Annual Report and Accounts 2005/06
National Grid Gas plc

Safety

Reliability

Efficiency

Responsibility

nationalgrid

Contents

01 Chairman's Statement
02 Business Review
04 Operating and Financial Review
28 Directors' Report
32 Statement of Directors' Responsibilities
33 Independent Auditors' Report
34 Group Accounting Policies
40 Group Income Statement
41 Group Balance Sheet
42 Group Statement of Recognised Income and Expense
43 Group Cash Flow Statement
44 Notes to the Accounts
73 Company Accounting Policies
76 Company Balance Sheet
77 Notes to the Company Accounts
83 Definitions

Chairman's Statement

Financial performance
The Group's adjusted operating profit* was up by £104 million to £862 million compared to last year. This was primarily a result of reduced UK gas distribution controllable operating costs and the effect of colder weather on our revenues.

Strategy
As an infrastructure based network provider, it is essential that we deliver high standards of service and reliability as well as outperforming our benchmarks and regulatory targets. We need to continue managing our regulatory relationships successfully to benefit both our customers and shareholders of the National Grid group. Our disciplined approach to capital management remains paramount.

Progress
Delivering our strategy involves the continued focus on our key strengths of operational excellence, our ability to exceed our efficiency targets, and our prudent use of capital. Investment in our current businesses and strategic opportunities are made only where we believe we can create shareholder value.

Our parent company, National Grid, has re-branded its businesses during the year, adopting the National Grid name as a common identity. As part of this re-branding, Transco has become National Grid Gas and is implementing a new livery for its vehicle fleet, as they are replaced.

Our regulatory controls provide significant incentives towards improving operational efficiency by permitting the sharing of the benefits of increased efficiencies between energy users and shareholders. This year we have added to our impressive cost efficiency track record when UK gas distribution achieved its cost-efficiency target one year early.

* Excludes the impact of exceptional items and remeasurements.

On 1 June 2005 we completed the sales of four of our regional gas distribution networks for a total cash consideration of £5.8 billion. This creates, what is in effect, a new gas distribution market in the UK. We have retained four of the networks, which together represent the largest of the UK gas distribution businesses.

Our safety performance has continued to improve through the implementation of best practice with a further 44% reduction in lost time injuries. Once again, we exceeded all our safety related standards of service.

Investment
Investment in our networks remains a priority for the Group. Total investment reached £0.9 billion this year, up by 50% on last year's £0.6 billion. We expect it will stay at or above £1.0 billion each year over the medium term.

Investment in UK gas transmission is primarily due to new infrastructure required to meet the changing gas supply pattern as the UK becomes a net importer of gas. This includes our largest ever project, connecting the new LNG (liquefied natural gas) terminals currently being built at Milford Haven. This will require investment of more than £750 million over the next two years.

Outlook
Our priority remains to create value for National Grid's shareholders through the efficient delivery of our regulatory contracts, while maintaining the drive for continuous improvement in safety, reliability, efficiency and responsibility.

Business Review

What we do

National Grid Gas is a part of National Grid, an international network utility. National Grid is dedicated to becoming the world's premier network utility. National Grid's core skills are in the management of large and complex networks. Its businesses are concerned with energy delivery and related services where core skills can be exploited to create value.

UK gas transmission

We own and operate the gas transmission network for Great Britain. This is the high-pressure gas pipeline network that runs across the country, comprising 4,282 miles of high-pressure gas pipelines.

UK gas distribution

Our UK gas distribution business comprises almost half of Great Britain's gas distribution system. These are the gas pipelines that service homes and businesses. Our gas distribution business is the largest gas distribution network in the country. It comprises 82,000 miles of distribution pipelines, distributing gas to 11 million homes and businesses in England. It covers an area from the North West, through the Midlands and Eastern England, to North London.

On 1 June, we successfully completed the sales of four gas distribution networks for £5.8 billion.

We also continue to operate the UK national gas emergency number for our networks, the sold networks and other gas transporters.

We achieved our 35% controllable cost reduction target one year early.

UK gas metering

Our UK gas metering business provides metering and meter reading services in the regulated gas metering market throughout Great Britain.

Our brand promise

This is the way National Grid Gas approaches the delivery of all its services in all the communities in which it operates:

Safety

Nothing we do is more important than the safety of our employees, contractors, customers and the general public. A sustainable business must operate to the highest safety standards.

Reliability

Our society depends on the reliable transmission and distribution of gas. National Grid Gas is focused on the highest levels of reliability, developing our networks and other businesses to meet the changing patterns of supply and demand.

Efficiency

We aim to deliver world-class operational and financial performance. Our culture enables us to improve continuously against demanding targets for safety, reliability and customer service and to enhance value for our shareholders.

Responsibility

We are committed to operating in a responsible way that contributes to society. In all our activities we operate within National Grid's Framework for Responsible Business.

Safety

Following the sales of four of our gas distribution networks, we continue to operate the UK national gas emergency number (0800 111 999) for our networks, the sold networks and other gas transporters. During 2005/06, we handled approximately 2.5 million calls to the national gas emergency number.

We again exceeded our targets on safety-related standards of service for the four gas distribution networks we continue to own.

More than 97% of 'uncontrolled' gas escapes (where the gas leak cannot be stopped by turning the gas supply off at the meter) were attended within one hour. More than 98% of 'controlled' gas escapes (where the gas leak can be stopped at the meter) were attended within two hours.

Reduction in lost time injuries

Safety will always be at the centre of everything we do. During 2005/06, 36 of our employees received injuries that resulted in them taking time off work, a 44% reduction compared on a like-for-like basis with 2004/05.

The employee lost time injury frequency rate provides a more accurate indicator of year-on-year performance by taking into account changes in employee numbers. The number of employee lost time injuries per 100,000 hours worked in 2005/06 fell to 0.2, a 44% improvement when compared with the previous year.

There has also been a significant reduction in the number of contractor lost time injuries, falling from 57 in 2004/05 to 41 in 2005/06, a 28% decrease.

Golden Rules for safety

National Grid's Golden Rules for UK gas operations are a fundamental building block for our 'Road to Zero'. The Road to Zero is our five-year programme to reach the target of zero injuries. The Golden Rules are a framework that will help everyone in the business to be safe in everything they do. These rules apply as much to working in offices as they do to working on site.

The Golden Rules do not introduce new policies and procedures. They reinforce what we should be doing all the time, setting the standards for good safety behaviours and continuing to develop the culture whereby safety becomes second nature. They will also be used to identify areas where improvements can be made to make our working practices and behaviours even safer.

Reliability

Investment in gas distribution networks

UK gas distribution invested £444 million in the reinforcement, extension and replacement of the UK gas distribution network 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). Replacement expenditure increased from £255 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 Health and Safety Executive. This enabled us to de-commission approximately 1,700 km of gas main/old gas pipe in 2005/06 compared to 1,458 km in 2004/05.

Gas Operations fulfils the role of UK Gas Transmission System Operator

Operating from a newly established control facility, the Gas National Control Centre (GNCC) is responsible for operating Great Britain's gas transmission network safely, effectively and efficiently, managing the flow of gas from suppliers to customers. We ensure all gas entering the gas transmission network meets the appropriate quality standards. We operate the system in accordance with appropriate legislation and the Health and Safety Executive safety case, whilst facilitating equitable and transparent access to all market participants.

The GNCC operates around 4,300 miles of high pressure transmission pipeline across Great Britain, facilitating the transportation of around 100 billion cubic metres of gas per year to power stations, industrial and commercial customers and approximately 20 million domestic customers.

Efficiency

Way Ahead

Following completion of the 'Way Ahead' restructuring programme in UK gas distribution, a series of strategic development initiatives has been successfully 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. Having completed the Way Ahead transformation we are now concentrating on continuous improvement techniques to refine our existing business processes.

Automated meter reading

Available to businesses via their gas suppliers, our UK gas metering business is now installing smart meter units for monthly and six-monthly read gas meters. The new technology logs data remotely and uses either SMS text message or GPRS to send the meter reading data to the customer.

Benefits to commercial users include synchronised billing for multi-sites, identification of energy wastage and better management of cost.

Responsibility

As a part of National Grid it is important to us that we promote and maintain National Grid's reputation as a company that manages its businesses in a responsible way and which contributes to all societies in which it operates.

Group awarded top grade for apprentice scheme

National Grid has been ranked among the top 10 per cent of UK employers for its engineering apprenticeship scheme. The company has been awarded Grade 1 – one of the few UK energy organisations to achieve the top mark – for outstanding leadership and management of its scheme by the Adult Learning Inspectorate, the Government body that monitors the standards of industry education and training. The grade recognises National Grid's standards in a range of areas, including attraction and recruitment, learning plans for apprentices and contractual requirements set out by the Learning and Skills Council.

National Grid Gas' apprentices are on a three year scheme and receive practical on and off the job training through National Grid's training centre at Eakring.

Inclusion and diversity

Women in Networks is a network for women in the UK and the US to provide an opportunity to bring together employees who share a common interest in making National Grid a great place to work. Its aim is to allow employees to share and explore some of the issues affecting women in the workplace.

Women in Networks was launched on 29 November with a live cross-Atlantic link. The UK event took place at the Heritage Motor Museum in Warwick, attended by about 200 people. Deputy Group Chief Executive of National Grid, Steve Holliday, launched the UK event and Mike Jesanis, Chief Executive of National Grid in the US, did the same in the US.

Energy delivery and climate change

National Grid's Framework for Responsible Business includes a commitment to make our contribution to minimising climate change. The Board of National Grid agreed our long term strategy, mapping out how we will achieve this as well as contributing to the UK Government's long-term emission reduction targets.

During 2005/06, our direct and indirect emissions of greenhouse gas amounted to some 3.7 million tonnes CO_2 equivalent, a 35% reduction compared with 2004/05. This reduction largely results from the sale of the four UK gas distribution networks during the year.

Operating and Financial Review

This Operating and Financial Review describes the main trends and factors underlying the development, performance and position of National Grid Gas 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 Gas

Principal operations

We are a part of the National Grid group of businesses. Our principal operations are in regulated gas networks and comprise the transmission and distribution of gas and the provision of gas metering services within Great Britain.

History

National Grid Gas originated from the restructuring of the UK gas industry in 1986. 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.

Key milestones

1986	British Gas incorporated as a public limited company
1997	British Gas demerged Centrica
1999	Financial and restructuring programme completed leading to creation of a new parent company, BG Group, separation of the regulated Transco business from the other businesses of BG Group and the establishment of a financial ring-fence around Transco
2000	Lattice Group, including Transco, demerged from BG Group
2002	Merger of Lattice Group and National Grid to form National Grid Transco
2005	Sales of four UK regional gas distribution networks
2005	National Grid Transco renamed National Grid and National Grid adopted as the group brand name
2005	Transco renamed National Grid Gas

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 gas transmission	Owner and operator of the gas transmission network in Great Britain and storage facilities for liquefied natural gas (LNG).
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.
Other Businesses and corporate activities	UK gas metering	The provision of regulated gas metering and meter reading services in Great Britain.
	Other activities	Corporate activities.

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 one-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.

External market environment

The principal market in which we operate is the gas energy market in the UK.

Gas energy market in the UK

The supply of gas in the UK is 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 gas producers or importers 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.

Energy is transported through the gas transmission network to regional gas distribution networks that then deliver that energy to consumers. We are the owner and operator of the gas transmission network and of four of the eight regional gas distribution networks in Great Britain, and transport gas through our networks on behalf of gas shippers. Contractual arrangements between the shippers and ourselves are set out in the Uniform Network Code.

Energy market developments
The UK is entering a period of changing supply patterns for both gas and electricity, as more reliance is placed on imported gas. The decline in UK continental shelf gas reserves and the UK Government's emphasis on combating climate change mean that we continue to see a trend toward greater use of imported gas for both consumption and use in power generation.

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

Regulatory environment

As a result of our position in, and importance to, the UK economy, our gas transmission and distribution businesses are subject to UK and European Union laws and regulations.

In the UK, our businesses are regulated under the Gas Act 1986 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.

Our businesses are covered by safety legislation which is enforced by the Health and Safety Executive (HSE) in the UK. 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.

National Grid Gas has securities which are listed on the London Stock Exchange and on the New York Stock Exchange. Accordingly, 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 15 to 20.

Regulatory developments
Regulatory developments in the UK during the year included:

- on 1 May 2005, our UK gas transmission business and UK gas distribution business (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; and
- Ofgem intends to extend the current gas distribution price control review 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.

Business drivers

Our principal activities include the operation of highly complex gas 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	The prices we charge for use of our gas transmission and distribution networks are determined in accordance with regulator-approved price controls in the UK. The negotiation of these arrangements has a significant impact on the revenues we obtain from our operations. In addition, these arrangements include incentives that permit us to earn additional revenues based on our performance or penalise us if we do not meet various targets. 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.
Safety and reliability	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.
Efficiency	Our objective, and that of our regulators, is for us 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 shareholders.
Capital investment	Capital investment is a significant driver for organic growth. In our regulated energy networks, the prices we charge include an allowed return for capital investment determined in accordance with our price controls. These provide incentives for us to enhance the quality and reach of our networks through capital improvements.
Acquisitions and disposals	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.
Responsibility	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.

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	Changes in the quantities of gas delivered through our transmission and distribution networks may result in an increase or decrease in our revenues. 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.

Commodity and pass-through costs	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. We are allowed to recover certain costs 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.
Inflation	Without action to improve efficiency, our operating costs 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. Our price controls in the UK are linked to retail price inflation.
Seasonality	Revenues from our gas transmission and distribution networks 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. With the exception of commodity costs, our operating costs are generally not seasonal.
Interest rates	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.

Objectives and strategy

Our principal objective is to create value for National Grid's shareholders, by helping National Grid achieve its 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 or 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 gas 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.

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.

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.

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 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	Number of significant direct environmental incidents
		Greenhouse gas emissions per £m of revenue
		Total amount of fines from environmental prosecutions
	Employ an inclusive and diverse work-force	Percentage of female employees
		Percentage of ethnic minority employees
Shareholder value	Improve financial performance	Operating cash flows
	Invest for future growth	Capital expenditure

* Adjusted operating profit is equal to operating profit excluding exceptional items and remeasurements.

Details of KPIs for the year ended 31 March 2006 are included on page 10, whilst segment-specific KPIs are reflected in the business segment sections on pages 15 to 20.

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 more detail in the segmental sections of this Operating and Financial Review on pages 15 to 20 and our financial position is described on pages 21 to 24.

Developing our people

We continue to invest in the development of our people.

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.

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, continues 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 National Grid's first group-wide employee opinion survey in 2004, we identified a number of areas for improvement. These included improving opportunities for dialogue across the National Grid group, developing a better understanding of National Grid 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.

We have also refined our employee briefing processes and publications. We have re-launched National Grid's intranet sites and National Grid's UK employee newspaper. We have also introduced a National Grid group-wide publication, 'National Grid World', to provide employees with a broader view of National Grid 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 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 across the National Grid group 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.

