been integrated, which has resulted in improved efficiency, as well as continuity in meeting the requirements of our customers on a more consistent basis.

Having completed the Way Ahead transformation we are now concentrating on continuous improvement techniques to refine our existing business processes.

Performance during the year

Operating performance

Actual gas consumption rose to 347 TWh in 2005/06, compared with 344 TWh in 2004/05 due to the weather being colder in 2005/06. However, underlying levels of gas demand, excluding the effects of weather, fell from 357 TWh in 2004/05 to 346 TWh in 2005/06, due to the increasing levels of gas supply prices during 2005/06 affecting usage. The reduction was experienced across all types of consumers, but was particularly noticeable for larger users.

Our progress against our operating performance objectives during the year included the following:

Objective	Performance
Safety	<p>As described on page 31 there was one employee fatality during 2005/06.</p> <p>Lost time injuries for the retained networks fell from 56 in 2004/05 to 24 in 2005/06, a 57% decrease. The lost time injury frequency rate fell from 0.35 to 0.17.</p> <p>We again exceeded our targets on safety-related standards – more than 97% of ‘uncontrolled’ gas escapes (where the gas leak cannot be controlled by turning the gas supply off at the meter) were attended within one hour, and more than 98% of ‘controlled’ gas escapes (where the gas leak can be controlled at the meter) were attended within two hours.</p> <p>We have decommissioned in excess of 1,710 km (1,063 miles) of gas pipes in 2005/06 (in line with our target of 1,724 km (1,071 miles)) compared with 1,458 km (906 miles) in 2004/05.</p>
Reliability	<p>Over the year we have achieved all our connections standards of service along with all other standards of service set by Ofgem that relate to our gas transportation services.</p>
Efficiency	<p>Our target of 35% reduction in controllable costs has been achieved one year early.</p> <p>Our performance during 2005/06 under the current distribution network exit incentive scheme and the mains replacement incentive scheme was broadly neutral.</p> <p>During the year ended 31 March 2006, we made around 50,000 new connections to our network.</p>

Financial performance

The results for the UK gas distribution segment for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 £m
Revenue	1,222	1,113
Other operating income	4	–
Operating costs excluding exceptional items	(743)	(689)
Adjusted operating profit	483	424
Exceptional items	(51)	(91)
Operating profit	432	333

These results exclude the results of the four regional gas distribution networks that were sold on 1 June 2005, which are presented within discontinued operations.

The principal movements between 2004/05 and 2005/06 can be summarised as follows:

	Revenue and other operating income £m	Operating costs £m	Operating profit £m
2004/05 results	1,113	(780)	333
Add back 2004/05 exceptional items	–	91	91
2004/05 adjusted results	1,113	(689)	424
Business rates pass-through	23	(23)	–
Weather and volumes	12	–	12
Other price changes	10	–	10
Way Ahead operating costs	–	52	52
Gas commodity costs	–	(17)	(17)
Other revenues and costs	68	(66)	2
2005/06 adjusted results	1,226	(743)	483
2005/06 exceptional items	–	(51)	(51)
2005/06 results	1,226	(794)	432

Revenues in UK gas distribution increased by £109 million in 2005/06 compared with 2004/05. This included a £45 million increase in revenue recovered under the distribution price control formulae. The weather in 2005/06 was colder than 2004/05 and this contributed £29 million of the increase, and an average price rise of 4.6% was implemented on 1 October 2005 resulting in a further £33 million increase. This was partially offset by a £17 million reduction in underlying volumes.

Other revenues increased by £64 million in 2005/06 compared with 2004/05, primarily because of the provision of services to the four regional gas distribution networks following their sales on 1 June 2005.

Significant cost efficiencies have been achieved as a result of the Way Ahead restructuring programme. Controllable costs, which exclude increases in ongoing pension costs and gas commodity prices, as well as the costs of providing services to the sold networks and the Group's other businesses, decreased by 19% in real terms during the year. They have now reduced by 35% in real terms since March 2002, thus achieving one year early the target reduction originally set for March 2007.

Total operating costs excluding exceptional items increased by £54 million in 2005/06 compared with 2004/05. Business rates increased by £23 million following changes to rateable values from 1 April 2005, but these have been recovered through the price increases under the distribution price control, as referred to above. The remaining increases in operating costs of £31 million were primarily because of the effects of higher gas commodity prices and the costs of providing services to the sold networks and the Group's other businesses, partially offset by the savings made in Way Ahead operating costs.

Adjusted operating profit was £59 million higher in 2005/06 than 2004/05, an increase of 14%.

Exceptional charges of £51 million in 2005/06 and £91 million in 2004/05 predominantly related to restructuring costs under the Way Ahead programme.

Operating profit was £99 million higher in 2005/06 than 2004/05, an increase of 30%. In summary, revenue was £109 million higher, other operating income was £4 million higher, operating costs were £54 million higher and exceptional charges were £40 million lower.

Capital expenditure

Gross investment in the reinforcement, extension and replacement of the UK gas distribution network was £444 million in 2005/06 compared with £359 million in 2004/05. This excludes the investment in the four regional gas distribution networks that were sold on 1 June 2005.

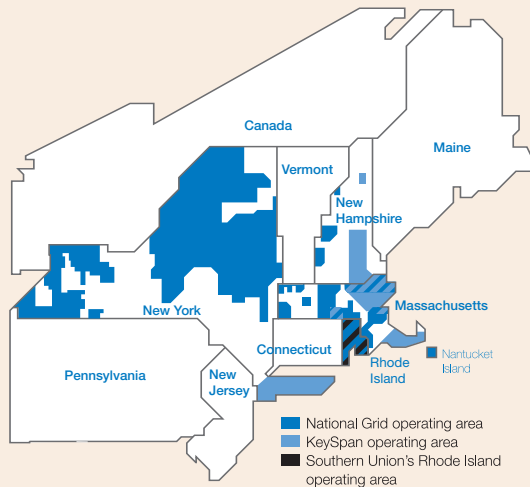
Years ended 31 March	2006 £m	2005 £m
Capital expenditure	149	120
Replacement expenditure	295	239
Gross investment in the continuing business	444	359

Capital expenditure increased from £120 million in 2004/05 to £149 million in 2005/06 because of a higher level of investment in the reinforcement of high pressure pipelines, such projects being dependent on forecasts of future demand, as well as higher expenditure on new connections and the replacement of commercial vehicles.

Replacement expenditure increased from £239 million in 2004/05 to £295 million in 2005/06 in line with the planned increase in the long-term iron mains replacement programme agreed with the HSE.

US electricity and gas distribution

About the segment



Principal activities

We are one of the leading electricity distribution service providers in the northeastern US, as measured by energy delivered, and one of the largest utilities in the US, as measured by the number of electricity distribution customers. US electricity and gas distribution serves approximately 3.4 million electricity customers over a network of 72,000 circuit miles in New England and New York and around 569,000 gas customers over a pipeline of 8,600 miles in New York.

External and regulatory environment

In the US, our electricity system spans upstate New York, Massachusetts, Rhode Island and New Hampshire to customers that include residences and small and large commercial and industrial enterprises. Our gas distribution system serves customers in cities and towns in central and eastern New York. Sharp increases in energy prices have renewed interest in the public policy debate about restructuring the nation's electricity industry and increased the pressure on regulators and politicians to consider taking action to mitigate the effects of increased prices on customers.

As the debate continues, we have taken a leadership position, by advocating that a well-managed electricity system is the key to enabling robust competitive electricity markets that offer customers choice, savings and other benefits. State regulators continue to strongly support current recovery of power supply costs.

Our regulated operations and certain unregulated businesses must comply with rules prescribed by the applicable state utility commissions of New York, Massachusetts, Rhode Island and New Hampshire as well as the rules prescribed by the Federal Energy Regulatory Commission. Certain regulated operations were also subject to regulation by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 until its repeal became effective on 8 February 2006.

Our New York business files reports with the Securities and Exchange Commission under its legal name, Niagara Mohawk Power Corporation.

Business drivers

Our primary business drivers are the long-term rate plans with state regulators through which we can earn and retain certain amounts in excess of traditional regulatory allowed returns. These plans provide incentive returns and shared savings allowances, which allow us an opportunity to benefit from efficiency gains we may identify within our operations.

Our other main business drivers for US electricity and gas distribution include our ability to streamline operations, to enhance reliability and to generate funds for investment in our infrastructure.

We recover our costs of providing electricity and gas distribution under rates approved by applicable regulators. The rates are set based on historical or forecasted costs, and we earn a return on our assets. We benefit from the savings associated with identifying additional efficiencies. Commodity costs are passed through to customers. We are also subject to service quality standards with respect to reliability and certain aspects of customer service and safety.

We work towards service quality standards that our state regulators expect us to achieve. If we fall below a prescribed standard, we may incur a penalty. If we do better than the standard, we may in some cases achieve an incentive.

New York

Our electricity delivery rates are governed by a ten-year rate plan that began on 1 February 2002. Under the plan, after reflecting our share of savings related to the acquisition of our New York business, we may earn a threshold return on equity for our electricity distribution business of 10.6%, or 12.0% if certain customer outreach, education, competition-related and low income incentive targets are met, and half of any earnings in excess of that amount up to 14%, 25% of any earnings in excess of that up to 16% and 10% beyond that.

This effectively offers us the potential to achieve a return in excess of the regulatory allowed return of 10.6%.

Under the plan, gas delivery rates were frozen until the end of the 2004 calendar year, and we now have the right to request an increase at any time, if needed. We may earn a threshold return on equity ranging from 10.6% to 12.6% depending on the achievement of certain customer migration levels and customer awareness and understanding of gas competitive opportunities. Above this threshold, the revenue equivalent of gas earnings must be shared equally between shareholders and customers.

Massachusetts Under our long-term rate plan in Massachusetts, which runs until 2020, there is no cap on earnings and no earnings-sharing mechanism until 2010. From May 2000 until February 2005, rates were frozen. In March 2005, a settlement credit in the company's rates expired, which represents an increase of £6 million in pre-tax income through to February 2006. From March 2006, rates are adjusted each March until 2009 by the annual percentage change in average electricity distribution rates in the northeastern US. Regulators approved the first such annual increase in the amount of £11 million, effective 1 March 2006. In 2009, actual earned savings will be determined and we will be allowed to retain 100% of annual earned savings up to £39 million and 50% of annual earned savings between £39 million and £81 million before tax. Earned savings represent the difference between a test year's distribution revenue and our cost of providing service during the same test year, including a regional average authorised return.

These efficiency incentive mechanisms provide an opportunity to achieve returns in excess of traditional regulatory allowed returns. We will be allowed to include our share of earned savings in demonstrating our costs of providing service to customers from January 2010 until May 2020.

Rhode Island Our distribution rates in Rhode Island are also governed by a long-term rate plan. Between May 2000 and the end of October 2004, rates were frozen, and we were permitted to retain 100% of our Rhode Island earnings up to an allowed return on equity of 12%. We kept 50% of earnings between 12% and 13%, and 25% of earnings in excess of 13%. With effect from November 2004 until December 2009, we agreed to lower our rates by £6 million before tax per year.

From January 2005 onwards we are able to keep an amount equal to 100% of our earnings up to an allowed return on equity of 10.5%, plus £2.6 million before tax, which represents our share of demonstrated savings subsequent to the acquisition of Eastern Utilities Associates in 2000. Earnings above that amount up to an additional 1% return on equity are to be shared equally with our customers, while additional earnings will be allocated 75% to customers and 25% to us. This regulatory mechanism offers the potential to achieve returns in excess of traditional regulatory allowed returns.

New Hampshire Our distribution rates in New Hampshire are based on our costs of providing distribution service plus a return on our investment, predominantly in the distribution system infrastructure. These rates are authorised by the New Hampshire Public Utilities Commission.

Objectives and strategy

Our objective is to be the premier US energy delivery company through innovation and continuous improvement in safety, service quality and efficiency, and by operating in an environmentally and ethically responsible manner, to the benefit of customers, shareholders and employees alike.

Meeting or exceeding our regulated service quality goals is a main objective. We aim to realise this objective by increasing customer satisfaction through a focus on improving service quality as we strive for the optimum performance, and implementing a reliability enhancement programme to improve service to our customers. A significant increase in spending on our infrastructure is under way in order to modernise it to attain service quality goals.

Our approach to working towards our safety and occupational health objective is to cultivate a culture in which acting safely becomes second nature. Zero injuries every day for both our employees and the people within our service territories is our goal and we believe this is achievable and sustainable. We will continue to collaborate with regulators, policy makers and customers to advance the development of the competitive electricity and natural gas marketplace.

In line with our reliability objective, in order to improve performance we have developed and begun execution of a five-year reliability enhancement programme. This is made up of four main categories of work:

- vegetation management – incremental tree trimming to address an increase in customer interruptions related to contacts with tree limbs;
- feeder hardening – upgrading our worst-performing overhead electric circuits by replacing aged and deteriorated components and protecting against lightning strikes and animal contacts;
- asset replacement – replacing aging distribution equipment before its expected end of life, including poles, underground cable and substation equipment; and
- inspection and maintenance – increasing our preventive maintenance and repair activities to find potential faults before they occur.

The planned capital investment of £290 million over the next five years from these initiatives will be recovered from customers in accordance with our rate plans. The remaining incremental operating costs will be offset by efficiencies created within our business.

Our workforce recruitment objective is to become the employer of choice. We seek to source and hire the best and the brightest to create a workplace as diverse as the population we serve. Our strategy is to expand conventional sourcing strategies, such as educational partnerships, and offer challenging career opportunities and succession plans to retain our valued employees.

We are committed to creating a climate that values, respects, appreciates and celebrates the unique differences of all employees, stakeholders and customers. The objective is to be a company that better reflects our customer base and is recognised for our inclusion and diversity efforts by our employees, peers and the communities we serve.

Current and future developments

We expect to complete the purchase of Southern Union Company's Rhode Island gas distribution network this summer. The transaction is subject to approval by state regulatory authorities.

We are moving forward with the proposed acquisition of KeySpan Corporation. This is subject to approvals from the federal, state and local authorities, our shareholders and KeySpan's shareholders and is planned to be completed in early 2007.

These two transactions, combined with our current US operations, will make us the third largest gas distribution business in the US based on customers in the US.

Performance during the year

Operational performance

Our progress toward our operational objectives included the following:

Safety	The number of employee lost time injuries in the US electricity and gas distribution business fell from 81 recorded at the end of 2004/05 to 66 in 2005/06, a decrease of 19%. As a consequence, our lost time injury frequency rate reduced from 0.5 in 2004/05 to 0.45 in 2005/06.
Customer service	We met or improved our standards on customer service, earning an incentive of £2.3 million in Massachusetts.
Reliability	We missed targets for reliability in the 2005 calendar year, incurring an aggregate penalty of £8.7 million. We are committed to reducing the frequency and duration of service interruptions.

Financial performance

The results of the US electricity and gas distribution segment for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 constant currency £m	2005 £m
Revenue	3,711	3,225	3,087
Other operating income	2	–	–
Operating costs excluding exceptional items	(3,349)	(2,833)	(2,712)
Adjusted operating profit	364	392	375
Exceptional items	–	(122)	(117)
Operating profit	364	270	258

The average exchange rates used to translate the results of US operations during 2005/06 and 2004/05 were \$1.79:£1 and \$1.87:£1 respectively. In order to illustrate underlying performance, the impact of exchange rate movements has been separated from other changes by also presenting the operating results for 2004/05 on a constant currency basis, using the average exchange rate for 2005/06 of \$1.79:£1.

The principal movements between 2005/06 and 2004/05 can be summarised as follows:

	Revenue and other operating income £m	Operating costs £m	Operating profit £m
2004/05 results	3,087	(2,829)	258
Add back 2004/05 exceptional items	–	117	117
2004/05 adjusted results	3,087	(2,712)	375
Exchange movements	138	(121)	17
2004/05 constant currency	3,225	(2,833)	392
Purchased power	439	(444)	(5)
Volume	18	–	18
Weather	14	–	14
Storm costs	–	(13)	(13)
Depreciation and amortisation	–	(7)	(7)
Pension costs	–	(23)	(23)
Other	17	(29)	(12)
2005/06 results	3,713	(3,349)	364

US electricity and gas distribution revenue increased by £486 million in 2005/06 compared with 2004/05 on a constant currency basis. This was primarily due to the recovery of higher purchased power costs of £439 million. Commodity costs are recovered in full from customers although the recovery of these costs can occur in more than one financial year. The remaining increases in revenue were due to favourable weather impact of £14 million, primarily due to the hot summer weather, and underlying growth which added £18 million, as weather-normalised deliveries to residential customers increased 1.7% over last year.

US electricity and gas distribution operating costs, excluding exceptional items, increased by £516 million in 2005/06 compared with 2004/05 on a constant currency basis. This was primarily due to higher purchased power costs of £444 million which, as mentioned above, are recovered from customers. The remainder of the variance was largely due to increased pension costs of £23 million, the majority of which will be recovered from customers beginning in 2006/07, an increase in depreciation and amortisation expense of £7 million as capital projects, including new IT systems, went into service, and higher storm costs of £13 million.

The £28 million decrease in adjusted operating profit from US gas and electricity distribution was primarily due to a £23 million increase in pension costs, the majority of which will be recovered in future years, as described above, and timing in the recovery of commodity costs. Excluding these items, US electricity and gas distribution operating profit was flat year on year. Growth was offset by higher depreciation and amortisation expense. The increase in deliveries due to weather was offset by higher storm costs. The strong focus on managing bad debts resulted in an increase of only £2 million despite high gas and electricity prices.

There were no exceptional items in 2005/06 and so adjusted operating profit was equal to operating profit. In 2004/05 exceptional charges of £117 million related to restructuring costs, exceptional pension charges and increases in environmental provisions.

Capital investment

Capital investment in the replacement, reinforcement and extension of the US electricity and gas distribution networks was £244 million in 2005/06, compared with £234 million in 2004/05.

US electricity and gas distribution capital investment expenditure increased by £10 million in 2005/06, reflecting a £10 million impact of exchange rate movements. There was also an increase of £14 million due to an investment in our Nantucket cable project, which was offset by a lease recapitalisation of £13 million and other capital reductions.

US stranded cost recoveries

About the segment

Principal activities

The US stranded cost recoveries segment captures the recovery of some of our historical investments in generating plants together with costs incurred under certain commodity purchase contracts that were 'stranded' when we divested our generation business during the industry restructuring in New England and New York. In addition, this segment includes the recovery of certain above-market costs of commodity purchase contracts that were in place at the time of restructuring and deregulation.

We are able, with the approval of the utility commissions in the states in which we operate, to recover most of these costs, through a special rate charged to electricity customers. Pursuant to the agreements with our regulators, revenue from this segment will decline as the recovery of stranded costs is completed.

Current and future developments

USGen settlement

In 1998, we transferred entitlement to power procured under several long-term contracts to USGen New England, Inc., which agreed to fulfil our performance and payment obligations under the contracts.

When USGen subsequently filed for bankruptcy, as part of the bankruptcy settlement we resumed the performance and payment obligations under the power contracts and received proceeds of approximately £115 million. We received £6 million in January 2005 and £109 million in June 2005, and we are crediting the £115 million to customers through a reduction in their rates over the period ending 31 December 2009.

The cost of power under commodity purchase contracts is in excess of market values for electricity and so power purchased is currently being resold at a loss. These losses are recovered in full from customers although the recovery of these losses can occur in more than one financial year. These contracts are carried in the balance sheet at fair value, with remeasurements recognised in the income statement as energy prices fluctuate. At 31 March 2006 these commodity purchase contract liabilities were carried at £169 million.

Performance during the year

Financial performance

The results of the US stranded cost recoveries segment for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 constant currency £m	2005 £m
Revenue	511	427	409
Operating costs excluding remeasurements	(22)	59	56
Adjusted operating profit	489	486	465
Remeasurements	(49)	(40)	(38)
Operating profit	440	446	427

The average exchange rates used to translate the results of US operations during 2005/06 and 2004/05 were \$1.79:£1 and \$1.87:£1 respectively. To illustrate underlying performance, the impact of exchange rate movements has been separated from other changes by also presenting the operating results for 2004/05 on a constant currency basis, using the average exchange rate for 2005/06 of \$1.79:£1.

The £84 million increase in revenue comparing 2005/06 with 2004/05 resulted from the recovery of higher purchased power contract costs and increased recoveries of stranded costs in accordance with our rate plans.

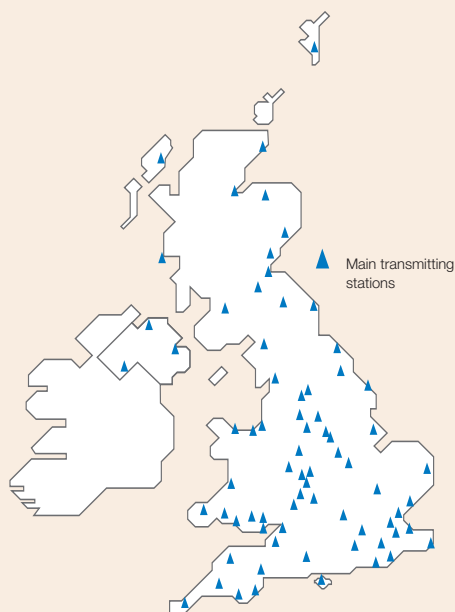
Operating costs for US stranded cost recoveries increased by £81 million, mainly because of higher purchased power contract costs.