Safety

Our approach to safety and occupational health is set out in National Grid's Group Vision for Safety. This is underpinned by Group-wide policies and strategy statements that are available on National Grid's 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.

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 operational 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.

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 National Grid's website. We believe strong corporate governance is essential to operating responsibly and achieving our goals. National Grid's approach to corporate governance is described in that company's annual report and accounts.

Ethics

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

Allegations of misconduct are investigated and reported to National Grid's Business Conduct Committee. We aim to ensure that reported breaches are thoroughly and promptly investigated and, where appropriate, acted upon and any necessary improvements implemented. The National Grid 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.

All of our employees work to systems certified to ISO 14001.

Climate change

We are committed to making a contribution towards minimising climate change and National Grid's 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, National Grid 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.

Contaminated land

We own a portfolio of contaminated land comprising former manufactured gas plants and former gas holder stations. Sites can sometimes have a complex mix of contamination dating back over 100 years. The main focus of our remediation programme is on managing the environmental risk.

Community investment

The role of National Grid Gas 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 National Grid group's Community Investment Policy provides a framework for ensuring 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.

Stakeholder engagement

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

Capital investment

The Group's total annual capital expenditure is expected to remain at approximately £1.0 billion per year, slightly above that achieved in the year ended 31 March 2006, over the medium term. This reflects changing energy infrastructure requirements as the UK's dependency on gas imports increase, and expenditure to maintain the safety of the gas distribution networks.

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 attaining our objectives.

The most significant risk factors we have identified relate to:

- changes in laws or regulations;
- breaches in environmental or health and safety law or regulations;
- network failure or inability to carry out critical non-network operations;
- achievement of business performance objectives;
- reputation damage from disruptions to supply, even if outside our control;
- business development activities;
- 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.

National Grid operates a group-wide risk management process which provides for a consistent approach to the assessment, recording and reporting of key risks in a visible, structured and continuous manner. This process helps to safeguard our assets and is designed to manage, rather than eliminate material risks to the achievement of our business objectives, while also recognising that any such process can only provide reasonable and not absolute assurance against material mistatement or loss. This process complies with the Turnbull working party guidance (revised October 2005).

We also comment on financial risks and risk management in the section on financial position and financial management on pages 21 to 23.

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 a European Union Directive concerning measures to safeguard security of natural gas supply which 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 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	Employee lost time injury frequency rate	Injuries resulting in employees taking time off work (per 100,000 hours worked)	Zero	2005/06: 0.20 2004/05: 0.36
	Gas safety-related service standards	Proportion of uncontrolled gas escapes attended within one hour	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 Set annually in agreement with the HSE	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: 2.20% 2004/05: 2.76%
Reliability	Business-specific reliability and service quality measures are discussed in the business segment section on pages 15 to 20.			
Efficiency	Adjusted operating profit*	Operating profit excluding exceptional items and remeasurements	To increase each year	2005/06: £862 million 2004/05: £758 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 own-fault direct environmental incidents	Category 1 environmental incidents	Zero	2005/06: 1 2004/05: 7
	Greenhouse gas emissions per £m of revenue	CO_2 equivalent emissions estimated to be directly or indirectly caused by our operations	60% reduction by 2050	2005/06: 1,529 tonnes per £m 2004/05: 1,829 tonnes per £m
	Fines from environmental prosecutions	Financial quantity of fines imposed	Zero	2005/06: Zero 2004/05: Zero
	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: 19.4 2004/05: 15.7
	Percentage of ethnic minority employees	Proportion of employees who are from ethnic minorities		2005/06: 4.5 2004/05: 3.3
Shareholder value	Operating cash flows	Cash generated from continuing operations	To increase each year	2005/06: £1,055 million 2004/05: £1,146 million
	Capital expenditure	Additions to plant and equipment and to intangible assets	There is no numerical target for capital expenditure, as each investment is different and is considered on its merits	2005/06: £868 million 2004/05: £575 million

* Operating profit from continuing operations including exceptional items and remeasurements increased from £649 million in 2004/05 to £835 million in 2005/06.
† The sickness absence rate includes absences resulting from both work-related and non-work related illnesses.

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 four fatalities directly associated with our operations during 2005/06.

In October 2005, an employee died whilst 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 one of our Group Directors.

Two contractors died in a helicopter crash in Scotland while carrying out an aerial survey of our gas transmission network.

There has also been one public fatality resulting directly from our operations: an elderly person died after being hit by a vehicle from our UK gas distribution operations.

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

Over the past 12 months we have continued to see an encouraging improvement in our safety performance, excluding the sold networks, 36 of our employees received injuries that resulted in them taking time off work during 2005/06 compared with 64 in 2004/05, a 44% 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 disposals, such as the sale 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 0.20, a 44% improvement when compared with the previous year.

There has also been a significant reduction in the number of contractor lost time injuries (LTIs), falling from 57 in 2004/05 to 41 in 2005/06, a 28% decrease.

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.

We have continued to focus on our employees' health by promoting physical well-being, and highlighting mental health issues such as stress. We have also published a stress management standard and implemented a drugs and alcohol policy.

Around 2.2% of available work days were lost due to sickness absence compared with 2.8% for the previous year.

Responsibility

This year has again seen external endorsement of National Grid's responsible business approach. National Grid continues to feature in the Dow Jones Sustainability World and FTSE4Good indices. National Grid is 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, National Grid was 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.

Environmental management

The number of significant environmental incidents in 2005/06 arising directly from our operations was one, compared with seven in the previous year.

There were no prosecutions by enforcing bodies resulting from these incidents.

Contaminated land

We are responsible for a number of contaminated sites, which are managed on our behalf by SecondSite Properties, a fellow subsidiary undertaking of National Grid.

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 is 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 have appealed this decision, which we believe is incorrect in law.

Climate change

The largest sources of our direct emissions continue to be methane leakage and venting from our UK gas networks. During 2005/06, our direct and indirect emissions of greenhouse gas amounted to some 3.7 million tonnes CO_2 equivalent, a 35% reduction compared with 2004/05. This reduction largely results from the sales of the four UK gas distribution networks during the year.

Our emissions per £million of revenue amounted to some 1,529 tonnes CO_2 equivalent compared with 1,829 tonnes for the previous year.

Inclusion and diversity

At 31 March 2006, of our 6,675 employees 19.4% were females and 4.5% were from ethnic minority groups compared with 15.7% and 3.3% at 31 March 2005.

Community investment

The London Benchmarking Group model has been adopted by National Grid to provide a framework for measuring and reporting of community contributions. Processes are now in place so that community spend across the National Grid group can be captured and categorised according to the model, and spend against our agreed themes can be reported as described on page 8.

During 2005/06, the Company has invested some £421,000 in support of community initiatives and relationships.

Business segment performance

The operating performance of each business segment is described in the business segment reviews on pages 15 to 20.

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 24 to 25.

Continuing and discontinued operations

The financial results of our business segments (as described on page 4) 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

The Group separately discloses 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 derivative financial instruments, recorded at fair value in the balance sheet.

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

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 removes their distorting impact in order to provide a clearer comparison from year to year.

Remeasurements arise on financial instruments as these are recorded in the balance sheet at their fair values. Financial remeasurements relate to the changes in the fair values of derivative financial instruments resulting principally from changes in interest rates.

Operating financial performance

	Years ended 31 March	
Continuing operations	**2006 £m**	2005 £m
Revenue	**2,244**	1,996
Operating costs excluding exceptional items and remeasurements	**(1,382)**	(1,238)
Adjusted operating profit	**862**	758
Exceptional items and remeasurements	**(27)**	(109)
Total operating profit	**835**	649

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

Revenues by business segment

	Years ended 31 March	
Continuing operations	**2006 £m**	2005 £m
UK gas transmission	**751**	582
UK gas distribution	**1,222**	1,113
UK gas metering	**342**	359
Total segment revenues	**2,315**	2,054
Less: sales between business segments	**(71)**	(58)
Revenue	**2,244**	1,996

Segmental operating profit before exceptional items and remeasurements

	Years ended 31 March	
Continuing operations	**2006 £m**	2005 £m
UK gas transmission	**287**	277
UK gas distribution	**483**	419
UK gas metering	**107**	83
Other activities	**(15)**	(21)
Adjusted operating profit	**862**	758

Segmental operating profit after exceptional items and remeasurements

	Years ended 31 March	
Continuing operations	**2006 £m**	2005 £m
UK gas transmission	**287**	274
UK gas distribution	**456**	313
UK gas metering	**107**	83
Other activities	**(15)**	(21)
Operating profit	**835**	649

Details of the financial performance of business segments, including information on exceptional items and remeasurements, are included in the business segment reviews on pages 15 to 20.

Revenue, operating costs and operating profit

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

	Revenue £m	Operating costs £m	Operating profit £m
2004/05 results	1,996	(1,347)	649
Add back 2004/05 exceptional items and remeasurements	–	109	109
2004/05 adjusted results	1,996	(1,238)	758
UK gas transmission	169	(159)	10
UK gas distribution	109	(45)	64
UK gas metering	(17)	41	24
Other activities	–	6	6
Sales between businesses	(13)	13	–
2005/06 adjusted results	2,244	(1,382)	862
2005/06 exceptional items and remeasurements	–	(27)	(27)
2005/06 results	2,244	(1,409)	835

Significant increases in revenues and operating costs occured in both UK gas transmission and UK gas distribution.

Adjusted operating profit increased by £104 million. This was driven by favourable results from capacity auctions in LNG storage and controllable cost savings in UK gas distribution. These factors more than offset an increase in depreciation charges in UK gas transmission.

The operating exceptional items for 2005/06 related to restructuring costs, primarily cost reduction programmes. The operating exceptional items for 2004/05 related to £105 million of restructuring costs, relating to cost reduction programmes and £4 million of environmental costs.

Total operating profit rose by £186 million from 2004/05 to 2005/06, resulting from an increase in adjusted operating profit of £104 million, and by a reduction in operating exceptional charges and remeasurements of £82 million as compared with 2004/05.

Earnings from continuing operations

Adjusted earnings

Years ended 31 March Continuing operations	**2006 £m**	2005 £m
Adjusted operating profit	**862**	758
Net finance costs excluding exceptional items and remeasurements	**(184)**	(325)
Adjusted profit before taxation	**678**	433
Taxation excluding taxation on exceptional items and remeasurements	**(152)**	(122)
Adjusted profit from continuing operations	**526**	311

Earnings

Years ended 31 March Continuing operations	**2006 £m**	2005 £m
Total operating profit	**835**	649
Net finance costs	**(209)**	(325)
Profit before taxation	**626**	324
Taxation	**(136)**	(91)
Profit from continuing operations	**490**	233

Net finance costs

Net interest excluding exceptional finance costs and remeasurements decreased by £141 million from 2004/05 to 2005/06. This was primarily explained by the reduction in our net debt following the sales of the four gas distribution networks.

Exceptional finance costs of £11 million in 2005/06 related to the early repayment of debt, using the proceeds generated from the network sales.

Financial remeasurements of £14 million in 2005/06 relate to net losses on derivative financial instruments.

Taxation

A net charge of £136 million arose in 2005/06, compared with £91 million in 2004/05. This reflects net tax credits amounting to £16 million and £31 million in respect of exceptional items and remeasurements in 2005/06 and 2004/05 respectively. The effective tax rate was 21.7% for 2005/06 and 28.1% 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 22.4% and 28.2% 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 10 to the accounts.

Profit for the year from continuing operations

Profit for the year from continuing operations increased from £233 million in 2004/05 to £490 million in 2005/06 as a consequence of the change 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 Continuing operations	**2006 £m**	2005 £m
Adjusted operating profit	**862**	758
Exceptional operating items	**(27)**	(109)
Total operating profit	**835**	649

Adjusted operating profit is presented on the face of the Group Income Statement, under the heading 'Operating profit – before exceptional items and remeasurements'.

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

Continuing operations	Years ended 31 March 2006 £m	2005 £m
Adjusted profit before taxation	**678**	433
Exceptional operating items	**(27)**	(109)
Exceptional finance costs	**(11)**	–
Financial remeasurements	**(14)**	–
Total profit before taxation	**626**	324

Adjusted profit before taxation is presented on the face of the Group Income Statement, under the heading 'Profit before taxation – before exceptional items and remeasurements'.

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

Continuing operations	Years ended 31 March 2006 £m	2005 £m
Adjusted earnings	**526**	311
Exceptional operating items	**(27)**	(109)
Exceptional finance costs	**(11)**	–
Financial remeasurements	**(14)**	–
Tax on exceptional items and remeasurements	**16**	31
Earnings	**490**	233

Adjusted earnings is presented on the face of the Group Income Statement, under the heading 'Profit for the year from continuing operations – before exceptional items and remeasurements'.

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
Taxation	**(18)**	(140)
Profit from discontinued operations	**28**	296
Gain on disposal of discontinued operations	**2,466**	–
Profit for the year	**2,494**	296

Discontinued operations 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 for 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 in respect of a breach of the Health and Safety at Work Act 1974 arising from a fatal gas explosion at Larkhall in Scotland in 1999. 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 gain on disposal of discontinued operations in 2005/06 relates to the sales of the gas distribution networks.

Net profit for the year

Net profit from both continuing and discontinued operations was £2,984 million in 2005/06 (£529 million in 2004/05).

Cash flows

Cash flows from operating activities

Cash generated from continuing operations was £1,055 million in 2005/06 compared with £1,146 million in 2004/05. This included cash flows relating to exceptional items of £79 million and £52 million respectively. After reflecting cash flows relating to discontinued operations and tax paid, net cash inflow from operating activities was £751 million, compared with £1,487 million in 2004/05.

Net corporate tax payments amounted to £282 million in 2005/06 compared with £202 million in 2004/05.

Cash inflows from investing activities

Cash outflows from continuing operations investing activities increased from £701 million in 2004/05 to £3,692 million in 2005/06. This was primarily as a result of an interest free loan of £2,967 million to our immediate parent undertaking, National Grid Gas Holdings plc, representing part of the £5,750 million cash received from the sales of four of our gas networks. Purchases of property, plant and equipment and intangible fixed assets, net of disposal proceeds, absorbed cash of £695 million compared with £663 million in 2004/05.

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.

Cash flows from financing activities

Net cash used in financing activities of £2,475 million in 2005/06 (compared with £454 million in 2004/05) included £1,937 million in respect of repayment of debt using part of the £5,750 million cash proceeds from the sales of the four networks. Payments to providers of finance, in the form of net interest and dividends, totalled £538 million in 2005/06 compared with £786 million in 2004/05. Net interest cash outflows fell from £286 million in 2004/05 to £228 million in 2005/06, due to the repayment of debt and lower short-term interest rates.