Adjusted operating profit increased by £3 million to £489 million.

Remeasurements are related to changes in the carrying value of commodity contract liabilities. Operating profit decreased by £6 million as a consequence of the above changes.

Wireless infrastructure

About the segment



Principal activities

National Grid Wireless operates in the UK and the US. In the UK, we are the leading independent provider of network infrastructure to mobile network operators and one of two providers of transmission networks for analogue and digital television and radio broadcasters.

Our primary operations comprise:

UK mobile telephone infrastructure We have around 5,000 active sites used for mobile communications. Our main activity is the provision of sites under contracts to the UK's five mobile phone operators. In addition, sites are also used by other customers such as the emergency services and taxi companies. We also provide other services such as site design, antenna installation and project management. In total we have around 13,500 marketable sites.

As the leading independent provider of network infrastructure to mobile operators, with a substantial portfolio of undeveloped sites, the business is well positioned to benefit from continued demand for mobile infrastructure, not least the roll-out of 3G networks.

UK broadcast infrastructure Our broadcast transmission business is a network of transmission towers and broadcast equipment. It has contracts to transmit analogue and digital radio and television signals for reception by the public from content providers such as the BBC, BSkyB, MTV, Channel 4, Virgin Radio and talkSPORT. We own some 750 purpose-built broadcast towers and associated transmission equipment used for this purpose. We also hold licences for two digital television multiplexes utilised by broadcasters to broadcast eleven digital channels in the UK.

US operations Our US business provides communications infrastructure and related network services to wireless and fixed network operators in the northeastern US. Services include the use of communication towers, wireless pylon attachments, distributed antenna system networks and related network services and a dark fibre network.

External and regulatory environment

The UK broadcast market comprises four transmission platforms: terrestrial, satellite, cable and ADSL broadband. The terrestrial platform is provided on a free-to-air basis, while other services are typically bundled with a subscription package including other products, for example telephony or internet access.

Analogue terrestrial television and radio signals are transmitted by a number of different broadcasting organisations including the BBC, ITV, Channel 4 and Five as well as other regional television companies and commercial radio stations. In addition, there are six multiplex licences to provide digital terrestrial television services, with two licences held by the BBC, one by D3&4, one by SDN and two by National Grid Wireless.

National Grid Wireless is one of the two incumbent suppliers of terrestrial broadcasting infrastructure in the UK. Terrestrial broadcasting infrastructure suppliers provide managed transmission services to individual broadcasters, consisting of the provision of dedicated broadcast equipment, and network access, which represents the provision of shared sites and equipment to support multiple services. Network access services are regulated by Ofcom because of the uniqueness of these sites and assets.

Ofcom licenses all services that relate to fixed and wireless communications and broadcasting in the UK market.

Business drivers

The principal business drivers for the Wireless infrastructure segment are considered to be as follows:

Multi-year contractual arrangements	We have contracts with a number of broadcasters, of which the most significant is our contract with the BBC. We also have long-term contracts with mobile telecommunication providers in the UK, including Vodafone, Orange, T-Mobile, Hutchinson 3G and O2.
UK digital switchover	The switchover in the UK from analogue to digital television by 2012 will have major capital investment implications as well as freeing up spectrum for alternative uses.
Mobile operator demand	Another driver of our business is the continued demand for site infrastructure to support the expansion of the mobile operators' networks, particularly important to the roll out of 3G. The advent of new technologies such as mobile television may drive future increases in demand.
Channel technology	We expect the broadcast business to continue to benefit from advances in technology over time, allowing additional channels to be offered to the marketplace.

Current and future developments

Completion of integration

During 2005/06 we completed the process of integrating the UK operations of Crown Castle International Corp., which we acquired for £1.1 billion in August 2004.

This enabled us to achieve a run-rate of £18 million cash savings ahead of the March 2006 target.

New digital multiplex channels

Due to improvements in multiplexing technology, three new channels were successfully launched in the year.

UK digital switchover

A significant change within the UK terrestrial broadcast market is the transition from analogue to digital television broadcasting. This is expected to take place on a region by region basis over the six years to 2012 and will involve the roll-out of new national broadcast infrastructure.

We are currently working closely with the broadcast industry and Government on the planning of switchover. We expect to invest over £200 million in new common digital television broadcast infrastructure over the six years to 2012, and around £50 million on our own digital broadcast transmission assets.

During the year we successfully secured an extension to our largest broadcast contract for the provision of analogue television and radio services to the BBC during the switchover period.

Network access price control

During the year, Ofcom introduced regulatory requirements governing network access services including access to the masts, the towers, the buildings and equipment used for broadcasting.

Under these regulations we have to provide fair, reasonable and non-discriminatory access to these assets. Ofcom is currently consulting on the regulatory framework for public service broadcasting. It has provisionally announced that we can earn a return, before specific risk adjustments, of 10.4% before tax on the assets used for this service. The final outcome is still awaited.

Performance during the year

Operating performance

Objective	Performance
Safety	The major operational risks in our business arise from working at height and driving. During 2005/06, Wireless infrastructure had one employee lost time injury compared with five in 2004/05. As a consequence our lost time injury frequency rate reduced from 0.25 in 2004/05 to 0.07 in 2005/06.
Reliability	Our broadcast networks operate with an average availability in excess of 99.9%.
Efficiency	We achieved our target of £18 million annualised cash savings in January 2006, two months ahead of target. Improvements in multiplexing technology allowed us to offer a further three new channels for commercial broadcasting, bringing the total number of television channels to eleven across our two multiplexes.

Financial performance

The results for Wireless infrastructure for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 £m
Revenue	325	208
Other operating income	-	3
Operating costs excluding exceptional items	(250)	(169)
Adjusted operating profit	75	42
Exceptional items	(5)	(13)
Operating profit	70	29

The principal movements between 2004/05 and 2005/06 can be summarised as follows:

	Revenue and other operating income £m	Operating costs £m	Operating profit £m
2004/05 results	211	(182)	29
Add back 2004/05 exceptional items	-	13	13
2004/05 adjusted results	211	(169)	42
Full year trading results and synergies	114	(81)	33
2005/06 adjusted results	325	(250)	75
2005/06 exceptional items	-	(5)	(5)
2005/06 results	325	(255)	70

The £114 million increase in Wireless infrastructure revenue and other operating income, £81 million increase in operating costs and £33 million increase in adjusted operating profit between 2005/06 and 2004/05 primarily reflects a full year's (2004/05 seven months) contribution from the UK operations of Crown Castle International Corp., synergies and underlying profit growth.

Exceptional charges of £13 million in 2004/05 and £5 million in 2005/06 primarily relate to restructuring costs incurred in the acquisition and integration of the UK operations of Crown Castle International Corp. into National Grid Wireless.

Capital expenditure

Capital investment in Wireless infrastructure was £43 million in 2005/06 compared with £19 million in 2004/05.

The increase in capital expenditure primarily reflects a full year's capital expenditure compared with seven months capital spending in 2004/05.

Other activities

About other activities

Principal activities

Other activities include the following businesses and activities:

Business or activity	Description
Metering	National Grid Metering and OnStream provide installation, maintenance and meter reading services to gas and electricity suppliers in the regulated and unregulated markets. National Grid Metering provides services for an asset base of around 20 million domestic, industrial and commercial gas meters. OnStream's focus is the provision of metering services to the competitive market.
National Grid Australia	The Basslink project is a 600 MW interconnector linking the electricity network on the island state of Tasmania to mainland Australia.
Grain LNG	The Isle of Grain liquefied natural gas (LNG) import terminal is the first new LNG import terminal constructed and operated in the UK for some 20 years, involving planned investment of approximately £500 million for Phases I and II.
National Grid Property	National Grid Property is responsible for the management of all major occupied properties in the UK, and for the management, clean up and disposal of surplus properties, largely comprising contaminated former gas works.
Fulcrum Connections	Fulcrum Connections is the largest provider of gas connections and associated design services with a national footprint in the UK.
Advantica	Advantica is a consultancy providing engineering and software services to enhance safety in the gas, oil, electricity and water sectors, primarily in the UK and US.
Corporate activities	This includes corporate overheads that are not allocated to individual businesses, and expenditure incurred on business development.

External and regulatory environment

The majority of our other businesses either operate in markets related to those of our principal businesses or provide support to our own businesses.

With the exception of National Grid Metering, which is subject to price controls, our other businesses are only indirectly affected by the relevant regulatory regimes. Grain LNG was granted an exemption by Ofgem from the regulated third party access provisions for both Phase I and Phase II of the development. The exemption introduced certain obligations to put in place effective measures to allow third parties to access unused capacity. The exemption is similar in nature to that in place at other new gas supply infrastructure projects in the UK.

National Grid Metering is regulated by Ofgem as it has a dominant market position in the provision of existing meters to UK gas suppliers. OnStream is a participant in the competitive market that now exists in the provision of new meters to gas and electricity suppliers who wish to install or to replace meters as required.

National Grid Australia is a supplier to a regulated electricity utility, Hydro Tasmania, and so is indirectly affected by the requirements of state and federal energy regulators in Australia.

Business drivers

The principal business drivers for our other activities are considered to be as follows:

Regulatory price controls	National Grid Metering operates within the parameters set out within its licence.
Multi-year contractual arrangements	The majority of National Grid Metering's domestic meters are covered by long-term contracts with gas suppliers. These contracts provide gas suppliers with the flexibility to replace our meters while reducing the risk of asset stranding. OnStream has a five-year contract with Centrica for the provision of gas and electricity meters. National Grid Australia has a 25-year contract with Hydro Tasmania to build, own and operate the Basslink Interconnector. Phase I of Grain LNG is underpinned by a long-term contract with BP/Sonatrach. Similarly Phase II, currently under construction, is underpinned by long-term contracts signed with Centrica, Gaz de France and Sonatrach.
Capital investment	We seek to make capital investments in projects that utilise our infrastructure expertise, such as our investments in Grain LNG and Basslink, which we believe will result in returns being generated from the operation of these assets.
Efficiency	Efficiency in delivering capital programmes and in operating our other businesses and corporate activities results in driving improved financial performance.

Current and future developments

Grain LNG

In July 2005, commercial operations for the first phase of the Isle of Grain LNG import terminal commenced. The second phase of development at the Isle of Grain LNG import terminal, announced in March 2005, is now under way and is expected to be completed by the end of 2008. This next phase will increase the facility's capacity to import and process LNG from 3.3 million tonnes per year up to 9.8 million tonnes per year, representing around 13% of current annual UK gas demand. Grain LNG Phase I was completed in the year at a cost of £132 million and we have spent £117 million of the £355 million to be invested in Phase II.

Market demand for a third phase of development is currently being evaluated.

National Grid Australia

During the year we invested a further £71 million in Basslink and, excluding financing costs, total construction costs amounted to £323 million.

Following a project delay the Basslink Interconnector was successfully commissioned in April 2006.

Basslink can provide up to 600 MW of hydroelectricity to mainland Australia and over 300 MW of electricity into Tasmania.

Metering

Both National Grid Metering and OnStream are investing in new automated meter reading systems in response to customer requirements.

Other developments

The HSE has recently issued new planning guidance on the development of sites in close proximity to hazardous installations, including gas holders. Without taking mitigating action, this may lead to a reduction in the selling price likely to be realised for our sites located close to gas holders. As such, we are currently assessing the consequence for our portfolio along with the actions we can take to mitigate the impact of the new guidance.

Performance during the year

Operating performance

Our progress against our principal non-financial operating objectives during the year included the following:

Objective	Performance
Safety	There was an increase in the total number of employee lost time injuries in other businesses and corporate activities from 10 in 2004/05 to 12 in 2005/06.
Reliability	Our other businesses operated reliably throughout the year.
Invest for future growth	We completed two major capital investment projects, being Phase I of Grain LNG, which commenced operations in July 2005, and the Basslink Interconnector, which commenced operations in April 2006.

Financial performance

The results for other activities for the years ended 31 March 2006 and 2005 were as follows:

Years ended 31 March	2006 £m	2005 £m
Revenue	701	734
Other operating income	74	67
Operating costs excluding exceptional items	(630)	(649)
Adjusted operating profit	145	152
Exceptional items	18	(33)
Operating profit	163	119

The principal movements between 2004/05 and 2005/06 can be summarised as follows:

	Revenue and other operating income £m	Operating costs £m	Operating profit £m
2004/05 results	801	(682)	119
Add back 2004/05 exceptional items	–	33	33
2004/05 adjusted results	801	(649)	152
Metering	(10)	38	28
Property	(4)	(10)	(14)
Grain LNG	27	(16)	11
Insurance	(15)	2	(13)
Other	(24)	5	(19)
2005/06 adjusted results	775	(630)	145
2005/06 exceptional items	–	18	18
2005/06 results	775	(612)	163

Revenue and other operating income from other activities has fallen from £801 million in 2004/05 to £775 million in 2005/06 primarily due to reduced revenue from our metering businesses, where reductions at National Grid Metering were partially offset by revenue growth in OnStream, and reductions in other revenue, including property, insurance and other businesses. These decreases were partially offset by an increase in revenue from Grain LNG following its successful commissioning in July 2005.

Operating costs excluding exceptional items reduced by £19 million to £630 million in 2005/06. The lower costs for metering are linked to the reduction in revenues along with further cost savings arising from operational efficiencies. This was partially offset by an increase in costs at Grain LNG.

Exceptional items explain the difference between adjusted operating profit and operating profit. The favourable movement this year principally relates to the gain on sale of Energis Polska and the reversal of a previous impairment in Copperbelt Energy Corporation.

Capital expenditure

Capital expenditure in 2005/06 amounted to £350 million, an increase of £47 million compared with £303 million in 2004/05. This reflected an increase of £85 million invested in the Grain LNG import terminal, a net increase of £19 million in our metering businesses and £42 million from the purchase of National Grid House in Warwick, partially offset by a reduction of £65 million in Australia as a result of the completion of the Basslink Interconnector, £16 million in other property capital expenditure and £18 million in other activities.

Financial position and financial management

Going concern

Having made enquiries, the Directors consider that the Company and the Group have adequate resources to continue in business for the foreseeable future and that it is therefore appropriate to adopt the going concern basis in preparing the accounts.

We intend to finance the proposed acquisition of KeySpan for \$7.3 billion (£4.2 billion), together with the assumption of debt of \$4.5 billion (£2.6 billion), through operating cash flows, existing credit facilities, future facilities and other financing that we reasonably expect to be able to secure in the future.

Capital structure

Balance sheet

Our balance sheet at 31 March 2006 can be summarised as follows:

	Assets £m	Liabilities £m	Net assets £m
Property, plant & equipment and non-current intangible assets	19,256	-	19,256
Goodwill and non-current investments	2,302	-	2,302
Current assets and liabilities	1,668	(2,749)	(1,081)
Other non-current assets and liabilities	38	(2,255)	(2,217)
Post-retirement obligations	-	(1,915)	(1,915)
Deferred tax	159	(2,161)	(2,002)
Total before net debt	23,423	(9,080)	14,343
Net debt	2,501	(13,351)	(10,850)
Total as at 31 March 2006	25,924	(22,431)	3,493
Total as at 31 March 2005	27,560	(25,439)	2,121

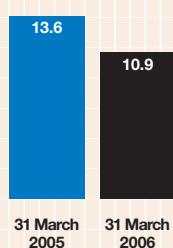
The increase in net assets from £2,121 million at 31 March 2005 to £3,493 million at 31 March 2006 resulted from the profit from continuing operations of £1,217 million, the profit for the year from discontinued operations of £2,633 million, net income recognised directly in equity of £250 million and other changes in equity of £69 million, partially offset by the return of value to shareholders of £2,009 million, dividends paid of £745 million and the effect of the implementation of IAS 39 of £43 million.

Net debt and gearing

Net debt decreased by £2.7 billion from £13.6 billion at 31 March 2005 to £10.9 billion at 31 March 2006, primarily as a result of debt repayments following the disposals of the four regional gas networks for £5.8 billion, partially offset by the £2 billion return of capital to shareholders and an increase of £0.4 billion relating to the adoption of IAS 39 on financial instruments.

Net Debt

£bn



The composition of net debt at 31 March 2006 is shown in note 33 to the accounts.

Gearing at 31 March 2006 and 31 March 2005, calculated as net debt at that date expressed as a percentage of net debt plus net assets shown in the balance sheet, amounted to 76% and 87% respectively. By comparison, the gearing ratio, adjusted for the inclusion of UK and US regulated businesses at their estimated regulatory asset values (adjusted gearing ratio), amounted to 60% at 31 March 2006 compared with 63% at 31 March 2005.

The Directors believe this adjusted ratio is a more relevant measure of gearing than one based on book values alone, because the book values do not reflect the economic value of the UK regulated business assets. A reconciliation of the adjustments necessary to calculate adjusted net assets is shown in the table below:

Adjustment to net assets	2006 £m	2005 £m
Net assets per balance sheet	3,493	2,121
Adjustment for UK business regulatory values	2,815	5,821
Adjustment for US regulatory assets	2,702	2,754
Deferred tax	(1,925)	(2,848)
Adjusted net assets	7,085	7,848

Shareholders' equity

Shareholders' equity rose from £2,111 million at 31 March 2005 to £3,482 million at 31 March 2006. This increased for the same reasons that net assets increased, together with net movements in minority interests of £1 million.

Liquidity and treasury management

Cash flow

Cash flows from our operations are largely stable over a period of years, but they do depend on the timing of customer payments and exchange rate movements. The Group's electricity and gas transmission and distribution operations in the UK and US are subject to multi-year rate agreements with regulators. In the UK, this results in essentially stable cash flows in local currency terms. However, weather conditions can affect cash flows in those businesses, with abnormally mild or extreme weather driving volumes down or up respectively. In the US, the regulatory mechanisms for recovering costs from customers can result in very significant cash flow swings from year to year.

Cash flow forecasting

Both short- and long-term cash flow forecasts are produced frequently to assist in identifying the liquidity requirements of the Group.

These forecasts are supplemented by a financial headroom position, details of which are supplied to the Finance Committee of the Board regularly to demonstrate funding adequacy for at least a 12-month period. The Group also maintains a minimum level of committed facilities in support of that objective.

Credit facilities and unutilised Commercial Paper and Medium Term Note Programmes

The Group has both committed and uncommitted facilities that are available for general corporate purposes.

At 31 March 2006, National Grid had a US\$3.0 billion US Commercial Paper Programme (unutilised); National Grid Electricity Transmission plc had a US\$1.0 billion US Commercial Paper Programme (unutilised) and a US\$1.0 billion Euro Commercial Paper Programme (unutilised); and National Grid and National Grid Electricity Transmission plc had a joint Euro Medium Term Note Programme of €6 billion (€2.0 billion unissued). National Grid Gas plc had a US\$2.5 billion US Commercial Paper Programme (unutilised) and a US\$1.25 billion Euro Commercial Paper Programme (unutilised); and National Grid Gas plc and National Grid Gas Holdings plc had a joint Euro Medium Term Note Programme of €10 billion (€6.6 billion unissued). At 31 March 2006, the Group in the UK had £1.29 billion of long-term committed facilities (undrawn), £50 million of short-term (364 day) committed facilities (undrawn) and US\$1.55 billion of short-term (364 day) committed facilities (undrawn) and £1.0 billion of uncommitted borrowing facilities (undrawn). The short-term committed facilities include an option to extend these facilities.

National Grid's US companies had committed facilities of US\$680 million, all of which were undrawn at 31 March 2006. These facilities provide liquidity support for the tax-exempt debt programmes for New England Power Company, Massachusetts Electric Company and Nantucket Electric Company.

In addition to the above facilities, at 31 March 2006, National Grid Australia had an A\$630 million loan facility (A\$50 million undrawn) and National Grid Electricity Transmission plc has signed a loan agreement for £200 million with the European Investment Bank which can be drawn any time before June 2007.

Note 27 to the accounts shows the maturity profile of all undrawn committed borrowing facilities of the Group in sterling at 31 March 2006.

Treasury policy

The funding and treasury risk management of the Group is carried out under policies and guidelines approved by the Board. The Finance Committee, a Board Committee (for further details see page 70), is responsible for regular review and monitoring of treasury activity and for approval of specific transactions, the authority for which may be delegated. The Group has a Treasury function that raises all the funding for the Group and manages interest rate and foreign exchange rate risk.

The Group has financing programmes for each of the main Group companies. The Finance Committee and the finance committee or board of the appropriate Group undertaking approve all funding programmes. The Treasury function is not operated as a profit centre. Debt and treasury positions are managed in a non-speculative manner, such that all transactions in financial instruments or products are matched to an underlying current or anticipated business requirement.

The use of derivative financial instruments is controlled by policy guidelines set by the Board. Derivatives entered into in respect of gas and electricity commodities are used in support of operational requirements and the policy regarding their use is explained on page 59.

The Group had borrowings outstanding at 31 March 2006 amounting to £13,126 million (31 March 2005: £14,290 million). The table in note 27 shows the expected maturity of these borrowings.

The Group has in place appropriate committed facilities, and believes that the maturing amounts in respect of its contractual obligations as shown in 'Commitments and contingencies' on page 60 can be met from these facilities, operating cash flows and other refinancings that it reasonably expects to be able to secure in the future. The Group's financial position enables it to borrow on the wholesale capital and money markets and most of its borrowings are through public bonds and commercial paper.