Dividends

Dividends in respect of each financial year

	2006 £m	2005 £m
Interim	**310**	500
Final	**1,500**	–
Total	**1,810**	500

The table above shows the ordinary dividends paid or payable by National Grid Gas. These dividends do not include any associated UK tax credit in respect of such dividends.

In accordance with IFRS, dividends are now reported in the financial statements for the year in which they are approved. As a consequence the final dividend proposed for 2005/06, amounting to £1,500 million, will be reported in the financial statements for the year ending 31 March 2007.

UK gas transmission

About the segment

Principal activities

Our UK gas transmission segment has the following principal activities:

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.
LNG storage	We own and operate four liquefied natural gas (LNG) storage facilities in the UK.

External and regulatory environment

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 gas is delivered.

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 end consumers. Detailed arrangements for the gas industry are provided through the Uniform Network Code, which defines the obligations, responsibilities and roles of the industry participants.

Certain end consumers, primarily large industrial users, receive gas direct from the transmission network.

The Company holds 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 activity 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 gas infrastructure in the UK. 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 period is due to commence on 1 April 2007.

Our LNG storage facilities do not form part of our gas transmission network and are separately regulated. 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 gas transmission owner, we own and maintain the physical assets, develop the network to accommodate new connections and disconnections, and manage a programme of asset replacement and investment to ensure the long-term reliability of the network.

As gas system operator, we undertake a range of activities necessary for the successful delivery in real-time of secure, reliable and efficient energy. 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 gas transmission activities include:

- the price controls set by Ofgem, which determine the prices that can be charged to users of the gas transmission network;
- 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 gas system, 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 gas transmission system are currently determined by a formula linked to retail price inflation (RPI). This is set at RPI-2%. This formula is 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. Our regulatory asset value as of 31 March 2006 is currently £2.8 billion (£2.5 billion March 2005).
Efficiency	Our gas system operation has incentive schemes where, if we operate our network more efficiently than Ofgem's forecasts, we can increase our revenues. 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

Licences

On 1 May 2005 our gas transporter licence was amended to become specific to our gas transmission activities. At the same time, we were granted five new gas transporter licences specific to gas distribution activities, four of which related to the gas distribution networks subsequently sold on 1 June 2005.

UK energy market developments

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

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 National Grid's own 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 Kellett 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 in response to changing supply sources require over £1,000 million in capital expenditure on the gas transmission system in the period up to 2008/09.

Gas supply

In 2004 the gas 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, other non-daily metered customers and certain identified priority 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 demand/supply 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 in 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 gas transmission networks is, by its nature, variable and is largely driven by changing sources of supply and asset replacement requirements. Our gas transporter licence obliges us to provide connections and capacity upon request.

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 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

2005/06 saw a maximum demand for gas 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 objectives during the year includes the following:

Objective	Performance
Safety	During 2005/06 there was an increase in the lost time injury frequency rate to 0.57 from 0.21 in 2004/05.
Reliability	Compressor fleet performance during 2005/06 improved with the average time between compressor failures at 10% above our five-year average, compared with 24% above the five-year average in the mean time between failures in 2004/05.

Financial performance

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

	Years ended 31 March 2006 £m	2005 £m
Revenue	**751**	582
Operating costs excluding exceptional items and remeasurements	**(464)**	(305)
Adjusted operating profit	**287**	277
Exceptional items	**–**	(3)
Total operating profit	**287**	274

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	582	(308)	274
Add back 2004/05 exceptional items		3	3
2004/05 adjusted results	582	(305)	277
LNG storage	34	(4)	30
Transmission owner depreciation and amortisation	–	(19)	(19)
Other	135	(136)	(1)
2005/06 adjusted results	751	(464)	287
2005/06 exceptional items	–	–	–
2005/06 results	751	(464)	287

The £169 million increase in UK gas transmission revenue comparing 2005/06 with 2004/05 was due to higher pass through costs under the gas system operator incentive scheme and to beneficial outcomes from the capacity auctions in the LNG storage market.

Operating costs, excluding exceptional items and remeasurements, increased by £159 million in 2005/06 compared to 2004/05. This is due to increased gas incentivised costs, one-off compensation costs and higher pass through costs, particularly business rates. Transmission owner depreciation and amortisation has increased by £19 million due to reassessment of asset lives and an increase in core depreciation reflecting the ramp up in the capital programme.

The £10 million increase in UK gas transmission adjusted operating profit comparing 2005/06 with 2004/05 reflected the movement in revenue and operating costs as described above.

The £3 million exceptional charge in 2004/05 related to cost reduction programmes.

Capital expenditure

Capital investment in the replacement, reinforcement and extension of the UK gas transmission systems in 2005/06 was £360 million compared with £128 million in 2004/05.

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	**311**	108
Intangible	**49**	20
Capital investment	**360**	128

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

UK gas distribution

About the segment

Principal activities

Our UK gas distribution segment comprises almost half of Great Britain's gas distribution system, 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 national transmission system 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 national transmission system 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, 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 establish the prices we can charge for the services provided by each network.

Ofgem established an estimate of the separate regulatory asset value associated with each network's distribution assets by allocating an estimate of the UK Gas Distribution business's regulatory asset value as at 1 April 2002. This was done in a way aimed at minimising short-term regional differentials in transportation charges.

Business drivers

Business drivers specific to the segment include:

Business driver	Description
Price controls	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 (which is currently 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 network price control formulae specify a maximum allowed revenue for 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 it should be set to recover allowed revenue. Any difference is carried forward and our charges are adjusted accordingly
Replacement expenditure	Replacement expenditure maintains the safety of the network, by 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	To ensure supply security and to meet growing expenditure customer demand. Central co-ordination 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 consumers when they are due to be reconnected after an unplanned interruption;
- connections standards of service that require us to provide connections to consumers to agreed timescales; and
- guaranteed standards of service for our other transportation services. Compensation is paid to customers for any failures to meet these guaranteed standards.

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 National Grid returned £2 billion to its shareholders and we have repaid around £1.9 billion of debt.

During the coming year, we will be working with the sold networks in their exit from existing transitional agreements. These agreements came into place prior to completion of the network sales and amongst these, we provide a front office 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 achieved economies of scale while maintaining local alignment of our operational workforce to satisfy consumer requirements.

Control of the gas distribution networks 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 meeting the requirements of our customers on a more consistent basis.

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.

Progress against our operating performance objectives during the year included the following notable items:

Objective	Performance
Safety	As described on page 11 there was one employee fatality during 2005/06.
	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.
	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.
	We decommissioned in excess of 1,710 km of gas pipes in 2005/06, in line with our target of 1,724 km, compared with 1,458 km in 2004/05.
Reliability	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.
Efficiency	Our target of 35% reduction in controllable costs has been achieved one year early.
	Our performance under the current distribution network exit incentive scheme during 2005/06 and the incentive mechanism for mains replacement was broadly neutral.
	During the year ended 31 March 2006, we made around 50,000 new connections to our network.

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
Operating costs excluding exceptional items and remeasurements	**(739)**	(694)
Adjusted operating profit	**483**	419
Exceptional items	**(27)**	(106)
Total operating profit	**456**	313

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	1,113	(800)	313
Add back 2004/05 exceptional items	–	106	106
2004/05 adjusted results	1,113	(694)	419
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	64	(57)	7
2005/06 adjusted results	1,222	(739)	483
2005/06 exceptional items	–	(27)	(27)
2005/06 results	1,222	(766)	456

Revenues in UK gas distribution increased by £109 million in 2005/06 compared with 2004/05, including a £45 million increase in revenue recovered under the distribution price control formula. 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 and remeasurements increased by £45 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 £22 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 £64 million higher in 2005/06 than 2004/05, an increase of 15%.

Exceptional charges of £27 million in 2005/06 and £106 million in 2004/05 predominantly related to restructuring costs under the Way Ahead programme.

Operating profit was £143 million higher in 2005/06 than 2004/05, reflecting the movements in revenues, operating costs and exceptional items explained above.

Capital expenditure

Gross investment in the reinforcement, extension and replacement of the UK gas distribution network was £444 million in 2005/06 compared with £381 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
Reinforcement and extension	**149**	126
Replacement expenditure	**295**	255
Capital investment in the continuing business	**444**	381

Reinforcement and extension expenditure increased from £126 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 £255 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.

UK gas metering

About the segment

Principal activities

Our UK gas metering segment provides installation, maintenance and meter reading services to gas suppliers in the regulated gas market. It provides services to an asset base of around 20 million domestic, industrial and commercial gas meters, situated throughout Great Britain.

External and regulatory environment

UK gas metering is regulated by Ofgem as it has a dominant market position in the provision of existing meters to UK gas suppliers.

Business drivers

The principal business drivers for UK gas metering are considered to be as follows:

Regulatory price controls	UK gas metering operates within the parameters set out within the Company's gas transporter licences.
Multi-year contractual arrangements	The majority of UK gas 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 whilst reducing the risk of asset stranding.

Current and future developments

UK gas metering is investing in new automated meter reading systems in response to customer requirements.

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 a reduction in the total number of employee lost time injuries from 3 in 2004/05 to 1 in 2005/06.

Financial performance

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

	Years ended 31 March 2006 £m	2005 £m
Revenue	**342**	359
Operating costs excluding exceptional items and remeasurements	**(235)**	(276)
Adjusted operating profit	**107**	83
Exceptional items	**–**	–
Total operating profit	**107**	83

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	359	(276)	83
Add back 2004/05 exceptional items	–	–	–
2004/05 adjusted results	359	(276)	83
Business rates		28	28
Other	(17)	13	(4)
2005/06 adjusted results	342	(235)	107
2005/06 exceptional items	–	–	–
2005/06 results	342	(235)	107

Revenue for UK gas metering has fallen by £17 million reflecting reducing market share.

Operating costs have decreased by £41 million. This is due to a change in the valuation basis for business rates and a reduction in other costs linked to the reduction in revenues.

The increase in operating profit of £24 million is explained by the decrease in revenues and operating costs.

Capital expenditure

Capital expenditure in 2005/06 amounted to £64 million, a decrease of £2 million compared with £66 million in 2004/05.

Other activities

About other activities

Other activities includes corporate overheads that are not allocated to individual businesses.

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.

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 and equipment and non-current intangible assets	8,063	–	8,063
Other non-current assets and liabilities	5,614	(1,015)	4,599
Current assets and liabilities	659	(934)	(275)
Deferred tax	–	(1,543)	(1,543)
Total before net debt	14,336	(3,492)	10,844
Net debt	478	(3,816)	(3,338)
Total as at 31 March 2006	14,814	(7,308)	7,506
Total as at 31 March 2005	15,902	(10,998)	4,904

The increase in net assets from £4,904 million at 31 March 2005 to £7,506 million at 31 March 2006 resulted from the profit from continuing operations of £490 million, the profit for the year from discontinued operations of £2,494 million and other changes in equity of £3 million, partially offset by net expenses recognised directly in equity of £16 million, dividends paid of £310 million and the effect of the implementation of IAS 39 of £59 million.

Net debt and gearing

Net debt decreased by £2.0 billion from £5.3 billion at 31 March 2005 to £3.3 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, partly offset by an increase of £0.3 billion relating to the adoption of IAS 39.

The composition of net debt at 31 March 2006 is shown in note 28(c) 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 31% and 52% respectively. By comparison, the gearing ratio, adjusted for the inclusion of regulated businesses at their estimated regulatory asset values (adjusted gearing ratio), amounted to 26% at 31 March 2006 compared with 41% 31 March 2005.

The Group believes 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 regulated business assets. A reconciliation of the adjustments necessary to calculate adjusted net assets is shown in the table below:

	2006 £m	2005 £m
Net assets per balance sheet	**7,506**	4,904
Adjustment for regulatory asset values	**2,900**	3,700
Deferred tax	**(870)**	(1,110)
Adjusted net assets	**9,536**	7,494

Shareholders' equity

Shareholders' equity rose from £4,904 million at 31 March 2005 to £7,506 million at 31 March 2006. This increased for the same reasons that net assets increased.

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. The Group's UK gas transmission and distribution operations are subject to multi-year price control agreements with the regulator, Ofgem. This results in essentially stable cash flows. However, weather conditions can affect cash flows in those businesses, with abnormally mild or cold weather driving volumes down or up respectively.

Over time, the Group expects to fund investment expenditure from its operating cash flows, through price control agreements with Ofgem.

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 National Grid 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 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 had £840 million of long term committed facilities (undrawn), £25 million of short-term (364 day) committed facilities (undrawn) and £0.9 billion of uncommitted borrowing facilities (undrawn).

Treasury policy

The funding and treasury risk management of the Group is carried on its behalf by a central department operating under policies and guidelines approved by the Board of National Grid. The Finance Committee, a committee of the Board of National Grid, is responsible for regular review and monitoring of treasury activity and for approval of specific transactions, the authority for which may be delegated. The National Grid group has a Treasury function that raises all the funding for the National Grid group and manages interest rate and foreign exchange rate risk.

There is a separate financing programme for National Grid Gas. The Finance Committees of both National Grid and of National Grid Gas 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 of National Grid. Derivatives entered into in respect of gas commodities are used in support of the business' operational requirements and the policy regarding their use is explained below.

The Group had borrowings outstanding at 31 March 2006 amounting to £3,712 million (31 March 2005: £5,276 million). The table in note 22 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 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 note 18 to the accounts.

National Grid Gas plc has a credit rating of A2/A/A+ provided by Moody's, S&P and Fitch respectively.

In connection with the proposed acquisition of KeySpan by National Grid, the outlook for the ratings of the Group has been moved to 'Creditwatch with negative implications' by S&P. Moody's have placed the ratings of National Grid Gas plc on negative outlook.

It is a condition of the regulatory ring-fence around National Grid Gas plc that it uses reasonable endeavours to maintain an investment grade credit rating. At these ratings, it 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 below. The Board of National Grid and the Finance Committee of that Board review and agree policies for managing each risk and they are summarised below.

Refinancing risk management

The Board of National Grid 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. The Group's 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.

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.

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 currency and average interest rate compositions of the Group's financial liabilities and assets are shown in note 18 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 of National Grid 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 floating and fixed 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 18 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, the Group only uses 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 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.

Interest rate sensitivity

Details of the sensitivity of the Group's income statement and equity to changes in UK interest rates are set out in note 18. Under the assumptions set out in note 18, a 0.10% change in UK interest rates would affect the income statement by £8 million, but would have no effect on equity.

Commodity contracts

Commodity derivatives

In the normal course of business, the Group is party to commodity derivatives. These have included gas futures, gas options and gas forwards that are used to manage commodity prices associated with its gas delivery operations. This includes the repurchase of capacity rights already sold in accordance with the Group's 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.

Commodity trading

In our UK gas transmission operation 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.

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	**767**	313
Total operating lease commitments	**95**	110
Other commitments and contingencies	**154**	140

Retirement arrangements
The substantial majority of the Group's employees are members of the National Grid UK Pension Scheme, formerly named the Lattice Group Pension Scheme (the 'Scheme').