The Group places surplus funds on the money markets, usually in the form of short-term fixed deposits that are invested with approved banks and counterparties. Details relating to the Group's cash, short-term investments and other financial assets at 31 March 2006 are shown in notes 22 and 26 to the accounts.

We have a long-term senior unsecured credit rating of Baa1/A-, provided by Moody's and S&P respectively. In addition, certain Group undertakings are also credit-rated. National Grid Electricity Transmission plc has a credit rating of A2/A provided by Moody's and S&P respectively, whereas National Grid Gas plc has a credit rating of A2/A/A+ and National Grid Gas Holdings plc has been separately rated A3/A-/A by Moody's, S&P and Fitch respectively. In connection with the proposed acquisition of KeySpan Corporation, our ratings have been moved to 'creditwatch with negative implications' by S&P. Moody's has placed the ratings of National Grid Gas plc, National Grid Gas Holdings plc and National Grid Electricity Transmission plc on negative outlook and the other Group ratings on to review for downgrade. We expect the long-term credit ratings of National Grid plc to reduce by one notch as a direct result of the financing required for the KeySpan acquisition.

It is a condition of the regulatory ring-fences around National Grid Electricity Transmission plc, National Grid Gas plc and National Grid Gas Holdings plc that they use reasonable endeavours to maintain an investment grade credit rating. At these ratings, the principal borrowing entities of the Group should have good access to the capital and money markets for future funding when necessary.

The main risks arising from the Group's financing activities are set out on page 58, as are the policies for managing these risks, which are agreed and reviewed by the Board and the Finance Committee.

Refinancing risk management

The Board controls refinancing risk mainly by limiting the amount of financing obligations (both principal and interest) arising on borrowings in any financial year. This policy restricts the Group from having an excessively large amount of debt to refinance in a given time-frame. During the year, a mixture of short-term and long-term debt was issued.

Interest rate risk management

The interest rate exposure of the Group arising from its borrowings and deposits is managed by the use of fixed- and floating-rate debt, interest rate swaps, swaptions and forward rate agreements. Our interest rate risk management policy is to seek to minimise total financing costs (being interest costs and changes in the market value of debt) subject to constraints so that, even with large movements in interest rates, neither the interest cost nor the total financing cost can exceed pre-set limits. Some of the bonds in issue from National Grid Electricity Transmission plc and National Grid Gas Holdings plc are index-linked, that is their cost is linked to changes in the UK Retail Price Index (RPI). The Group believes these bonds provide a good hedge for revenues that are also RPI-linked under the price control formulae.

The performance of the Treasury function in interest rate risk management is measured by comparing the actual total financing costs of its debt with those of a passively managed benchmark portfolio. More information on the interest rate profile of our debt is included in note 23 to the accounts.

Foreign exchange risk management

The Group has a policy of hedging certain contractually committed foreign exchange transactions over a prescribed minimum size. It covers a minimum of 75% of such transactions expected to occur up to six months in advance and a minimum of 50% of transactions six to twelve months in advance. Cover generally takes the form of forward sale or purchase of foreign currencies and must always relate to underlying operational cash flows.

The principal foreign exchange risk to which the Group is exposed arises from assets and liabilities denominated in US dollars. In relation to these risks, the objective is to match the US dollar proportion of the Group's financial liabilities to the proportion of its cash flow that arises in dollars and is available to service those liabilities.

Foreign exchange fluctuations will affect the translated value of overseas earnings and cash flows. This translation has no impact on the currency cash flows of the Group, and accordingly is not hedged other than indirectly through the natural hedge of having foreign currency interest expense arising on currency denominated liabilities. Cash flows may be hedged through matching with interest flows or by forward foreign exchange deals and options.

The currency and average interest rate compositions of the Group's financial liabilities and assets are shown in note 23 to the accounts.

Counterparty risk management

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Finance Committee has agreed a policy for managing such risk, which is controlled through credit limits, approvals and monitoring procedures. Where multiple transactions are entered into with a single counterparty, a master netting arrangement can be put in place to reduce the Group's exposure to credit risk of that counterparty. At the present time the Group uses standard International Swap Dealers Association (ISDA) documentation, which provides for netting in respect of all transactions governed by a specific ISDA agreement with a counterparty, when transacting interest rate and exchange rate derivatives.

Derivative financial instruments held for purposes other than trading

As part of its business operations, the Group is exposed to risks arising from fluctuations in interest rates and exchange rates. The Group uses financial instruments (derivatives) to manage exposures of this type and they are a useful tool in reducing risk. The Group's policy is not to use derivatives for trading purposes. Derivative transactions can, to varying degrees, carry both counterparty and market risk.

The Group enters into interest rate swaps to manage the composition of fixed- and floating-rate debt and so hedge the exposure of borrowings to interest rate movements. In addition, the Group enters into bought and written option contracts on interest rate swaps. These contracts are known as swaptions. The Group also enters into foreign currency swaps to manage the currency composition of borrowings and so hedge the exposure to exchange rate movements. Certain agreements are combined foreign currency and interest rate swap transactions. Such agreements are known as cross-currency swaps.

The Group enters into forward rate agreements to hedge interest rate risk on short-term debt and money market investments. Forward rate agreements are commitments to fix an interest rate that is to be paid or received on a notional deposit of specified maturity, starting at a future specified date.

More details on derivative financial instruments are provided in note 23 to the accounts.

Valuation and sensitivity analysis

The Group calculates the fair value of debt and derivative instruments by discounting all future cash flows by the market yield curve at the balance sheet date. The market yield curve for each currency is obtained from external sources for interest and foreign exchange rates. In the case of instruments that include options, the Black's variation of the Black-Scholes model is used to calculate fair value.

The valuation techniques described above for interest rate swaps and currency swaps are a standard market methodology. These techniques do not take account of the credit quality of either party but this is not considered to be a significant factor unless there is a material deterioration in the credit quality of either party.

In relation to swaptions, we use swaptions for hedging purposes with a European style exercise. As a consequence, the Black's variation of the Black-Scholes model is considered to be sufficiently accurate for the purpose of providing fair value information in relation to these types of swaptions. More sophisticated valuation models exist but the Group does not believe it is necessary to employ these models, given the limited extent of its activities in this area.

For debt and derivative instruments held, the Group utilises a sensitivity analysis technique to evaluate the effect that changes in relevant rates or prices will have on the market value of such instruments.

At 31 March 2006, the potential change in the fair value of the aggregation of long-term debt and derivative instruments, assuming an increase or decrease of 10% in the level of interest rates and exchange rates, was £44 million and £46 million for interest rates and £427 million and £521 million for exchange rates respectively.

Commodity contracts

Power purchase contracts for normal sale and purchase

In the US we purchase electricity and gas to supply to our customers. The electricity contracts, many of which are long-term in nature, enable us to provide the electricity purchased by customers who do not choose to purchase their energy from independent suppliers. Gas is purchased on behalf of those customers who continue to buy supply service from us, and encompasses both the gas itself and the interstate transportation and storage services required to deliver gas to our system. In addition, we purchase electricity and gas in both the UK and the US for our own operational requirements.

Commodity derivatives

In the normal course of business, the Group is party to commodity derivatives. These have included indexed swap contracts, gas futures, electricity swaps, gas options, gas forwards and gas basis swaps that are principally used to manage commodity prices associated with its gas and electricity delivery operations. This includes the repurchase of capacity rights already sold in accordance with our UK gas transporter licences and Uniform Network Code obligations.

These financial exposures are monitored and managed as an integral part of the Group's financial risk management policy. At the core of this policy is a condition that the Group will engage in activities at risk only to the extent that those activities fall within commodities and financial markets to which it has a physical market exposure in terms and volumes consistent with its core business. The Group does not issue or intend to hold derivative instruments for trading purposes, and holds such instruments consistent with its various licence and regulatory obligations in the UK and US.

Commodity contracts carried at fair value

As a result of the restructuring of the electricity industry in New York State, a portion of existing power purchase agreements were replaced in 1998 with indexed swap contracts that expire in June 2008. These indexed swaps are the subject of regulatory rulings that allow the gains and losses to be passed on to customers.

At 31 March 2006, the Group had liabilities of £309 million (31 March 2005: £327 million) in respect of the above indexed swap contracts. The liability will be discharged over the remaining term of the swaps as nominal energy quantities are settled and will be adjusted as periodic reassessments are made of energy prices. A 10% movement in the market price of electricity and gas would result in a £12 million movement in the value of the index-linked swap contracts assuming a US dollar to sterling exchange rate of \$1.79:£1.

The fair value of the index-linked swap contracts is based on the difference between projected future market prices and projected contract prices as applied to the notional quantities stated in the contracts and discounted using a US Treasury Bill rate curve to the current present value.

Payments made under indexed swap contracts are affected by the price of natural gas and we use New York Mercantile Exchange (NYMEX) gas futures as hedges to mitigate the volatility of this impact. The futures contracts are derivative commodity instruments with gains and losses deferred as an offset to the corresponding increases and decreases in the swap payments.

We do not currently use options to hedge gas commodity requirements. Gains relating to gas futures as at 31 March 2006 were not material.

Our rate agreement in New York allows for collection of the commodity cost of natural gas sold to customers. The regulator also requires that actions be taken to limit the volatility in gas prices passed on to customers. We meet this requirement through the use of NYMEX gas futures. These contracts are hedges of our natural gas purchases. Gains and losses are deferred until the month that the hedged contract settles. At 31 March 2006, deferred gains on these contracts were immaterial in the context of the Group as a whole.

During 2005/06, a number of power purchase contracts reverted to us as part of the settlement arising from USGen's bankruptcy as described on page 51. The power contracts were originally entered into prior to the restructuring of the electricity industry in New England. The power delivered is not required for our normal energy delivery activities and is sold in the energy markets at prices that are currently significantly below the amount we are required to pay. The fair value of these contracts amounted to £169 million at 31 March 2006 (not applicable at 31 March 2005). A 10% movement in the market price of electricity and gas would result in a £16 million movement in the value of these contracts assuming a US dollar to sterling exchange rate of \$1.79:£1.

We are also a party to several other power purchase arrangements entered into by the former generating business, the output of which is sold to third parties through back-to-back arrangements. The agreements extend for various terms through 2017. We recover the costs incurred under the contracts, net of proceeds received on sales, from customers as part of the US stranded cost recoveries segment.

As at 31 March 2006, our obligations under these agreements totalled \$1.3 billion (£0.7 billion) and our expected revenues from sales was \$0.9 billion (£0.5 billion). The fair value of the difference between our obligations and the expected revenues from sales is recorded in the balance sheet within commodity contract liabilities.

Commodity trading

In our UK gas transmission operations we are obliged to offer for sale, through a series of auctions (both short- and long-term), a predetermined quantity of entry capacity for every day in the year at specified locations. Where, on the day, the gas transmission system's capability is constrained, such that gas is prevented from entering the system for which entry capacity rights have been sold, then UK gas transmission is required to buy back those entry capacity rights sold in excess of system capability. Forward and option contracts are used to reduce the risk and exposure to on-the-day entry capacity prices.

Our UK electricity transmission operations have also entered into electricity options, pursuant to the requirement to stabilise the electricity market in Great Britain through the operation of BETTA. The options are for varying terms and have been entered into so that the Group has the ability to deliver electricity as required to meet its obligations under the electricity transmission licence. The Group has not and does not expect to enter into any significant derivatives in connection with its BETTA role.

Commitments and contingencies

The Group's commitments and contingencies outstanding at 31 March are summarised in the table below:

	2006 £m	2005 £m
Future capital expenditure contracted but not provided for	1,343	927
Total operating lease commitments	831	930
Power commitments	5,453	4,915
Other commitments, contingencies and guarantees	334	349

Information regarding the Group's obligations under pension and other post-retirement benefits is given below under the heading 'Pensions and other post-retirement obligations'.

The power commitments shown in the commitments and contingencies table above reflect the Group's obligation to purchase energy under long-term contracts. These contracts are used in respect of the normal sale and purchase requirements for the Group and do not include commodity contracts carried at fair value as described on page 59.

In addition to the above, we have entered into agreements to purchase KeySpan Corporation for \$7.3 billion (£4.2 billion) together with the assumption of debt of \$4.5 billion (£2.6 billion) and Southern Union's Rhode Island gas distribution network for cash consideration of \$498 million (£286 million) and assumed debt of \$77 million (£44 million) as described on page 21.

The Group proposes to meet all of its commitments from operating cash flows, existing credit facilities, future facilities and other financing which we reasonably expect to be able to secure in the future.

Contractual obligations at 31 March 2006

The table of contractual obligations shown below analyses the long-term contractual obligations of the Group according to its payment period.

Purchase obligations reflect the Group's commitments under power commitments and future capital expenditure contracted for but not provided. The other long-term liabilities reflected in the balance sheet at 31 March 2006 comprise commodity contracts carried at fair value and trade and other liabilities that represent contractual obligations.

Contractual obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Total borrowings	13,126	2,839	1,690	1,383	7,214
Derivative financial liabilities	222	92	6	7	117
Operating lease commitments	831	87	156	138	450
Purchase obligations	6,796	2,847	1,688	682	1,579
Trade and other liabilities reflected in the balance sheet	2,394	1,756	420	125	93
	23,369	7,621	3,960	2,335	9,453

Off balance sheet arrangements

There were no significant off balance sheet arrangements other than the contractual obligations and commitments and contingencies described above.

Pensions and other post-retirement obligations

UK retirement arrangements

The Group operates three UK occupational pension schemes:

- the National Grid UK Pension Scheme, formerly named the Lattice Group Pension Scheme (National Grid UK Scheme);
- the National Grid Electricity Group of the Electricity Supply Pension Scheme (National Grid Electricity Scheme); and
- the National Grid Wireless Pension Scheme, formerly named the Crown Castle UK Pension Scheme (the Wireless Scheme).

With the exception of the National Grid UK Scheme, which also has a defined contribution section, the above schemes are defined benefit pension schemes. All three defined benefit pension schemes are closed to new entrants. Membership of the defined contribution section of the National Grid UK Scheme is offered to all new employees in the UK.

Actuarial valuations of the Wireless Scheme and the National Grid UK Scheme are being carried out at 31 December 2005 and 31 March 2006 respectively and have not yet been completed. The last actuarial valuation for the National Grid Electricity Scheme was as at 31 March 2004.

The last completed full actuarial valuation of the National Grid UK Scheme was as at 31 March 2003. This concluded that the pre-tax deficit was £879 million (£615 million net of tax) in the defined benefit section on the basis of the funding assumptions adopted by the actuary. An interim annual assessment of the National Grid UK Scheme was conducted at 31 March 2005. This assessment showed that the deficit had decreased in the defined benefit section on the basis of the funding assumptions adopted by the actuary.

It has been agreed that no funding of the deficit identified in the 2003 actuarial valuation will need to be provided to the scheme until the outcome of the actuarial valuation at 31 March 2007 is known. At this point, the Group will pay the gross amount of any deficit up to a maximum amount of £520 million (£364 million net of tax) into the scheme. Until the 31 March 2007 actuarial valuation has been completed, the Group has arranged for banks to provide the trustees of the National Grid UK Scheme with letters of credit. The main conditions under which these letters of credit could be drawn relate to events which would imperil the interests of the scheme, such as National Grid Gas plc, a Group undertaking, becoming insolvent or the Group failing to make agreed payments into the fund. Employer cash contributions for the ongoing cost of the National Grid UK Scheme are currently being made at a rate of 23.7% of pensionable payroll.

The actuarial valuation of the National Grid Electricity Scheme at 31 March 2004 was completed during the year ended 31 March 2005 and revealed a pre-tax deficit of £272 million (£190 million net of tax) on the basis of the funding assumptions adopted by the actuary.

It has been agreed that no funding of the deficit identified in the 2004 actuarial valuation will need to be provided to the scheme until the outcome of the actuarial valuation at 31 March 2007 is known. At this point, the Group will pay the gross amount of any deficit up to a maximum amount of £68 million (£48 million net of tax) into the scheme. Until the 31 March 2007 actuarial valuation has been completed, the Group has arranged for banks to provide the trustees of the National Grid Electricity Scheme with letters of credit. The main conditions under which these letters of credit could be drawn relate to events which would imperil the interests of the scheme, such as National Grid Electricity Transmission plc, a Group undertaking, becoming insolvent or the Group failing to make agreed payments into the fund. Employer cash contributions for the ongoing cost of the National Grid Electricity Scheme are currently being made at a rate of 13.1% of pensionable payroll.

The last completed full actuarial valuation of the Wireless Scheme was as at 31 December 2002. This revealed that the pre-tax deficit was £3 million (£2 million net of tax) on the basis of the funding assumptions adopted by the actuary. Employer cash contributions for the ongoing cost of the Wireless Scheme are currently being made at a rate of 18.4% of pensionable payroll.

US retirement arrangements

The Group operates defined benefit pension plans for its US employees. Post-retirement healthcare and life insurance benefits are also provided to qualifying retirees.

Our US operations companies have non-contributory defined benefit pension plans covering substantially all employees. All employees, except union-represented employees, hired on or after 15 July 2002 participate in a cash balance pension plan design. Under that design, pay-based credits are applied based on service time, and interest credits are applied based on an average annual 30-year Treasury bond yield. Non-union employees hired by our New England business prior to 15 July 2002 and New England business union employees generally participate in the historic final average pay pension plans which have been in effect for several decades. In addition, a large

number of employees hired by our New York business prior to July 1998 are cash balance design participants who receive a larger benefit if so yielded under pre-cash balance conversion final average pay formula provisions. Employees hired by our New York business following the August 1998 cash balance design conversion participate under cash balance design provisions only.

Supplemental non-qualified, non-contributory executive retirement programmes provide additional defined pension benefits for certain executives.

We also provide post-retirement benefits other than pensions. Benefits include healthcare and life insurance coverage to eligible retired employees. Eligibility is based on certain age and length of service requirements and in some cases retirees must contribute to the cost of their coverage.

In New England, except in unusual circumstances, the funding policy is to contribute to the plans each year the maximum tax-deductible amounts for that year. In New York, the funding policy is determined largely by our settlement agreements with the New York Public Service Commission and the amounts recovered in rates. However, the contribution for any year will not be less than the minimum contribution required by federal law or greater than the maximum tax-deductible amount.

We manage our benefit plan investments to minimise the long-term cost of operating the plans, with a reasonable level of risk. Risk tolerance is reviewed based on the results of a periodic asset/liability study. This study includes an analysis of plan liabilities and funded status and results in the determination of the allocation of assets across equity and fixed income. Equity investments are broadly diversified across US and non-US equities, as well as across growth, value, and small and large capitalisation equity. Likewise, the fixed income portfolio is broadly diversified across the various fixed income market segments. For the other post-retirement benefits, since the earnings on a portion of the assets are taxable, those investments are managed to maximise after-tax returns consistent with the broad asset class parameters established by the asset allocations. Investment risk and return are reviewed on a quarterly basis.

Details of material litigation to which the Group was a party at 31 March 2006

The Group was not party to litigation that was considered to be material at 31 March 2006.

Related party transactions

The Group provides services to and receives services from related parties. In the year ended 31 March 2006, the Group charged £4 million and received charges of £32 million from its related parties (other than Directors) compared with £4 million and £24 million respectively in 2004/05.

Further information on related party transactions is contained within note 34 to the accounts.

Accounting policies

Basis of accounting

The consolidated financial statements present our results for the years ended 31 March 2006 and 2005 and our financial position as at 31 March 2006 and 2005. They have been prepared using the accounting policies shown, in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

We also provide a reconciliation from our results and financial position as prepared under IFRS to the results and financial position as if they had been prepared in accordance with generally accepted accounting principles in the United States (US GAAP), together with condensed US GAAP financial information. A discussion of the principal differences between IFRS and US GAAP is provided on pages 66 and 67.

Segmental reporting

In addition to presenting the consolidated financial results and financial position in the financial statements, we provide a breakdown of those results and balances into our business segments. The presentation of segment information is based on the management responsibilities that existed at 31 March 2006. Our business segments are UK electricity and gas transmission, US electricity transmission, UK gas distribution, US electricity and gas distribution, US stranded cost recoveries and Wireless infrastructure, with our other businesses and corporate activities, including business development, being aggregated within Other activities. Our geographical segments reflect the Group's principal activities in the UK and the US.

UK LNG storage activities and the Scottish and French electricity interconnectors are now included within the UK electricity and gas transmission segment, having previously been reported within Other activities. This change in segmental presentation follows a change in the organisational and management structure within the Group and the change in regulatory arrangements for the Scottish interconnector following the introduction of BETTA.

The results of the four gas distribution networks sold on 1 June 2005 are no longer included within the UK gas distribution segment, but are instead presented as discontinued operations.

Adoption of IFRS

With effect from 1 April 2005, we present our consolidated financial statements in accordance with IFRS.

Note 1 to the consolidated financial statements presents the impact of conversion from UK GAAP to IFRS on the financial results for the year ended 31 March 2005 and the financial position at 31 March 2005 and 1 April 2004. As permitted by the US Securities and Exchange Commission, only one year of IFRS comparatives are included in the financial statements for the year ending 31 March 2006 and hence the results for the year ended 31 March 2004 have not been presented under IFRS.