The Scheme has both a defined benefit section, which is closed to new entrants, and a defined contribution section, which is offered to all new employees.

An actuarial valuation of the Scheme is being carried out as at 31 March 2006 and has not yet been completed.

The last completed full actuarial valuation of the 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 Scheme was conducted at 31 March 2005. This assessment showed that the deficit has 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, National Grid will pay the gross amount of any deficit up to a maximum amount of £520 million (£364 million net of tax) into the scheme. National Grid Gas' share of these payments is £468m (£328m net of tax). Until the 31 March 2007 actuarial valuation has been completed, National Grid has arranged for banks to provide the trustees of the 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 becoming insolvent or National Grid failing to make agreed payments into the fund. Employer cash contributions for the ongoing cost of the Scheme are currently being made at a rate of 23.7% of pensionable payroll.

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 £19 million and received charges of £208 million from its related parties (other than Directors), compared with £48 million and £386 million respectively in 2004/05.

Further information relating to related party transactions is contained within note 29 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.

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 gas transmission, UK gas distribution and UK gas metering, with corporate activities reported under Other activities. Geographical segments are not reported as our activities are all within the UK.

UK LNG storage activities are now included within the UK gas transmission segment and UK gas metering is reported as a separate segment, both having previously been reported within Other activities. This change in segmental presentation follows a change in the organisational and management structure within the Group.

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.

The principal differences to 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
Intangible assets	Computer software assets are included within tangible fixed assets under UK GAAP, but are disclosed as other intangible assets under IFRS
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 or liabilities' carrying value in the balance sheet and its associated tax basis.

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	1,946	2,141
Replacement expenditure	3,014	2,778
Deferred taxation	(58)	(46)
Other	2	–
Net assets reported under IFRS	4,904	4,873

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	303
Replacement expenditure	236
Deferred taxation	(12)
Other	2
Profit for the year reported under IFRS	529
Less: profit for the year from discontinued operations	(296)
Profit for the year from continuing operations	233

Amounts shown above are net of any related deferred tax on the underlying IFRS adjustment.

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 37 and 38.

The impact of the adoption was to increase net debt by £269 million from £5,260 million to £5,529 million, and to reduce net assets by £59 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 1 April 2004	1 April 2004
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)
Use of UK GAAP or IFRS in Individual accounts	Adopt IFRS for parent company and subsidiaries IFRS for parent company and UK GAAP for subsidiaries Retain UK GAAP for parent and subsidiaries	Retain UK GAAP for parent and subsidiaries' individual financial statements

Critical accounting policies

The application of accounting principles requires us to make estimates, judgments 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. 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 Group financial statements.

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

Estimated asset economic lives	The reported amounts for amortisation of intangible fixed assets and depreciation of property, plant and equipment can be materially affected by the judgments exercised in determining their estimated economic lives. Intangible asset amortisation and depreciation of property, plant and equipment amounted to £19 million and £395 million respectively in 2005/06 and £16 million and £371 million respectively in 2004/05.
Carrying value of assets and potential for impairments	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 £14,814 million, including £8,029 million of property, plant and equipment, £34 million of other intangible assets and £5,611 million owed by the Group's immediate parent undertaking. Impairment reviews are carried out either when a change in circumstance is identified that indicates an asset might be impaired. 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.
Revenue accruals	Revenue includes an assessment of transportation services supplied to customers between the date of the last meter reading and the year end. Changes to the estimate of the transportation services supplied during this period would have an impact on the reported results of the Group. Our estimates of unbilled revenues amounted to £136 million at 31 March 2006 compared with £172 million at 31 March 2005.
Assets and liabilities carried at fair value	Certain assets and liabilities, principally financial investments and derivative financial instruments, are carried in the balance sheet at their fair value rather than historical cost. 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 are valued using financial models, which include judgments on, in particular, future movements in exchange and interest rates as well as equity prices.
Hedge accounting	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. 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 by being offset by adjustments to the carrying value of debt.
Assets held for sale and discontinued operations	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 the 1 June 2006. The results of these operations have been classified as discontinued operations and the comparatives reclassified accordingly. The determination of the date that the planned sales met the criteria to be classified as assets held for sale is a matter of judgment by management, with consequential impact on balance sheet presentation and the amount recorded for depreciation in the results of the discontinued operation.
Exceptional items	Exceptional items, in particular restructuring costs, are items of income or expense which 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 estimates. These include provisions for the cost of environmental restoration and remediation, and restructuring. 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 liabilities are based on management estimates supported by the use of external consultants. At 31 March 2006, we have recorded provisions totalling £128 million (2005: £185 million), including £44 million (2005: £89 million) in respect of environmental liabilities.
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:

Asset 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 £23 million and our annual amortisation charge on intangible assets by £4 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 by approximately £10 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 of £11 million.
Hedge accounting	If the gains and losses arising on derivative financial instruments during the year ended 31 March 2006 had not achieved hedge accounting then the profit for the year would have been £12 million lower than that reported net of tax and net assets would have been £1 million higher.
Provisions	A 10% change in the estimates of future cash flows estimated in respect of provisions for liabilities would result in an increase or decrease in net assets of approximately £11 million.

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 about entities management of their capital resources and compliance with capital requirements.
Pensions costs, assets and liabilities	*'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures'* removes the requirement for the Group to recognise a proportionate share of the actuarial gains and losses and assets and liabilities of the National Grid UK Pension Scheme.
Cash flow hedges	*'Amendment to IAS 39 Financial Instruments: Recognition and Measurement: Cash Flow Hedge Accounting of Forecast Intragroup Transactions'* allows the foreign currency risk of a highly probable forecast intragroup 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, assets or liabilities.

Leases	International Financial Reporting Interpretations Committee (IFRIC) 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 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 that otherwise would be required under the contract, in which case reassessment is required.

Directors' Report

Board of Directors

Roger Urwin (60)
Chairman
Appointed a Director of the Company in October 2002, he is also Group Chief Executive of National Grid. He was Managing Director and Chief Executive of London Electricity from 1990 to 1995. He is a Non-executive Director of Utilico Investment Trust plc and is a Fellow of the Royal Academy of Engineering. He has announced his intention to retire from National Grid at the end of 2006.

Steve Holliday (49)
Chief Executive
Appointed a Director of the Company in October 2002 and Chief Executive in April 2003. He is also Deputy Group Chief Executive of National Grid and is responsible for UK gas distribution and business services. He was formerly an Executive Director of British Borneo Oil and Gas. Previously, he spent 19 years with the Exxon group, where he held senior positions in the international gas business and operational areas such as refining and shipping. His international experience includes a four-year spell in the US. He also developed business opportunities in countries as diverse as China, Australia, Japan, Brazil and the former Soviet Union. He is also a Non-executive Director of Marks and Spencer Group plc. Following the announcement of Roger Urwin's retirement he was appointed Group Chief Executive designate, becoming Deputy Group Chief Executive on 1 April 2006.

Mark Fairbairn (47)
Chief Operating Officer
Appointed a director of the Company in June 2003. He joined National Grid in 1989 from BNFL. Within National Grid he held a variety of senior roles in Asset Management, Systems Operation and Engineering Services. He was instrumental in achieving significant improvements on Safety and Environmental issues within National Grid and was awarded the OBE in 2002 for his services to the Electrical Industry in respect of his leadership of the fundamental changes implemented for the introduction of the New Electrical Trading Arrangements (NETA).

Colin Buck (56)
Finance Director
Appointed a Director of the Company in October 2002 and is responsible for all financial aspects and Corporate Governance issues within the Company. He joined National Grid in 1990 and held a number of posts in finance. He was appointed Finance Director of National Grid Company plc in January 2001 before moving to his current position.

Steve Lucas (52)
Executive Director
Appointed a Director of the Company in December 1999, he is also Group Finance Director of National Grid. Previously he had been Executive Director, Finance of Lattice Group since its demerger from BG Group plc in 2000. Prior to this, he was Treasurer of BG Group plc having joined British Gas plc in 1994. A Chartered Accountant, he worked in private practice in the City of London until 1983. He then joined Shell International Petroleum Company, occupying a number of finance management roles, including seven years in Africa and the Far East. Steve is also a Non-executive Director of Compass Group plc.

Chris Murray (50)
Executive Director
Appointed a director of the Company in June 2005. He is also Network Operations Director for National Grid UK transmission and he was previously the Company's director for the West Midlands distribution network. Prior to this, he held several senior positions in the energy industry including Chief Executive Officer of Phoenix Natural Gas in Northern Ireland and General Manager of Accord Energy. He is a Member, and past Section Chairman, of the Institute of Gas Engineers and Managers and is a Member of the Institute of Directors.

Nick Winser (45)
Executive Director
Appointed a Director of the Company in July 2003, he is also Executive Director of National Grid responsible for UK and US transmission operations. He was previously Chief Operating Officer of US transmission for National Grid Transco plc. He joined National Grid Company plc in 1993, becoming Director of Engineering in 2001. Prior to this, he had been with Powergen since 1991 as principal negotiator on commercial matters, having joined the Central Electricity Generating Board in 1983 where he served in a variety of technical engineering roles.

During the year Jim O'Sullivan, Engineering and Safety Director, resigned as a director of the Company on 31 July 2005.

Alison Kay
Company Secretary
Alison Kay was appointed Company Secretary on 21 October 2002. She is also Company Secretary of National Grid Electricity Transmission plc.

Other information

Business Review

Accompanying this Directors' Report is an Operating and Financial Review (OFR). The OFR has been prepared in accordance with 'Reporting Statement: Operating and Financial Review', issued by the UK Accounting Standards Board, and the Directors therefore consider that this will fulfil the requirement for a Business Review. The OFR also includes information in respect of financial risks under the heading 'Liquidity and treasury management' and employee involvement and employment practices principally on page 7.

Principal activities

The Company's principle activities are the transmission and distribution of gas and the provision of gas metering services.

Company name

National Grid Gas plc changed its name from Transco plc on 10 October 2005.

Material interests

At no time during the year has any Director had any material interest in a contract within the Group, being a contract of any significance in relation to the Group's business.

Substantial shareholders

National Grid Gas plc is a wholly owned subsidiary undertaking of National Grid Gas Holdings plc, formerly Transco Holdings plc. The ultimate parent company of National Grid Gas is National Grid plc, formerly National Grid Transco plc.

Directors' remuneration

Details of Directors' remuneration are shown in note 7, page 54.

National Grid Gas does not have a Remuneration Committee, National Grid Gas's Directors being remunerated in line with the policy developed by the National Grid Remuneration Committee, details of which may be found in that company's annual report and accounts.

Directors' interests

Roger Urwin, Steve Holliday, Steve Lucas and Nick Winser are also Directors of National Grid plc and details of their interests in the shares of National Grid plc appear in that company's annual report and accounts. Interests of the other directors are set out on the following page.

In August 2005 National Grid plc carried out a Return of Cash, which consisted of the issue of "B" shares and an ordinary share consolidation – 43 new shares of $11\frac{17}{43}$ pence for every 49 existing ordinary shares of 10 pence – (the "Share Consolidation"), however interests in share options, the Performance Share Plan and the matching awards under the Share Matching Scheme, were not subject to the Share Consolidation.

None of the Directors (nor any person connected with them) has a beneficial interest or non-beneficial interest in the share capital of the Company. None of the Directors (nor any person connected with them) holds any interest in any other securities, including options over the Company's shares, of the Company.

Directors' beneficial interests

	At 1 April 2005 or appointment	At 31 March 2006
Colin Buck	20,657	20,315
Mark Fairbairn (i)	13,236	11,426
Chris Murray	8,000(ii)	5,405

All interests are in shares in National Grid plc, the Company's ultimate parent undertaking. Interests include shares acquired pursuant to the National Grid Share Incentive Plan, but exclude shares acquired pursuant to the National Grid Share Matching Scheme (see below under Directors' interests in share options note (ii)).
(i) As a result of the Share Consolidation, Mark Fairbairn held 616 "B" shares as at 31 March 2006.
(ii) Interests held on appointment.

Performance Share Plan interests

	Beneficial holding at 1 April 2005 or on appointment	Awarded in year	Beneficial holding at 31 March 2006	Release dates
Colin Buck	40,748	15,653	56,401	June 2007 to June 2009
Mark Fairbairn	76,683	40,225	116,908	June 2007 to June 2009
Chris Murray	28,252 (i)	12,712	40,964	June 2007 to June 2009

All interests are held in accordance with the National Grid Performance Share Plan details of which are given in the annual report and accounts of that company.
(i) Interests held on appointment.

Director's interests in share options

	Beneficial holding at 1 April 2005 or on appointment	Granted	Exercised	Beneficial holding at 31 March 2006	Weighted average exercise price per share (pence)	Normal exercise period
Colin Buck	55,160	344	23,968	31,536	494.4p	Jun 2003 – Jun 2012
Mark Fairbairn	101,582	–	–	101,582	503.7p	Jun 2001 – Jun 2012
Chris Murray	9,211 (i)	–	–	9,211	434.3p	Dec 2005 – Dec 2012

All interests are in shares in National Grid plc, the Company's ultimate parent undertaking.
(i) Interests held on appointment.
(ii) In addition to the interests shown above the following hold interests in the National Grid Share Matching Scheme as follows:

	Date of grant	Number of shares	Purchase price (pence)	Matching option
Colin Buck	June 2003	991	402.75	1,940
Colin Buck	May 2004	1,341	431.25	2,626
Colin Buck	June 2005	612	528.50	1,195
Mark Fairbairn*	June 2003	1,245	402.75	2,437
Mark Fairbairn*	May 2004	2,501	431.25	4,897
Mark Fairbairn*	June 2005	1,094	528.50	2,134
Chris Murray*	May 2004	935	431.25	1,831
Chris Murray*	June 2005	853	528.50	1,665

The Matching Option is exercisable at £1.00 per option, between three and ten years from the date of grant.
* As a result of the Share Consolidation, the following Directors held "B" shares as at 31 March 2006:

Mark Fairbairn 5,516 "B" shares
Chris Murray 2,038 "B" shares

Options were granted under the Executive Share Option Schemes, Sharesave Schemes and Share Matching Scheme operated by the ultimate parent undertaking, National Grid plc, and details of each scheme are given in the annual report and accounts of that company.

Dividends
An interim dividend of £310 million was paid during the year (2005: £500 million) and the Directors have proposed a final dividend of £1,500 million (2005: £nil).

Donations
Charitable donations of £421,000 were made during the year in support of community initiatives and relationships in the UK (2005: £243,000).

No donations were made in the UK and EU for the purposes of the Political Parties, Elections and Referendums Act 2000.

Payment to suppliers
It is the Company's policy to include in contracts or other agreements, terms of payment with suppliers. Once agreed, the Company aims to abide by these terms of payment. The average creditor payment period at 31 March 2006 was 27 days (29 days at 31 March 2005).

Employee share ownership
The Group facilitates share ownership among its employees by the operation of both sharesave and share incentive plans.