The principal differences in our reported results and financial position between UK GAAP and IFRS are as follows:

Replacement expenditure	Replacement expenditure, primarily relating to our UK gas distribution networks, was expensed under UK GAAP but is capitalised under IFRS.
Regulatory assets	Regulatory assets, principally representing the right to recover revenues in the future from customers in accordance with rate plans, were recorded as assets under UK GAAP. Under IFRS these are not recognised as assets.
Goodwill and intangible assets	Goodwill was amortised under UK GAAP. Under IFRS goodwill is not amortised, and we have elected to retain the goodwill balance under UK GAAP at 31 March 2004 as our brought forward goodwill balance at 1 April 2005 under IFRS. Under IFRS more intangibles, such as customer relationships acquired in a business combination, are recognised as assets than was the case under UK GAAP. These intangible assets are amortised over their useful economic lives.
Post-retirement benefits	Under IFRS the actuarially calculated value of obligations in respect of pensions and other post-retirement benefit plans are recorded in the balance sheet, net of the market value of scheme investments. Changes in the value of the net liability that differ from the actuarially calculated service cost and expected investment returns and interest charges are recorded as actuarial gains and losses in the statement of recognised income and expense.
Deferred taxation	Deferred tax under UK GAAP was recorded based on timing differences. Under IFRS deferred tax is recorded based on temporary differences, in most cases being the difference between an asset's or a liability's carrying value in the balance sheet and its associated tax basis.
Proposed final dividend	Under UK GAAP the proposed final dividend was recorded as a liability in the balance sheet. Under IFRS it is not recorded as a liability until the subsequent financial period.

Summary of the impact of adoption of IFRS

The impact of the adoption of IFRS on net assets at 31 March 2005 and 1 April 2004 can be summarised as follows:

	31 March 2005 £m	1 April 2004 £m
Net assets as reported under UK GAAP	1,391	1,271
Replacement expenditure	3,014	2,778
Non recognition of regulatory assets	(1,587)	(1,791)
Goodwill and intangible assets	127	–
Post-retirement benefits	(1,149)	(1,382)
Deferred taxation	(95)	(84)
Proposed final dividend	469	366
Non-equity minority interests	(22)	(38)
Other	(27)	(10)
Net assets reported under IFRS	2,121	1,110

The impact of the adoption of IFRS on the profit for the year ended 31 March 2005 can be summarised as follows:

	2005 £m
Profit for the year as reported under UK GAAP	907
Replacement expenditure	236
Non recognition of regulatory assets	151
Goodwill and intangible assets	105
Post-retirement benefits	41
Deferred taxation	(11)
Non-equity minority interests	(2)
Other	(3)
Profit for the year reported under IFRS	1,424
Less: profit for the year from discontinued operations	(304)
Profit for the year from continuing operations	1,120

Accounting for financial instruments

On 1 April 2005, we implemented new accounting policies for financial instruments on the adoption of IAS 32 and IAS 39. As a consequence, derivative financial instruments are recorded on the balance sheet at fair value, with changes in those values recorded in the income statement or in equity. Our new accounting policies are described on pages 97 and 98.

The impact of the adoption was to increase net debt by £348 million from £13,638 million to £13,986 million, and to reduce net assets by £43 million as described in note 2 to the accounts.

As permitted by IFRS 1, we adopted IAS 32 and IAS 39 with no restatement of comparatives, and so the balance sheet at 31 March 2005 and the income statement for the year then ended have not been restated for these changes in accounting policies.

Choices made in adopting IFRS

We were required to make a number of choices on the adoption of IFRS. The principal choices available to us and the choices adopted were as follows:

Option	Choices available	Choice adopted
Date of transition to IFRS	1 April 2003 – two periods of IFRS comparatives 1 April 2004 – one period of IFRS comparatives	1 April 2004 – one period of IFRS comparatives
Business combinations	Restate some or all previous combinations Do not restate prior business combinations	Do not restate prior business combinations (in particular, retain merger accounting for Lattice merger)
Pensions	Recognise actuarial gains and losses each year Adopt 'corridor' method going forward Adopt 'corridor' method retrospectively	Recognise actuarial gains and losses each year in the statement of recognised income and expense
Financial instruments	Adopt IAS 39 retrospectively Adopt IAS 39 on 1 April 2004 Adopt IAS 39 on 1 April 2005	Adopt IAS 39 on 1 April 2005
Carrying value of assets at date of transition	Depreciated cost (adjusted for IFRS changes) Fair value at date of transition	Depreciated cost (adjusted for IFRS changes) in most cases
Share-based payments	Recognise all active grants retrospectively Recognise only grants since 7 November 2002	Recognise all active grants retrospectively (already adopted under UK GAAP with FRS 20)
Cumulative translation differences on foreign subs	Restate cumulative translations retrospectively Cumulative differences from 1 April 2004 only	Cumulative differences from 1 April 2004 only
Joint ventures	Equity account jointly controlled entities Proportionally consolidate jointly controlled entities	Equity account jointly controlled entities
Use of UK GAAP or IFRS in individual accounts	Adopt IFRS for parent company and subsidiaries IFRS for parent, UK GAAP for subsidiaries Retain UK GAAP for parent and UK subsidiaries	Retain UK GAAP for parent and subsidiaries' individual financial statements

Critical accounting policies

The application of accounting principles requires us to make estimates, judgements and assumptions that may affect the reported amounts of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities in the accounts. On an ongoing basis, we evaluate our estimates using historical experience, consultation with experts and other methods that we consider reasonable in the particular circumstances to ensure compliance with IFRS and US GAAP respectively. Actual results may differ significantly from our estimates, the effect of which is recognised in the period in which the facts that give rise to the revision become known.

Certain of the Group's accounting policies have been identified as critical accounting policies, as these policies involve particularly complex or subjective decisions or assessments. The discussion of critical accounting policies below should be read in conjunction with the description of the Group's accounting policies set out in the Group financial statements. Where critical accounting policies adopted under US GAAP are significantly different from the ones adopted under IFRS, additional information is included in the discussion on our US GAAP accounting on pages 66 and 67.

Our critical accounting policies and accounting treatments are considered to be:

Estimated asset economic lives	<p>The reported amounts for amortisation of intangible fixed assets and depreciation of property, plant and equipment can be materially affected by the judgements exercised in determining their estimated economic lives.</p> <p>Intangible asset amortisation and depreciation of property, plant and equipment for continuing operations amounted to £57 million and £895 million respectively in 2005/06 and £45 million and £774 million respectively in 2004/05.</p>
Carrying value of assets and potential for impairments	<p>The carrying value of assets recorded in the consolidated balance sheet could be materially reduced if an impairment were to be assessed as being required. Our total assets at 31 March 2006 were £25,924 million, including £18,935 million of property, plant and equipment, £2,142 million of goodwill and £321 million of other intangible assets. Impairment reviews are carried out either when a change in circumstance is identified that indicates an asset might be impaired or, in the case of goodwill, annually. An impairment review involves calculating either or both of the fair value or the value-in-use of an asset or group of assets and comparing with the carrying value in the balance sheet. These calculations involve the use of assumptions as to the price that could be obtained for, or the future cash flows that will be generated by, an asset or group of assets, together with an appropriate discount rate to apply to those cash flows.</p>
Revenue accruals	<p>Revenue includes an assessment of energy and transportation services supplied to customers between the date of the last meter reading and the year end. Changes to the estimate of the energy or transportation services supplied during this period would have an impact on the reported results of the Group.</p> <p>Our estimates of unbilled revenues in 2005/06 amounted to £169 million in the US and £268 million in the UK compared with £130 million and £276 million respectively in 2004/05.</p>

Assets and liabilities carried at fair value	<p>Certain assets and liabilities, principally financial investments, derivative financial instruments and certain commodity contracts are carried in the balance sheet at their fair value rather than historical cost.</p> <p>The fair value of financial investments is based on market prices, as are those of derivative financial instruments where market prices exist. Other derivative financial instruments and those commodity contracts carried at fair value are valued using financial models, which include judgements on, in particular, future movements in exchange and interest rates as well as equity and commodity prices.</p>
Hedge accounting	<p>We use derivative financial instruments to hedge certain economic exposures arising from movements in exchange and interest rates or other factors that could affect either the value of our assets or liabilities or affect our future cash flows.</p> <p>Movements in the fair values of derivative financial instruments may be accounted for using hedge accounting where we meet the relevant eligibility, documentation and effectiveness testing requirements. If a hedge does not meet the strict criteria for hedge accounting, or where there is ineffectiveness or partial ineffectiveness, then the movements will be recorded in the income statement immediately instead of being recognised in the statement of recognised income and expense or being offset by adjustments to the carrying value of debt.</p>
Pensions and other post-retirement benefit plans	<p>Pensions and other post-retirement benefit obligations recorded in the balance sheet are calculated actuarially using a number of assumptions about the future including inflation, salary increases, length of service and pension and investment returns, together with the use of a discount rate based on corporate bond yields to calculate the present value of the obligation.</p> <p>The selection of these assumptions can have a significant impact on both the pension obligation recorded in the balance sheet and on the net charge recorded in the income statement.</p>
Assets held for sale and discontinued operations	<p>At 31 March 2005, the planned sales of four of our regional gas distribution networks did not meet the criteria to be classified as assets held for sale. On 1 May 2005, these criteria were met and the assets and liabilities of these businesses were classified as assets held for sale and depreciation ceased from that date until their disposal on 1 June 2005.</p> <p>The results of these operations have been classified as discontinued operations and the comparatives reclassified accordingly.</p> <p>The determination of the date that the planned sales met the criteria to be classified as assets held for sale is a matter of judgement by management, with consequential impact on balance sheet presentation and the amount recorded for depreciation in the results of the discontinued operation.</p>

Exceptional items	Exceptional items, in particular restructuring costs, are items of income or expense that are identified as being material or one-off in nature that need to be separately identified in the income statement. Restructuring costs principally comprise severance or other costs necessary to complete a major programme of restructuring. Judgement is required in deciding the classification of items as exceptional.
Provisions	Provision is made for liabilities that are uncertain in timing or amount of settlement. These include provisions for the cost of environmental restoration and remediation, asset decommissioning, restructuring and employer and public liability claims. Calculations of these provisions are based on estimated cash flows relating to these costs, discounted at an appropriate rate where the impact of discounting is material. The total costs and timing of cash flows relating to environmental and decommissioning liabilities are based on management estimates supported by the use of external consultants. At 31 March 2006, we have recorded provisions totalling £771 million (2005: £791 million), including £429 million (2005: £491 million) and £127 million (2005: £105 million) in respect of environmental and decommissioning liabilities respectively.
Tax estimates	The Group's tax charge is based on the profit for the year and tax rates in effect. The determination of appropriate provisions for taxation requires us to take into account anticipated decisions of tax authorities and estimate our ability to utilise tax benefits through future earnings and tax planning. Our estimates and assumptions may differ from future events.
In order to illustrate the impact that changes in assumptions could have on our results and financial position, the following sensitivities are presented:	
Assets' useful economic lives	An increase in the useful economic lives of assets of one year on average would reduce our annual depreciation charge on property, plant and equipment by approximately £40 million and our annual amortisation charge on intangible assets by £9 million.
Revenue accruals	A 10% change in our estimate of unbilled revenues at 31 March 2006 would result in an increase or decrease in our recorded net assets and profit for the year of approximately £22 million net of tax.
Assets carried at fair value	A 10% change in assets and liabilities carried at fair value would result in an increase or decrease in the carrying value of derivative financial instruments and commodity contract liabilities of £44 million and £49 million respectively.
Hedge accounting	If the gains and losses arising on derivative financial instruments during the year ended 31 March 2006 had not achieved hedge accounting, the profit for the year would have been £131 million lower than that reported net of tax and net assets would have been £1 million lower.
Provisions	A 10% change in the estimates of future cash flows in respect of provisions for liabilities would result in an increase or decrease in net assets of approximately £50 million net of tax.