Research and development
Expenditure on research and development was £2 million during the year (2005: £4 million).

Auditors
PricewaterhouseCoopers LLP have indicated their willingness to be re-appointed auditors of the Group.

Audit information
So far as the Directors in office at the date of the signing of this report are aware, there is no relevant audit information of which the auditors are unaware and each Director has taken all reasonable steps to make themselves aware of any relevant audit information and to establish that the auditors are aware of that information.

Annual General Meeting
Notice of the Company's Annual General Meeting for 2006 will be issued separately to shareholders.

On behalf of the Board

Alison Kay
Company Secretary
30 June 2006

National Grid Gas plc
Registered Office:
1-3 Strand London WC2N 5EH

Registered in England and Wales No. 2006000

Statement of Directors' Responsibilities for Preparing the Accounts

The Directors are required by the Companies Act 1985 to prepare accounts for each financial year which give a true and fair view of the state of affairs of the Company and of the Group as at the end of the financial year and of the profit or loss of the Group for the financial year.

The Directors consider that in preparing the Group Financial Statements and the Company Financial Statements, the Company has used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates and all applicable accounting standards have been followed.

The Directors have responsibility for preparing the accounts on the going concern basis, unless it is inappropriate to presume that the Group will continue in business. Therefore, the accounts have been prepared on the going concern basis.

The Directors have responsibility for ensuring that the Company keeps accounting records which disclose with reasonable accuracy the financial position of the Company and of the Group and which enable them to ensure that the accounts comply with the Companies Act 1985.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and to detect fraud and other irregularities.

The Directors, having prepared the accounts, have requested the Auditors to take whatever steps and to undertake whatever inspections they consider to be appropriate for the purposes of enabling them to give their audit report.

The Directors confirm that the Audit Committee of National Grid plc continues to review the adequacy of the system of internal financial controls adopted by the Group.

Independent Auditors' Report to the Members of National Grid Gas plc

We have audited the Group and parent company financial statements (the 'Financial Statements') of National Grid Gas plc for the year ended 31 March 2006 which comprise of the Group Income Statement, the Group and Company Balance Sheets, the Group Statement of Recognised Income and Expense, the Group Cash Flow Statement, the Group and Company Accounting Policies, the Notes to the Accounts and the Notes to the Company Accounts. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of Directors and auditors
The Directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and the parent company financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985 and whether, in addition, the Group financial statements have been properly prepared in accordance with Article 4 of the IAS Regulation. We report to you whether, in our opinion, the information in the Directors' Report is consistent with the financial statements. The information in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross-referenced from the Business Review section of the Directors' Report. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report, the Chairman's Statement and the Operating and Financial Review. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion
In our opinion:

- The Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 March 2006 and of its profit and cash flows for the year then ended;
- The Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- The parent company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 March 2006;
- The parent company financial statements have been properly prepared in accordance with the Companies Act 1985; and
- The information given in the Directors' Report is consistent with the financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Birmingham
30 June 2006

Group Accounting Policies

for the year ended 31 March 2006

(a) Basis of preparation of Group financial statements
These Group financial statements have been prepared in accordance with International Financial Reporting Standards ('IFRS') and Interpretations adopted by the European Union. They are prepared on the basis of all IFRSs and Interpretations that are mandatory for periods ending 31 March 2006 and in accordance with applicable United Kingdom law and Article 4 of the IAS regulation. The 2005 comparative financial information has also been prepared on this basis, with the exception of certain standards, details of which are given below, for which comparative information has not been restated.

In respect of the comparative financial information disclosed, IFRS 1 requires that estimates made under IFRS must be consistent with estimates made for the same date under UK GAAP except where adjustments are required to reflect any differences in accounting policies.

The Group financial statements have been prepared on an historical cost basis, except for the revaluation of certain financial instruments from 1 April 2005 onwards.

These Group financial statements are presented in pounds sterling.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

IFRS transitional arrangements
The Group's transition date to IFRS is 1 April 2004. The rules for first-time adoption of IFRS are set out in IFRS 1 'First-time adoption of International Financial Reporting Standards'. In preparing the Group's first IFRS financial statements, these transition rules have been applied to the amounts reported previously under generally accepted accounting principles in the United Kingdom ('UK GAAP'). IFRS 1 generally requires full retrospective application of the Standards and Interpretations in force at the first reporting date. However, IFRS 1 allows certain exemptions in the application of particular Standards to prior periods in order to assist companies with the transition process. National Grid Gas has applied the following exemptions:

(i) The Group has elected to adopt International Accounting Standard (IAS) 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' with effect from 1 April 2005, with no restatement of comparative information for the year to 31 March 2005. Accounting policy notes (n) and (o) explain the basis of accounting for financial instruments pre and post 1 April 2005.

(ii) IFRS 3 'Business combinations' has not been applied to business combinations that occurred before the date of transition.

Other choices made on the adoption of IFRS:

(i) At the date of transition, the vast majority of assets were valued at depreciated cost, as adjusted for IFRS measurement changes, with some assets being measured at deemed cost.

(ii) For Share-based payments, all active grants were recognised retrospectively. See Group Accounting Policies – (q) Share-based payments.

New IFRS accounting standards and interpretations adopted in 2005/06
In preparing these financial statements, the Group has complied with all IFRSs applicable for periods beginning on or after 1 January 2005.

In addition, the Group has adopted the following amendments to standards:

Amendment to IAS 1 'Presentation of Financial Statements'

The amendment requires new disclosures about entities' management of their capital resources and compliance with capital requirements.

Amendment to IAS 19 'Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures'.

The amendment allows entities which are members of a group defined benefit pension scheme, such as National Grid Gas, to account for the scheme as if it were a defined contribution scheme and not recognise a share of the assets and liabilities or actuarial gains and losses in respect of the scheme.

Amendment to IAS 39 'Financial Instruments: Recognition and Measurement: Cash Flow Hedge Accounting of Forecast Intragroup Transactions'

In consolidated financial statements, the amendment allows the foreign currency risk of a highly probable forecast intragroup transaction to qualify as a hedged item 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.

IFRS 7 'Financial Instruments: Disclosures'
This replaces the disclosure requirements in IAS 32 'Financial Instruments: Presentation and Disclosure' 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.

New IFRS accounting standards and interpretations not yet adopted

IFRIC 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 IAS 17 'Leases'. Implementation of this Interpretation is not expected to have a material impact on the Group's results or assets and liabilities.

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. Implementation of this Interpretation is not expected to have a material impact on the Group's results or assets and liabilities.

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 that otherwise would be required under the contract, in which case reassessment is required. Implementation of this Interpretation is not expected to have a material impact on the Group's results or assets.

(b) Basis of consolidation

The Group financial statements incorporate the financial statements of the Company and its subsidiaries ('Group undertakings'). A subsidiary is defined as an entity controlled by the Company. Control is achieved where the Company has the power to govern the financial and operating policies of an entity so as to obtain the benefits from its activities.

Where necessary, adjustments are made to bring the accounting policies used under relevant local GAAP in the individual financial statements of the Company and subsidiaries into line with those used by the Group under IFRS.

The results of subsidiaries acquired or disposed of during the year are included in the Group income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

(c) Foreign currencies

Transactions in currencies other than the functional currency of the Group undertaking concerned, are recorded at the rates of exchange prevailing on the dates of the transactions. At each balance sheet date, monetary assets and liabilities that are denominated in foreign currencies are retranslated at closing exchange rates. Other non-monetary assets are not retranslated unless they are carried at fair value.

As set out in note (o) below, as permitted by IFRS 1, prior to 1 April 2005 the Group adopted UK GAAP for hedge accounting and, consequently, monetary assets and liabilities denominated in foreign currencies were translated at hedged rates instead of closing exchange rates.

Gains and losses arising on retranslation of monetary assets and liabilities are included in the income statement.

On consolidation, the assets and liabilities of the Group's overseas financing operations are translated at exchange rates prevailing at the balance sheet date. Income and expense items are translated at the weighted average exchange rates for the period. Exchange differences arising are classified as equity and transferred to the Group's translation reserve.

(d) Intangible assets other than goodwill

Identifiable intangible assets other than goodwill are recorded at cost less accumulated amortisation and any provision for impairment.

Internally generated intangible fixed assets, such as software, are recognised only if an asset is created that can be identified; it is probable that the asset created will generate future economic benefits; and that the development cost of the asset can be measured reliably. Where no internally generated intangible asset can be recognised, development expenditure is recorded as an expense in the period in which it is incurred.

Intangible assets other than goodwill are amortised on a straight-line basis over their estimated useful economic lives. Amortisation periods for the principal categories of intangible assets are:

Amortisation periods for categories of intangibles	Years
Software	3 to 5

(e) Property, plant and equipment

Property, plant and equipment is recorded at cost, less accumulated depreciation and any impairment losses.

Cost includes payroll and finance costs incurred which are directly attributable to the construction of property, plant and equipment.

Property, plant and equipment includes assets in which the Group's interest comprises legally protected statutory or contractual rights of use.

Additions represent the purchase or construction of new assets, including capital expenditure for safety and environmental assets, and extensions to, enhancements to, or replacement of existing assets.

Contributions received towards the cost of property, plant and equipment are included in creditors as deferred income and credited on a straight-line basis to the income statement over the estimated economic useful lives of the assets to which they relate.

No depreciation is provided on freehold land and assets in the course of construction.

Other property, plant and equipment are depreciated, principally on a straight-line basis, at rates estimated to write off their book values over their estimated useful economic lives. In assessing estimated useful economic lives, which are reviewed on a regular basis, consideration is given to any contractual arrangements and operational requirements relating to particular assets. Unless otherwise determined by operational requirements, the depreciation periods for the principal categories of property, plant and equipment are, in general, as shown below.

Depreciation periods for category of assets	Years
Plant and machinery	
– mains, services and regulating equipment	30 to 100
– meters	10 to 18
Freehold and leasehold buildings	up to 50
Motor vehicles and office equipment	up to 10

(f) Impairment of assets

Impairments of assets are calculated as the difference between the carrying value of the asset and its recoverable amount, if lower. Where such an asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash-generating unit to which that asset belongs.

Recoverable amount is defined as the higher of fair value less costs to sell and estimated value in use at the date the impairment review is undertaken.

Value in use represents the present value of expected future cash flows, discounted using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

Tests for impairment are carried out only if there is some indication that the carrying value of the assets may have been impaired.

Impairments are recognised in the income statement and, where material, are disclosed separately.

(g) Taxation

Current tax

Current tax asset and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

Deferred tax

Deferred tax is provided using the balance sheet liability method and is recognised on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit.

Deferred tax liabilities are generally recognised on all taxable temporary differences and deferred tax assets are recognised to the extent that is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from the initial recognition (other than a business combination) of assets and liabilities in a transaction that affects neither the accounting profits nor the taxable profits.

Deferred tax liabilities are recognised on taxable temporary differences arising on investments in subsidiaries except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised, based on the tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date. Deferred tax is charged or credited to the income statement, except where it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the deferred income tax asset to be recovered. Unrecognised deferred tax assets are reassessed at each balance sheet date and are recognised to the extent that is has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are offset when there is a legally enforceable right exists to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Group intends to settle its current tax asset and liabilities on a net basis.

(h) Discontinued operations and non-current assets held for sale

Cash flows and operations that relate to a major component of the business, or geographical area of operations, that have been sold or are classified as held for sale are shown separately from the continuing operations of the Group.

Non-current assets (and disposal groups) classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. No depreciation is charged on assets and disposal groups classified as held for sale.

Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

(i) Inventories
Inventories are stated at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs as well as those overheads that have been incurred in bringing the inventories to their present location and condition.

(j) Environmental costs
Provision is made for environmental costs, based on future estimated expenditures, discounted to present values.

Changes in the provision arising from revised estimates or discount rates or changes in the expected timing of expenditures are recognised in the income statement.

The unwinding of the discount is included within the income statement as a financing charge.

(k) Revenues
Revenues primarily represent the sales value derived from the transmission and distribution of gas together with the sales value derived from the provision of gas metering services to customers during the year and exclude value added tax and intra-group sales.

Revenues include an assessment of transportation services supplied to customers between the date of the last meter reading and the year end.

Where revenues received or receivable exceed the maximum amount permitted by regulatory agreement and adjustments will be made to future prices to reflect this over-recovery, no liability is recognised. Similarly no asset is recognised where a regulatory agreement permits adjustments to be made to future prices in respect of an under-recovery.

(l) Pensions and other post-retirement benefits
The substantial majority of the Group's employees are members of the defined benefit section of the National Grid UK Pension Scheme. There is no contractual arrangement or stated policy for charging the net defined benefit cost of the scheme to the Group. Accordingly the Group accounts for the scheme as if it were a defined contribution scheme. The pension charge for the year represents the contributions payable to the scheme for the period.

The Group does not recognise a share of the assets and liabilities or the actuarial gains and losses of the Scheme.

(m) Leases
Rentals under operating leases are charged to income on a straight-line basis over the term of the relevant lease.

Assets held under finance leases are recognised at their fair value or, if lower, the present value of the minimum lease payments on inception, and depreciated over their useful economic lives. The corresponding liability is recognised as a finance lease obligation within borrowings. Rental payments are apportioned between finance costs and reduction in the finance lease obligation, so as to achieve a constant rate of interest.

(n) Financial instruments
Financial assets, liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities and is recorded at the proceeds received, net of direct issue costs.

Trade receivables are initially recognised at fair value and subsequently measured at amortised cost, less any appropriate allowances for estimated irrecoverable amounts. A provision is established for irrecoverable amounts when there is objective evidence that the Group will not be able to collect all amounts due under the original payment terms. Indications that the trade receivable may become irrecoverable would include financial difficulties of the debtor, likelihood of the debtor's insolvency, and default or significant failure of payment.

Loans receivable and other receivables are carried at amortised cost using the effective interest rate method. Interest income, together with gains and losses when the loans and receivables are derecognised or impaired, are recognised in the income statement.

Other financial investments are initially measured at cost including transaction costs, but with effect from 1 April 2005 are subsequently carried at fair value. Changes in the fair value of investments classified at fair value through profit and loss are included in the income statement, while changes in the fair value of investments classified as available-for-sale are recognised directly in equity, until the investment is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the net profit or loss for the period. Investment income on investments classified at fair value through profit and loss and on available-for-sale investments is recognised in the income statement as it accrues.

Interest-bearing loans and overdrafts are recorded at the proceeds received, net of direct issue costs plus accrued interest less any repayments, and subsequently stated at amortised cost. Any difference between the proceeds after direct issue costs and the redemption value is recognised in the income statement over the life of the borrowing. Prior to 1 April 2005, accrued interest is presented as part of current liabilities and not combined with the principal amounts payable.

Derivative financial instruments are recognised initially at fair value, and are subsequently also measured at fair value. Changes in the fair value of derivative financial instruments are included in the income statement to the extent hedge accounting is not applied.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for issued liabilities. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

Finance charges, including premiums payable on settlement or redemption and direct issue costs, are accounted for on an accruals basis using the effective interest rate method.

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets (being assets that necessarily take a substantial period of time to get ready for their intended use or sale) are added to their cost. Such additions cease when the assets are substantially ready for their intended use or sale. All other borrowing costs are recognised in the income statement in the period in which they are incurred.

All regular way purchases and sales of financial assets are recognised on the trade date, being the date that the Group commits to purchase or sell the assets. Regular way transactions require delivery of assets within the time frame generally established by regulation or convention in the marketplace.

(o) Hedge accounting and derivative financial instruments
The Group enters into both derivative financial instruments ('derivatives') and non-derivative financial instruments in order to manage its interest rate and foreign currency exposures and commodity price risks in respect of expected energy usage. The principal derivatives used include interest rate swaps, forward rate agreements, currency swaps, forward foreign currency contracts, and interest rate swaptions.

All derivative transactions are undertaken, or maintained, with a view to providing a commercial hedge of the interest, currency or commodity price risks associated with the Group's underlying business activities and the financing of those activities.

With effect from 1 April 2005, derivatives are carried in the balance sheet at their fair value.

From 1 April 2005, the accounting policy for hedge accounting is as described below. Disclosures on the impact of implementing IAS 39 at 1 April 2005 are set out in note 2.

Changes in the carrying value of financial instruments that are designated and effective as hedges of future cash flows ('cash flow hedges') are recognised directly in equity and any ineffective portion is recognised immediately in the income statement. Amounts deferred in equity in respect of cash flow hedges are subsequently recognised in the income statement in the same period in which the hedged item affects net profit or loss. Where an asset or a liability results from a forecasted transaction or firm commitment being hedged, the amounts deferred in equity are included in the initial measurement of that non-monetary asset or liability.

Changes in the carrying value of financial instruments that are designated as hedges of the changes in the fair value of assets or liabilities ('fair value hedges') are recognised in the income statement. An equal and opposite amount is recorded as an adjustment to the carrying value of hedged items, with a corresponding entry in the income statement, to the extent that the change is attributable to the risk being hedged and that the fair value hedge is effective.

Exchange gains or losses arising on financial instruments that are designated and effective as hedges of the Group's net investment in overseas operations ('net investment hedges') are recorded directly in equity, with any ineffective portion recognised immediately in the income statement.

Changes in the fair value of derivatives that do not qualify for hedge accounting are recognised in the income statement as they arise.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, any cumulative gains or losses relating to cash flow hedges recognised in equity are initially retained in equity and subsequently recognised in the income statement in the same periods in which the previously hedged item affects net profit or loss. For fair value hedges the cumulative adjustment recorded to its carrying value at the date hedge accounting is discontinued is amortised to the income statement using the effective interest method.

If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement immediately.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of host contracts and the host contracts are not carried at fair value with unrealised gains or losses reported in the income statement.

Prior to 1 April 2005, the Group adopted UK GAAP accounting principles for hedge accounting and for derivatives. Derivatives used for hedging purposes were not recorded on the balance sheet as assets or liabilities. Monetary assets and liabilities in foreign currencies were retranslated at hedged rates instead of closing rates. Exchange gains and losses relating to the hedge of the net investment in overseas subsidiaries were recorded directly in equity.

As permitted by the provisions of IFRS 1, the comparative balance sheet and income statement for the year ended 31 March 2005 have not been restated to reflect the adoption of IAS 39 or IAS 32.

(p) Restructuring costs
Costs arising from Group restructuring programmes primarily relate to redundancy costs. Redundancy costs are charged to the income statement in the year in which the Group becomes irrevocably committed to incurring the costs and the main features of the restructuring plan have been announced to affected employees.

(q) Share-based payments
The Group issues equity-settled share-based payments to certain employees.

Equity-settled share-based payments are measured at fair value at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.

(r) Exceptional items and remeasurements
Exceptional items are credits or charges relating to non-recurring transactions that are material, by virtue of their size or nature, and therefore relevant to understanding the Group's financial performance and are shown separately to provide a better indication of the underlying results of the Group.

Remeasurements are gains or losses arising from movements in the carrying value of financial instruments, principally derivatives, which provide economic hedges but do not achieve hedge accounting, or are ineffective under IAS 39 and are shown separately to provide a better indication of the underlying results of the Group.

(s) Emission allowances
Emission allowances are recorded as an intangible asset within current assets and are initially recorded at deemed cost. For allocations of emission allowances granted to the Group by the UK government, cost is measured as fair value at the date of allocation. Receipts of such grants are treated as deferred income and are recognised in the income statement over the period to which they relate. A provision is recorded in respect of our obligation to deliver emission allowances and charges are recognised in the income statement in the period in which carbon dioxide emissions are made.

(t) Cash and cash equivalents
Cash and cash equivalents include cash held at bank and in hand, together with short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant change in value.

(u) Key sources of estimation uncertainty
The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates. Information about such judgements and estimation is contained in the accounting policies and/or the Notes to the Accounts, and the key areas are summarised below.

Areas of judgement that have the most significant effect on the amounts recognised in the financial statements:

- The categorisation of certain items as exceptional and the definition of adjusted earnings – notes 3 and 5.
- The exemptions adopted under IFRS including, in particular, those relating to business combinations — Group accounting policies (a) Basis of preparation of Group financial statements.

Key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year:

- Review of residual lives, carrying values and impairment charges for other intangible assets and property, plant and equipment — Group accounting policies (d) intangible assets other than goodwill, (e) Property, plant and equipment and (f) Impairment of assets.
- Valuation of financial instruments and derivatives — note 18.
- Revenue recognition and assessment of unbilled revenue — Group accounting policies (k) Revenues.
- Recoverability of deferred tax assets — Group accounting policies (g) Taxation and note 15.
- Environmental liabilities — note 25.

Group Income Statement

for the years ended 31 March

	Notes	**2006 £m**	2005(i) £m
Group revenue	3(a)	**2,244**	1,996
Operating costs	4	**(1,409)**	(1,347)
Operating profit			
Before exceptional items and remeasurements	3(b)	**862**	758
Exceptional items and remeasurements	5	**(27)**	(109)
Total operating profit	3(b)	**835**	649
Interest income and similar income	9	**86**	20
Interest expense and other finance costs			
Before exceptional items and remeasurements	9	**(270)**	(345)
Exceptional items and remeasurements	5, 9	**(25)**	–
	9	**(295)**	(345)
Profit before taxation			
Before exceptional items and remeasurements		**678**	433
Exceptional items and remeasurements		**(52)**	(109)
Total profit before taxation		**626**	324
Taxation			
Before exceptional items and remeasurements	10	**(152)**	(122)
Exceptional items and remeasurements	5,10	**16**	31
Total taxation	10	**(136)**	(91)
Profit from continuing operations after taxation			
Before exceptional items and remeasurements		**526**	311
Exceptional items and remeasurements	5	**(36)**	(78)
Profit for the year from continuing operations		**490**	233
Profit for the year from discontinued operations			
Before exceptional items	11	**43**	357
Exceptional items	11	**2,451**	(61)
	11	**2,494**	296
Profit for the year		**2,984**	**529**

(i) Refer to note 1 for the basis of preparation of the comparatives presented under International Financial Reporting Standards.

The notes on pages 44 to 72 form part of the Financial Statements.

Group Balance Sheet

at 31 March

	Notes	2006 £m	2005(i) £m
Non-current assets			
Intangible assets	13	**34**	42
Property, plant and equipment	14	**8,029**	12,810
Other receivables	16	**5,614**	2,648
Derivative financial assets	18	**118**	–
Total non-current assets		**13,795**	15,500
Current assets			
Intangible assets	13	**41**	–
Inventories	19	**22**	30
Trade and other receivables	20	**596**	356
Financial investments	17	**42**	12
Derivative financial assets	18	**95**	–
Cash and cash equivalents	21	**223**	4
Total current assets		**1,019**	402
Total assets	3(c)	**14,814**	15,902
Current liabilities			
Borrowings	22	**(1,014)**	(1,880)
Derivative financial liabilities	18	**(47)**	–
Trade and other payables	23	**(799)**	(1,209)
Current tax liabilities		**(69)**	(27)
Provisions	25	**(66)**	(94)
Total current liabilities		**(1,995)**	(3,210)
Non-current liabilities			
Borrowings	22	**(2,698)**	(3,396)
Derivative financial liabilities	18	**(57)**	–
Other non-current liabilities	24	**(953)**	(1,690)
Deferred tax liabilities	15	**(1,543)**	(2,611)
Provisions	25	**(62)**	(91)
Total non-current liabilities		**(5,313)**	(7,788)
Total liabilities	3(c)	**(7,308)**	(10,998)
Net assets		**7,506**	4,904
Equity			
Called up share capital	26	**45**	45
Share premium account	27	**204**	204
Retained earnings	27	**5,985**	3,323
Cash flow hedges	27	**(60)**	–
Other reserves	27	**1,332**	1,332
Total shareholders' equity		**7,506**	4,904

(i) Refer to note 1 for the basis of preparation of the comparatives presented under International Financial Reporting Standards.

These financial statements comprising the Group Income Statement, Group Balance Sheet, Group Statement of Recognised Income and Expense, Group Cash Flow Statement and the related notes 1 to 32, were approved by the Board of Directors on 30 June 2006 and were signed on its behalf by:

Steve Holliday Managing Director

Colin Buck Finance Director

Group Statement of Recognised Income and Expense

for the years ended 31 March

	2006 £m	2005(i) £m
Net losses taken to equity in respect of cash flow hedges	**(14)**	–
Transferred to profit or loss on cash flow hedges	**(3)**	–
Tax on items taken directly to or transferred from equity	**5**	–
Net expense recognised directly in equity	**(12)**	–
Profit for the year	**2,984**	529
Total recognised income and expense for the year	**2,972**	529
Effect of change in accounting policy – IAS 39 (ii)	**(59)**	–

(i) Refer to note 1 for the basis of preparation of the comparatives presented under International Financial Reporting Standards.
(ii) The Group has adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' prospectively with effect from 1 April 2005, in accordance with the transition provisions of IFRS 1. An analysis of the impact that the adoption of IAS 39 had on the Group's reserves is provided in note 27.

Group Cash Flow Statement

for the years ended 31 March

	Notes	2006 £m	2005(i) £m
Cash flows from operating activities			
Operating profit		**835**	649
Adjustments for:			
Exceptional items and remeasurements		**27**	109
Depreciation and amortisation		**414**	387
Changes in working capital		**(160)**	53
Changes in provisions		**18**	–
Cash flows relating to exceptional items		**(79)**	(52)
Cash flows generated from continuing operations		**1,055**	1,146
Cash flows relating to discontinued operations		**(22)**	543
Cash generated from operations		**1,033**	1,689
Tax paid – continuing operations		**(245)**	(104)
Tax paid – discontinued operations		**(37)**	(98)
Net cash inflow from operating activities	28(a)	**751**	1,487
Cash flows from investing activities			
Purchases of intangible assets		**(11)**	(27)
Purchases of property, plant and equipment		**(686)**	(636)
Disposals of property, plant and equipment		**2**	–
Purchases of financial investments		**(30)**	–
Sales of financial investments		**–**	62
Loan to immediate parent undertaking		**(2,967)**	(100)
Cash flows used in continuing operations investing activities		**(3,692)**	(701)
Cash flows relating to discontinued operations – disposal proceeds		**5,750**	–
Cash flows relating to discontinued operations – other investing activities		**(115)**	(323)
Net cash from/(used in) investing activities		**1,943**	(1,024)
Cash flows from financing activities			
Proceeds from loans received		**–**	400
Repayment of loans		**(1,160)**	(653)
Net movements in short-term borrowings and derivatives		**(777)**	585
Interest received		**86**	32
Interest paid		**(303)**	(318)
Exceptional finance costs on the repayment of debt		**(11)**	–
Dividends paid to shareholders		**(310)**	(500)
Net cash used in financing activities		**(2,475)**	(454)
Net increase in cash and cash equivalents		**219**	9
Cash and cash equivalents at start of year		**4**	(5)
Cash and cash equivalents at end of year	21	**223**	4

(i) Refer to note 1 for the basis of preparation of the comparatives presented under International Financial Reporting Standards.

Notes to the Accounts

1. Adoption of International Financial Reporting Standards (IFRS)

With effect from 1 April 2005, National Grid Gas plc is required to report its consolidated financial statements in accordance with IFRS.

The tables below present the impact of conversion from UK generally accepted accounting principles (UK GAAP) to IFRS on the primary statements. The transition date chosen for the adoption of IFRS is 1 April 2004 and one year of IFRS comparatives is included in these financial statements for the year ended 31 March 2006.

As permitted by International Financial Reporting Standard 1 'First-time Adoption of IFRS' (IFRS 1), the comparative balance sheet at 31 March 2005 and income statement for the year ended 31 March 2005 have not been restated to reflect the adoption of IAS 39 and IAS 32 on 1 April 2005. Summary disclosures on the impact of the adoption of IAS 39 and IAS 32 as at 1 April 2005 are included in note 2.

a) Impact of adoption of IFRS on net assets at 1 April 2004 (date of adoption of IFRS)

The following is a summary of the IFRS measurement adjustments as they affected net assets at 1 April 2004 (the date of adoption of IFRS), which arise as a consequence of applying IFRS measurement principles as compared with UK GAAP.

At 1 April 2004	Notes	**£m**
Net assets under UK GAAP		**2,141**
IFRS measurement adjustments		
Replacement expenditure	1(c)(i)	**2,778**
Deferred taxation	1(c)(ii)	**(46)**
Net assets under IFRS		**4,873**

Amounts shown above are net of any related deferred tax on the underlying IFRS adjustment.

b) Reconciliation of profit for the year and net assets under UK GAAP to IFRS

The following tables show the effect of IFRS measurement adjustments on profit for the year and net assets measured under UK GAAP as a consequence of applying IFRS measurement principles as compared with UK GAAP:

For the year ended 31 March 2005	Notes	**£m**
Profit for the year under UK GAAP		**303**
IFRS measurement adjustments		
Replacement expenditure – gross	1(c)(i)	**344**
Replacement expenditure – depreciation	1(c)(i)	**(108)**
Deferred taxation	1(c)(ii)	**(12)**
Other adjustments	1(c)(iii)	**2**
Profit for the year under IFRS		**529**
Less: profit for the year under IFRS – discontinued operations		**(296)**
Profit for the year under IFRS – continuing operations		**233**

Amounts shown above are net of any related deferred tax on the underlying IFRS adjustment.

At 31 March 2005	Notes	**£m**
Net assets under UK GAAP		**1,946**
IFRS measurement adjustments		
Replacement expenditure	1(c)(i)	**3,014**
Deferred taxation	1(c)(ii)	**(58)**
Other adjustments	1(c)(iii)	**2**
Net assets under IFRS		**4,904**

Amounts shown above are net of any related deferred tax on the underlying IFRS adjustment.