Accounting developments

New IFRS accounting standards and interpretations adopted in 2005/06

In preparing its consolidated financial statements, the Group has complied with International Financial Reporting Standards, International Accounting Standards and interpretations applicable for periods beginning on or after 1 April 2005.

Capital resource disclosures	'Amendment to IAS 1: Presentation of Financial Statements' requires new disclosures to be made about management of capital resources and compliance with capital requirements.
Actuarial gains and losses	'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures' enables actuarial gains and losses in respect of the Group's defined benefit schemes to be recognised in the statement of recognised income and expense.
Cash flow hedges	'Amendment to IAS 39 Financial Instruments: Recognition and Measurement: Cash Flow Hedge Accounting of Forecast Intra-group Transactions' allows the foreign currency risk of a highly probable forecast intra-group transaction to qualify as a hedged item in consolidated financial statements, provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.
Financial instrument disclosures	IFRS 7 'Financial Instruments: Disclosures' replaces the disclosure requirements in IAS 32 and locates in one place all disclosures relating to financial instruments. The new requirements incorporate many of IAS 32's disclosures as well as additional qualitative and quantitative disclosures on the risks arising from financial instruments.

Forthcoming changes in IFRS

The following accounting standards and interpretations have not yet been adopted, but are expected to be adopted by the Group in future periods. Implementation of the following interpretations are not expected to have a material impact on the Group's results or assets and liabilities.

Leases	International Financial Reporting Interpretations Committee (IFRIC) No. 4 'Determining whether an arrangement contains a lease' provides guidance on determining whether arrangements which convey the right to use an asset in return for a series of payments should be accounted for in accordance with IAS 17 'Leases'.
Share-based payments	IFRIC 8 'Scope of IFRS 2' addresses the issue of whether IFRS 2 'Share Based Payment' applies to transactions in which the entity cannot identify specifically some or all of the goods or services received.
Embedded derivatives	IFRIC 9 'Reassessment of Embedded Derivatives' prohibits reassessment of the treatment of embedded derivatives subsequent to initial recognition unless there is a change in the terms of the contract that significantly modifies the cash flows which otherwise would be required under the contract, in which case reassessment is required.

US GAAP reporting

Overview

The consolidated financial statements have been prepared in accordance with IFRS, which differs in certain significant respects from US GAAP. A reconciliation of net income and equity shareholders' funds from IFRS to US GAAP, together with a summary of adjustments, is provided in note 37 to the accounts. In addition, condensed income statements, balance sheets and segmental information prepared in accordance with US GAAP are provided in note 38 to the accounts.

Results and financial position under US GAAP

Net income from continuing operations for 2005/06 under US GAAP was £711 million (2004/05: £1,037 million). The US GAAP results for 2005/06 and 2004/05 included profits relating to discontinued operations amounting to £596 million and £267 million respectively. Consequently, net income for 2005/06 under US GAAP was £1,307 million (2004/05: £1,304 million). This compared with the profit for the year under IFRS for 2005/06 and 2004/05 of £3,850 million and £1,424 million respectively.

Shareholders' equity under US GAAP at 31 March 2006 was £9,747 million (2005: £10,591 million) compared with £3,842 million (2005: £2,111 million) under IFRS. Because the application of merger accounting principles retained under IFRS has fundamentally affected the comparison of IFRS results with US GAAP results, the following is a discussion of the impact the application of US GAAP has had on the results, which should be read in conjunction with the rest of this Operating and Financial Review.

The principal adjustments from net income and total shareholders' equity under IFRS to their equivalents under US GAAP relate to differences in accounting for the business combination with Lattice Group as a purchase instead of as a merger, US regulatory accounting, the recording of derivative financial instruments at their fair value in the balance sheet and hedge accounting; and differences in accounting for pensions. The other adjustments between IFRS and US GAAP are explained in more detail in note 37 to the accounts.

Some of the adjustments included within the US GAAP summary income statements and balance sheet substantially reflect reclassifications of items that are presented differently under IFRS and US GAAP, but that do not significantly impact net income or net assets.

Merger with Lattice Group

The application of UK GAAP to the business combination of National Grid Group and Lattice Group in 2002/03 resulted in the transaction being treated as a merger. As permitted by IFRS, merger accounting for this transaction continues under IFRS. Under US GAAP, purchase accounting was applied rather than merger accounting, and National Grid Group (now National Grid) was viewed as the acquirer of Lattice Group.

The results of the Group under US GAAP include the results of Lattice Group only from 21 October 2002, the date of the business combination and not prior to that date.

In addition, the recognition of Lattice Group's assets and liabilities at fair value under US GAAP resulted in £3,824 million of goodwill being recognised.

The former Lattice Group assets included the four regional gas distribution networks that were disposed of in 2005/06. The higher book value of these assets under US GAAP resulted in a significantly lower gain recognised on disposal. The gain on disposal under US GAAP was £2 billion lower than under IFRS.

Regulatory assets

These assets are recorded in the US GAAP balance sheet in accordance with the principles of SFAS 71 'Accounting for the Effects of Certain Types of Regulation'. SFAS 71 provides that certain costs may be deferred on the balance sheet (referred to as 'regulatory assets') if it is probable that the costs will be recovered through future increases in regulated revenue rates. An entity applying SFAS 71 does not need absolute assurance prior to capitalising a cost, only reasonable assurance. If the principles of SFAS 71 were not applicable, it is likely that this would result in the full or partial non-recognition of these regulatory assets and thereby materially alter the view given under US GAAP.

The total carrying value of regulatory assets, under US GAAP, at 31 March 2006 amounted to £3,051 million (£3,350 million at 31 March 2005).

Derivatives

Under US GAAP, all derivatives are recorded at fair value except those that qualify for exemptions, such as normal purchase rules for commodity contracts. Changes in fair values of derivatives not designated as a hedge under US GAAP are recorded through earnings. The Group applies a hedging strategy which meets IFRS requirements, but many of these hedges do not meet the requirements to achieve hedge accounting under US GAAP. This results in a much greater volatility in the US GAAP income statements. Under IFRS, the Group did not adopt IAS 39 until 1 April 2005 and, therefore, did not record derivatives at fair value in the year ended 2004/05. Upon adoption of IAS 39, the Group recorded its outstanding derivatives at fair value and took advantage of certain transition accommodations that allowed for hedge accounting. These transition alternatives were not available under US GAAP.

Pensions Under US GAAP, when the amount of pension scheme assets is less than the accumulated benefit obligation of that scheme, a minimum pension liability is recognised. When compared with IFRS, differences in the measurement of pension obligations, plan assets, and periodic pension expense exist. The primary difference is the fact that under US GAAP, the Group includes actuarial gains and losses as a component of periodic pension expense but, under IFRS, these items are recorded directly to equity. Differences in key assumptions used to measure plan assets and obligations also create differences.

New US accounting pronouncements adopted during 2005/06

During 2005/06, the Group adopted the following US GAAP accounting interpretations issued by the US Financial Accounting Standards Board (FASB).

Asset retirement obligations *FASB interpretation No. 47 'Accounting for Conditional Asset Retirement Obligations'* (FIN 47) clarified that the term 'conditional asset retirement obligation', as used in SFAS No. 143 'Accounting for Asset Retirement Obligations' (SFAS 143), refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the Group.

The adoption of FIN 47 did not have a material impact on the US GAAP consolidated financial statements.

Recent US pronouncements not yet adopted

In preparing the US GAAP reconciliation for 2005/06 we have not reflected the impact of recent US accounting pronouncements that are expected to be adopted in future periods. The most notable of these are:

Share-based payments *FASB Statement No. 123 'Share Based Payment'* (SFAS 123(R)) requires all share-based payments to employees, including grants of employee stock options, to be recognised in the income statement based on their fair values. Pro forma disclosure is no longer an alternative.

SFAS 123(R) is similar to IFRS 2, and to the method already adopted by the Group under FASB Statement No. 148 'Accounting for Stock Based Compensation – Transition and Disclosure'.

Adoption of SFAS 123(R) is not expected to have a material impact on our results of operations or financial position under US GAAP when it is adopted on 1 April 2006.

Exchanges of non-monetary assets *FASB Statement No. 153 'Exchanges of Non-Monetary Assets'* (SFAS 153) removes an exemption in APB Opinion No. 29 'Accounting for Non-Monetary Transactions' (APB 29) which permitted exchanges of similar productive assets to be accounted for at the carrying value of the assets relinquished. All non-monetary transactions (apart from those without commercial substance) must in future be recorded at fair value.

The impact of the adoption of SFAS 153 cannot be predicted at this time because it will depend on whether applicable non-monetary transactions take place after 1 April 2006.

Carrying value of inventories *FASB Statement No. 151 'Inventory Costs – an amendment of ARB No. 43'* (SFAS 151) clarifies that abnormal amounts of idle facility expense, freight handling costs and wasted materials (spoilage) should be recognised as current period expense.

The adoption of SFAS 151 is not expected to have a material effect on our results or financial position under US GAAP.

Accounting for changes in accounting policies *FASB Statement No. 154 'Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3'* (SFAS 154) requires retrospective application of prior periods' financial statements for changes in accounting principle.

The adoption of SFAS 154 on 1 April 2006 will not have a material effect on our US GAAP results and financial position. However, there would be significant differences in the presentation of changes in US GAAP accounting policies if changes were to be made in future periods compared with current requirements.

Hybrid financial instruments *FASB Statement No. 155 'Accounting for Certain Hybrid Financial Instruments – an amendment of SFAS No. 133 and SFAS No. 140'* (SFAS 155) provides a fair value measurement option for certain hybrid financial instruments, which allows the recording of an entire financial instrument at fair value rather than accounting for the host instrument and the embedded derivative separately, simplifying the accounting for these instruments. It also requires that beneficial interests in securitised financial assets be analysed to determine whether they are freestanding derivatives or they are hybrid instruments that contain embedded derivatives requiring separate recognition.

The adoption of SFAS 155 is not expected to have a material effect on our results or financial position under US GAAP.