1. Adoption of IFRS (continued)

c) IFRS measurement adjustments

The following relate to the measurement adjustments included in the income statement and balance sheet.

(i) Replacement expenditure (repex)

Repex represents the cost of planned replacement of gas mains and services and is undertaken to maintain the safety of the networks. Under UK GAAP, the gas distribution pipeline network is treated as a single infrastructure asset for accounting purposes and repex is recorded as an expense as it represents a repair to that single infrastructure asset and repex does not have the effect of enhancing the economic benefits of the pipeline network as a whole. Under IFRS, the individual assets and components within the gas distribution pipeline network are recorded separately, and hence repex is treated as the replacement or restoration of those individual assets or components.

The adjustment to net assets reflects the aggregate of the cumulative capitalisation of repex incurred, net of cumulative depreciation, the derecognition of previously replaced gas mains and services, the effect on cumulative depreciation of depreciating gas mains and services at an individual asset or component level, rather than at a distribution pipeline network level, and the effect of treating contributions received towards the cost of altering gas mains and services as deferred income.

(ii) Deferred taxation

Under UK GAAP, deferred tax is recognised in respect of timing differences. Under IFRS, deferred tax is recognised in respect of temporary differences, being the differences between the book recorded value and the tax base of assets and liabilities. The adoption of IFRS resulted in a total increase in the net deferred tax liability at 1 April 2004 of £1,236m, which includes the tax effect of the other IFRS adjustments which are shown net of tax in the reconciliations above.

(iii) Other measurement adjustments

Other differences on transition from UK GAAP to IFRS for the year ended 31 March 2005 comprises items which are not individually material.

d) IFRS presentation adjustments

The following notes relate to the presentation adjustments included in the income statement and balance sheet.

(i) Cash and cash equivalents

Under UK GAAP, cash excludes short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant change in value. Under IFRS, such investments are included within cash and cash equivalents.

(ii) Software

Under UK GAAP, software is capitalised together with the related hardware within property, plant and equipment. Under IFRS, software is classified within intangible assets.

(iii) Short term provisions

Under UK GAAP, provisions are presented on the balance sheet separately from creditors and include both current and non-current provisions. Under IFRS, the current portion of provisions is included within current liabilities.

e) Impact of adoption of IFRS on cash flow statement

The principal changes to the Group cash flow statement for the year ended 31 March 2005 on adoption of IFRS are summarised below.

Income taxes of £202m paid during the year ended 31 March 2005 are classified as part of operating cash flows under IFRS, but were classified as a separate category of the cash flow under UK GAAP.

Payments in respect of replacement expenditure of £506m, which were previously written off to the income statement under UK GAAP, are now capitalised under IFRS. Therefore, this expenditure is classified as investing activities in the IFRS cash flow statement, but was previously classified as operating cash flow under UK GAAP.

In accordance with IAS 7 ‘Cash flow statements’, cash equivalents include certain short-term highly liquid investments that are readily convertible to known amounts of cash and subject to an insignificant change in value. These were previously shown within cash flows from the management of liquid resources, as they did not fall within the definition of cash according to UK GAAP.

1. Adoption of IFRS (continued)

f) Reconciliation of summary financial statements for year ended 31 March 2005 from UK GAAP to IFRS

	As previously presented under UK GAAP (i) £m	IFRS measurement changes £m	IFRS presentation changes £m	IFRS discontinued operations £m	**IFRS £m**
Summary Group Income Statement for the year ended 31 March 2005					
Group revenue	3,045	–	–	(1,049)	**1,996**
Operating costs	(2,298)	338	–	613	**(1,347)**
Operating profit	747	338	–	(436)	**649**
Net finance costs	(325)	–	–	–	**(325)**
Profit before taxation	422	338	–	(436)	**324**
Taxation	(119)	(112)	–	140	**(91)**
Profit for the year from continuing operations	303	226	–	(296)	**233**
Profit for the year from discontinued operations	n/a	–	–	296	**296**
Profit for the year	303	226	–	–	**529**
Summary Group Balance Sheet as at 31 March 2005					
Non-current assets	7,935	4,910	2,655	–	**15,500**
Current assets	3,057	–	(2,655)	–	**402**
Total assets	10,992	4,910	–	–	**15,902**
Current liabilities	(3,101)	(15)	(94)	–	**(3,210)**
Non-current liabilities	(5,945)	(1,937)	94	–	**(7,788)**
Total liabilities	(9,046)	(1,952)	–	–	**(10,998)**
Net assets	1,946	2,958	–	–	**4,904**
Equity					
Called-up share capital	45	–	–	–	**45**
Share premium account	204	–	–	–	**204**
Retained earnings	365	2,958	–	–	**3,323**
Other reserves	1,332	–	–	–	**1,332**
Total equity	1,946	2,958	–	–	**4,904**
Summary Group Cash Flow Statement for the year ended 31 March 2005					
Cash generated from operations					
Cash flows from operating activities – continuing operations	1,175	506	8	(543)	**1,146**
Cash flows from operating activities – discontinued operations	–	–	–	543	**543**
Tax paid – continuing operations	(202)	–	–	98	**(104)**
Tax paid – discontinued operations	–	–	–	(98)	**(98)**
Net cash inflow from operations	973	506	8	–	**1,487**
Cash flows from investing activities					
Cash flows from investing activities – continuing operations	(510)	(506)	(8)	323	**(701)**
Cash flows from investing activities – discontinued operations	–	–	–	(323)	**(323)**
Net cash used in investing activities	(510)	(506)	(8)	–	**(1,024)**
Net cash outflows from financing activities	(454)	–	–	–	**(454)**
Net increase in cash and cash equivalents	9	–	–	–	**9**

(i) Represents UK GAAP measurement principles, but presented in IFRS formats for comparability.

2. Adoption of IAS 39 and IAS 32 and presentation of net debt at 1 April 2005

a) Adoption of IAS 39 and IAS 32

On 1 April 2005 the Group adopted IAS 39 and IAS 32. IAS 39 requires certain financial instruments to be recorded in the balance sheet at fair value rather than historical cost. Note 18 contains the disclosures required by IAS 39, IAS 32 and IFRS 7.

The principal effect of the adoption of these standards at 1 April 2005 is to record derivative financial instruments in the balance sheet at their fair value, while deferred gains and losses relating to items qualifying for hedge accounting are derecognised and instead recorded in equity (for cash flow hedges and net investment hedges) or by adjusting the carrying value of the hedged financial instrument (for fair value hedges).

As permitted by IFRS 1, the balance sheet at 31 March 2005 and the income statement for the year ended 31 March 2005 have not been restated to reflect the adoption of IAS 39 and IAS 32 on 1 April 2005.

b) Effect of IAS 39 on net debt and net assets

	At 31 March 2005 £m	IAS 39 transition adjustment at 1 April 2005 (i) (ii) £m	IAS 39 reclass-ifications at 1 April 2005 (iii) £m	**IFRS post-IAS 39 at 1 April 2005 £m**
Cash and cash equivalents	**4**	–	–	**4**
Financial investments	**12**	–	–	**12**
Borrowings	**(5,276)**	(173)	(165)	**(5,614)**
	(5,260)	(173)	(165)	**(5,598)**
Derivative financial assets	**–**	121	18	**139**
Derivative financial liabilities	**–**	(78)	8	**(70)**
Net debt	**(5,260)**	(130)	(139)	**(5,529)**
Accrued interest	**(139)**	–	139	**–**
Deferred gains and losses	**(23)**	23	–	**–**
Other assets and liabilities	**10,326**	48	–	**10,374**
Net assets	**4,904**	(59)	–	**4,845**

(i) On the adoption of IAS 39, derivative financial assets and liabilities are recognised on the balance sheet, with corresponding adjustments to retained earnings or to other reserves within equity (in respect of derivatives qualifying as cash flow hedges or net investment hedges) or to the carrying value of debt (in respect of derivatives qualifying as fair value hedges). The impact on other assets and liabilities principally relates to the deferred tax effect of these adjustments.

(ii) Up to 31 March 2005, deferred gains and losses relating to hedged financial instruments were carried forward in the balance sheet and reflected in the income statement in line with those hedged financial instruments. Under IAS 39, deferred gains and losses relating to qualifying hedge relationships are recorded in equity (for cash flow hedges and net investment hedges) or by adjusting the carrying value of the hedged financial instrument (for fair value hedges) or in the income statement if hedge accounting is not achieved.

(iii) Up to 31 March 2005, accrued interest were presented separately within creditors from the financial instruments to which it relates. Under IAS 32 and IAS 39 the carrying value of borrowings and derivative financial assets and liabilities includes the related accrued interest balance.

3. Segmental analysis

Segmental information is presented in accordance with the management responsibilities and economic characteristics, including consideration of risks and returns, of the Group's business activities.

The following table describes the main activities for each business segment:

UK gas transmission	The gas transmission network in the UK and the associated UK liquefied natural gas (LNG) storage activity
UK gas distribution	Four of the eight regional networks of Great Britain's gas distribution system
UK gas metering	Regulated gas metering activities in the UK

Other activities primarily relate to corporate overheads. In the Group UK GAAP accounts for the year ended 31 March 2005, UK gas metering and our UK liquefied natural gas (LNG) storage activity were reported within other activities.

Our LNG storage activity is now included within UK gas transmission following a change in the organisational and management structure within the Group and UK gas metering is reported as a separate segment, both having previously been reported within other activities under UK GAAP. The impact of these changes on segment results has been reflected in the tables below. The impact of this change on the UK gas transmission segment results for the year ended 31 March 2005 was to increase revenue by £21m and operating profit by £6m, increase total assets by £56m and total liabilities by £8m, increase capital expenditure by £7m and increase depreciation and amortisation by £7m. Within Other activities, revenue was decreased by £397m and operating profit by £110m, total assets and total liabilities decreased by £995m and £111m respectively, capital expenditure decreased by £73m and depreciation and amortisation decreased by £137m. Intra-group revenue eliminations were reduced by £17m. There was no difference between the impact on operating profit before exceptional items and remeasurements and that for operating profit after exceptional items and remeasurements.

3. Segmental analysis (continued)

Discontinued operations comprise the operations of the four gas distribution networks that the Group sold on 1 June 2005. The results for discontinued operations are disclosed in note 11.

The Group assesses the performance of its businesses principally on the basis of operating profit before exceptional items and remeasurements. The Group's primary reporting format is by business. All the Group's sales and operations take place within the UK, hence there is no secondary reporting format.

Sales between businesses are priced having regard to the regulatory and legal requirements that the businesses are subject, which include requirements to avoid cross-subsidies.

a) Group revenue

	Total sales 2006 £m	**Sales between businesses 2006 £m**	**Sales to third parties 2006 £m**	Total sales 2005 £m	Sales between businesses 2005 £m	Sales to third parties 2005 £m
Business segments						
UK gas transmission	**751**	**5**	**746**	582	6	576
UK gas distribution	**1,222**	**63**	**1,159**	1,113	47	1,066
UK gas metering	**342**	**3**	**339**	359	5	354
	2,315	**71**	**2,244**	2,054	58	1,996

The table above represents revenue from continuing operations only, as disclosed in the Group Income Statement as 'Group revenue'. Revenue from discontinued operations for the year ended 31 March 2006 was £168m (2005: £1,102m). See note 11 for additional disclosures on discontinued operations.

b) Operating profit

	Operating profit			
	Before exceptional items and remeasurements		After exceptional items and remeasurements	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Business segments				
UK gas transmission	**287**	277	**287**	274
UK gas distribution	**483**	419	**456**	313
UK gas metering	**107**	83	**107**	83
Other activities	**(15)**	(21)	**(15)**	(21)
	862	758	**835**	649

The table above represents operating profit from continuing operations only, as disclosed in the Group Income Statement, and excludes the results of discontinued operations. Operating profit before exceptional items and remeasurements for discontinued operations for the year ended 31 March 2006 was £61m (2005: £510m). Operating profit after exceptional items and remeasurements for the year ended 31 March 2006 was £46m (2005: £436m). See note 11 for additional disclosures on discontinued operations.

c) Total assets and total liabilities

	Total assets		Total liabilities	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Business segments				
UK gas transmission	**2,406**	2,147	**(391)**	(260)
UK gas distribution	**5,132**	4,767	**(1,166)**	(1,120)
UK gas metering	**869**	939	**(126)**	(103)
	8,407	7,853	**(1,683)**	(1,483)
Group undertakings – discontinued operations	**–**	5,300	**–**	(1,732)
Group undertakings	**8,407**	13,153	**(1,683)**	(3,215)
Unallocated	**6,407**	2,749	**(5,625)**	(7,783)
	14,814	15,902	**(7,308)**	(10,998)

The analysis of total assets and total liabilities excludes inter-business balances. Unallocated total assets include amounts owed by fellow subsidiary undertakings, cash and cash equivalents, taxation, financial investments and derivative assets. Unallocated total liabilities include amounts owed to fellow subsidiary undertakings, bank overdrafts, borrowings and derivative liabilities, taxation, interest and dividends.

3. Segmental analysis (continued)

d) Other segmental information

	Capital expenditure		Depreciation and amortisation	
	2006 £m	2005 £m	**2006 £m**	2005 £m
Business segments				
UK gas transmission	**360**	128	**(114)**	(94)
UK gas distribution	**444**	381	**(161)**	(163)
UK gas metering	**64**	66	**(139)**	(130)
	868	575	**(414)**	(387)
Group undertakings – discontinued operations	**87**	403	**(13)**	(176)
Group undertakings	**955**	978	**(427)**	(563)

Capital expenditure comprises additions to property, plant and equipment and other intangible assets amounting to £903m (2005: £950m) and £52m (2005: £28m) respectively.

Depreciation and amortisation includes depreciation of property, plant and equipment and amortisation of other intangible assets, amounting to £408m (2005: £547m) and £19m (2005: £16m) respectively.

4. Operating costs

	Before exceptional items and remeasurements		Exceptional items and remeasurements		Total	
	2006 £m	2005 £m	**2006 £m**	2005 £m	**2006 £m**	2005 £m
Depreciation of property, plant and equipment	**395**	371	**–**	–	**395**	371
Amortisation of intangible assets	**19**	16	**–**	–	**19**	16
Payroll costs (note 6(a))	**227**	269	**21**	71	**248**	340
Other operating charges:						
Purchases of gas	**148**	84	**–**	–	**148**	84
Rates	**180**	160	**–**	–	**180**	160
Other operating charges	**413**	338	**6**	38	**419**	376
	1,382	1,238	**27**	109	**1,409**	1,347
Operating costs include:						
Research expenditure					**2**	4
Operating lease rentals						
Plant and machinery					**7**	11
Other					**13**	18
Auditors' remuneration						
Statutory audit services						
Annual audit					**0.5**	0.4
Regulatory reporting					**0.2**	0.2
Further audit related services					**–**	0.3
Tax advisory services					**0.2**	–

5. Exceptional items and remeasurements

The Group separately discloses items of income and expenditure relating to transactions that are material, either by their nature or size, that are relevant to an understanding of the Group's financial performance. These include non-recurring exceptional charges that do not relate to the underlying financial performance of the Group and remeasurement gains or losses arising from movements in the carrying value of derivative financial instruments.

	2006 £m	2005 £m
Exceptional items – restructuring costs (i)	27	105
Exceptional items – environmental related provisions (ii)	–	4
Total exceptional items and remeasurements included within operating profit	27	109
Exceptional finance costs (iii)	11	–
Remeasurements – net losses on derivative financial instruments (iv)	14	–
Total exceptional items and remeasurements included within finance costs	25	–
Total exceptional items and remeasurements before taxation	52	109
Tax on restructuring costs (i)	(8)	(34)
Tax on environmental related provisions (ii)	–	(2)
Tax on exceptional finance costs (iii)	(3)	–
Tax on derivative financial instrument remeasurements (iv)	(5)	–
Other exceptional tax charges (v)	–	5
Tax on exceptional items and remeasurements	(16)	(31)
Total exceptional items and remeasurements	36	78

(i) Restructuring costs relate to planned cost reduction programmes. For the year ended 31 March 2005, restructuring costs included pension curtailment costs of £42m arising as a result of redundancies.
(ii) During the year ended 31 March 2005, a review of the environmental provisions was undertaken to take into account the impact of changes to UK regulations on waste disposal. This review, together with related revisions to the expected expenditure profile, resulted in a charge of £4m in 2005.
(iii) Exceptional finance costs for the year ended 31 March 2006 represent costs incurred on the early redemption of debt following the disposal of four gas distribution networks.
(iv) Remeasurements – net losses on derivative financial instruments comprise non-cash gains and losses arising on derivative financial instruments reported in the income statement. These exclude gains and losses for which hedge accounting has been effective, which have been recognised directly in equity or offset by adjustments to the carrying value of debt.
(v) The exceptional tax charge in 2005 relates to the settlement of the liabilities arising from operating the Group's Qualifying Employee Share Ownership Trust.

6. Payroll costs and employees

a) Payroll costs

	2006 £m	2005 £m
Wages and salaries	216	235
Social security costs	20	20
Other pension costs (note 8)	61	97
Share-based payments	5	5
Severance costs	4	21
	306	378
Less: Amounts capitalised	(58)	(38)
	248	340

Payroll costs above represent continuing operations only. Payroll costs for discontinued operations for the year ended 31 March 2006 were £29m (2005: £139m).

b) Number of employees, including Directors

	31 March 2006 Number	Average 2006 Number	Average 2005 Number
UK			
Continuing operations	6,675	6,665	7,012
Discontinued operations	–	686	4,147
	6,675	7,351	11,159

The vast majority of employees in the UK are either directly or indirectly employed in the transmission and distribution of gas.

6. Payroll costs and employees (continued)

c) Key management compensation

	2006 £m	2005 £m
Salaries and short-term employee benefits	**3**	3
Post-employment benefits	**2**	2
Share based payments	**1**	1
	6	6

Key management comprises the Board Directors of the Company together with those Executive Directors of National Grid plc who have managerial responsibility for any of the businesses of the Group and who are not also Directors of the Company.

d) Share option and award schemes

National Grid operates two principal forms of share option scheme in which the employees and Directors of the Group participate. They are an employee Sharesave scheme and an Executive Share Option Plan ('the Executive Plan'). The details given below relate to the schemes operated by National Grid and the Sharesave scheme formerly operated by Lattice. Following the Merger, most Lattice scheme options were converted into 0.375 National Grid plc options. The remaining Lattice scheme options lapsed on 29 April 2003.

In any 10-year period, the maximum number of shares that may be issued or issuable pursuant to the exercise of options under all of National Grid's share option schemes may not exceed the number of shares representing 10% of the issued ordinary share capital of National Grid from time to time.

The Sharesave scheme is savings related where, under normal circumstances, share options are exercisable on completion of a three or a five-year save-as-you-earn contract. The exercise price of options granted represents 80% of the market price at the date the option was granted.

The Executive Plan applies to senior executives, including Executive Directors. Options granted for the 1999/2000 financial year are subject to the achievement of performance targets related to earnings per share growth over a three-year period and have now vested. Options granted for the 2000/01 financial year and thereafter are subject to the achievement of performance targets related to total shareholder returns over a three-year period. The share options are generally exercisable between the third and tenth anniversaries of the date of grant if the relevant performance target is achieved.

National Grid also operates a number of share award schemes including a Performance Share Plan (PSP) and a Share Matching Plan.

Under the PSP, awards have been made to Executive Directors and approximately 150 senior employees who have significant influence over the Group's ability to meet its strategic objectives. Under the PSP, awards are conditional on National Grid's total shareholder return over a three-year period. Awards are delivered in National Grid plc shares. At 31 March 2006 the number of conditional awards of ordinary share equivalents outstanding under the PSP was 1,149,000 (2005: 1,012,000) of which nil (2005: nil) were exercisable. The number of conditional awards during the year ended 31 March 2006 was 400,000 (2005: 558,000) with lapses/forfeits during the year of 263,000 (2005: 58,000) and exercises of nil (2005: 1,000).

The Share Matching Plan applies to Executive Directors whereby a predetermined part of each Director's bonus entitlement is automatically deferred into National Grid plc shares and a matching award may be made under the Plan after a three-year period provided the Director is still employed by the Group. At 31 March 2006 the number of conditional awards of ordinary share equivalents outstanding under the Share Matching Plan was 38,000 (2005: 33,000) of which nil (2005: 2,000) were exercisable. The number of conditional awards during the year ended 31 March 2006 was 13,000 (2005: 25,000) with exercises during the year of 8,000 (2005: nil).

6. Payroll costs and employees (continued)

d) Share option and award schemes continued

Movement in options to subscribe for ordinary shares under the Group's various options schemes for the two years ended 31 March 2006 are shown below and include those options related to shares issued to employee benefit trusts:

	Sharesave scheme options		Executive Plan options		Total options
	Weighted average price £	millions	Weighted average price £	millions	millions
At 31 March 2004	3.23	22.3	4.54	0.5	22.8
Granted	3.83	2.4	–	–	2.4
Lapsed – expired	3.25	(0.9)	4.34	(0.1)	(1.0)
Exercised	3.34	(2.0)	–	–	(2.0)
At 31 March 2005	3.28	21.8	4.56	0.4	22.2
Granted	4.34	3.6	–	–	3.6
Lapsed – expired	3.36	(3.4)	–	–	(3.4)
Exercised	3.21	(10.9)	4.45	(0.2)	(11.1)
At 31 March 2006	**3.68**	**11.1**	**4.78**	**0.2**	**11.3**

Included within options outstanding at 31 March 2006 and 31 March 2005 were the following options which were exercisable:

At 31 March 2006	**3.15**	**0.5**	**4.84**	**0.2**	**0.6**
At 31 March 2005	–	–	–	–	–

The weighted average remaining contractual life of options in the employee Sharesave scheme at 31 March 2006 was 1 year and 10 months. These options have exercise prices between £3.15 and £4.34.

The weighted average share price at the exercise dates were as follows:

	2006	2005
Sharesave scheme options	**5.89**	4.49
Executive Plan options	**5.50**	4.65

Options outstanding and exercisable and their weighted average exercise prices for the respective ranges of exercise prices and years at 31 March 2006 are as follows:

	Weighted average exercise price of exercisable options £	Number exercisable	Weighted average exercise price of outstanding options £	Number outstanding	Exercise price per share pence	Normal dates of exercise years
Executive Plan	3.76	9,000	3.76	9,000	375.8	2002 – 2009
	4.55	12,000	4.55	12,000	455.2	2003 – 2010
	5.32	37,000	5.32	37,000	531.5	2004 – 2011
	5.63	34,000	5.63	34,000	563.0	2005 – 2012
	4.34	65,000	4.47	121,000	434.3 – 481.5	2006 – 2013
	4.84	157,000	4.78	213,000		

Share-based payment charges

Under IFRS, a charge is made to the income statement based on the fair value of grants in accordance with IFRS 2 'Share-based Payment'. All share awards are equity settled.

The charge to the income statement for the year ended 31 March 2006 was £7m (2005: £7m).

6. Payroll costs and employees (continued)

d) Share option and award schemes continued

Awards under share option plans

The average share prices at the date of options being granted during each of the two financial years ended 31 March were as follows:

	2006	2005
Where the exercise price is less than the market price at the date of grant	**569.0p**	496.0p

The average exercise prices of the options granted during each of the two financial years ended 31 March were as follows:

	2006	2005
Where the exercise price is less than the market price at the date of grant	**434.0p**	383.0p

The average fair values of the options granted during each of the two financial years ended 31 March were estimated as follows:

	2006	2005
Where the exercise price is less than the market price at the date of grant	**128.2p**	92.1p

The fair values of the options granted were estimated using the following principal assumptions:

	2006	2005
Dividend yield (%)	**4.5**	5.5-5.8
Volatility (%)	**15.6-18.9**	15.4
Risk-free investment rate (%)	**4.2**	4.5
Average life (years)	**4.3**	4.0

The fair values of awards under the Sharesave scheme have been calculated using the Black-Scholes model. This is considered appropriate given the short exercise window of sharesave options.

Volatility has been derived based on the following:

(i) implied volatility in traded options over National Grid plc's shares;

(ii) historical volatility of National Grid plc's shares from October 2002 (the date of the merger of National Grid Group plc and Lattice Group plc); and

(iii) implied volatility of comparator companies where options in their shares are traded.

Volatility is assumed to revert from its current implied level to its long run mean, based on historical volatility under (ii) above.

Awards under other share scheme plans

The average share prices and fair values at the date share awards were granted during each financial years ended 31 March were as follows:

	2006	2005
Average share price	**535.6p**	431.7p
Average fair value	**358.0p**	210.6p

The fair values of the awards granted were estimated using the following principal assumptions:

	2006	2005
Dividend yield (%)	**4.4**	5.3-5.7
Volatility (%)	**19.9**	15.4
Risk-free investment rate (%)	**4.1**	4.5-5.2

Fair values have been calculated using a Monte Carlo simulation model, for awards with total shareholder return performance conditions. Fair values of awards with performance conditions based on earnings per share have been calculated using the share price at date of grant less the present value of dividends foregone during the performance period.

For other share scheme awards, where the primary vesting condition is that employees complete a specified number of years service, the fair value has been calculated as the share price at date of grant, adjusted to recognise the extent to which participants do not receive dividends over the vesting period.

Volatility for share awards has been calculated on the same basis as used for share options, as described above.

7. Directors' emoluments

The aggregate amount of emoluments paid to Directors in respect of qualifying services for 2006 was £2,490,520 (2005: £2,372,748). The amount paid in respect of compensation for loss of office in 2006 was £284,510 (2005: £nil). Directors' emoluments include amounts in respect of accrued bonus which had not yet been approved at the date of these accounts.

Five Directors exercised share options during 2006 (2005: three Directors).

A number of the current Directors are also directors and employees of National Grid plc or a subsidiary undertaking of that company and are paid by these companies.

As at 31 March 2006, retirement benefits were accruing to seven Directors under a defined benefit scheme (2005: six defined benefit schemes, one defined contribution scheme).

The aggregate emoluments for the highest paid Director were £572,517 for 2006 (2005: £543,389); and total accrued annual pension at 31 March 2006 for the highest paid Director was £195,000 (2005: £220,731). The amount of contributions paid in respect of defined contribution pension schemes was £17,300 (2005: £20,400).

8. Pensions and other post-retirement benefits

Substantially all the Group's employees are members of the defined benefit section of the National Grid UK Pension Scheme (formerly named the Lattice Group Pension Scheme) (the 'scheme'). There is no contractual arrangement or stated policy for charging the net defined benefit cost of the scheme to the Group. Accordingly, the Group accounts for the scheme as if it were a defined contribution scheme.

Pension scheme

The scheme provides final salary defined benefits for employees who joined prior to 31 March 2002 and defined contribution benefits for employees joining from 1 April 2002. The scheme is funded with assets held in a separate trustee administered fund. It is subject to independent valuations at least every three years, on the basis of which the qualified actuary certifies the rate of employers' contribution, which, together with the specified contributions payable by the employees and proceeds from the scheme's assets, are expected to be sufficient to fund the benefits payable under the scheme.

The latest full actuarial valuation as at 31 March 2006 is currently being carried out by Watson Wyatt LLP. The last completed full actuarial valuation was as at 31 March 2003. The projected unit method was used and the principal actuarial assumptions adopted were that the annual rate of inflation would be 2.5% and that future real increases in pensionable earnings would be 1.5%. Investments held in respect of pensions before they become payable would average 5.05% real annual rate of return and investments held in respect of pensions after they become payable would average 2.7% real rate of return and that pensions would increase at a real annual rate of 0.05%. The aggregate market value of the scheme's assets was £10,141m and the value of the assets represented approximately 92% of the actuarial value of benefits due to members calculated on the basis of pensionable earnings and service at 31 March 2003 on an ongoing basis and allowing for projected increases in pensionable earnings.

The results of the actuarial valuation carried out at 31 March 2003 showed that based on long-term financial assumptions the contribution rate required to meet future benefit accrual was 23.7% of pensionable earnings (20.7% employers and 3% employees). This contribution rate is currently being reviewed. The ongoing contribution rate does not include an allowance for administration expenses. These contributions are renewed annually. From 1 April 2006 the rate used for the recovery of administration costs was 3% of salary. Employers are currently, therefore, paying a total contribution rate of 23.7%.

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 an actuarial valuation at 31 March 2007 is known. At this point, National Grid will pay the gross amount of any deficit up to a maximum amount of £520m (£364m net of tax) into the scheme. The Group's share of these payments would be £468m (£328m net of tax). Until the 31 March 2007, actuarial valuation has been completed, National Grid has arranged for banks to provide the trustees of the 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 becoming insolvent or National Grid failing to make agreed payments into the fund.

8. Pensions and other post-retirement benefits (continued)

The following disclosures relate to the scheme as a whole and include amounts not recognised in these financial statements, but which are recognised in the accounts of Lattice Group plc.

	Pensions	
	2006 £m	2005 £m
Amounts recognised in the balance sheet of Lattice Group plc:		
Present value of fund obligations	**13,246**	12,644
Fair value of plan assets	**12,739**	11,853
	(507)	(791)
Present value of unfunded obligations	**(21)**	(18)
Liability in the balance sheet	**(528)**	(809)

	Pensions	
	2006 £m	2005 £m
Changes in the present value of the defined benefit obligation		
Opening defined benefit obligation	**12,662**	12,349
Current service cost	**69**	91
Interest cost	**655**	664
Actuarial losses	**1,207**	92
Curtailment (gain)/loss on redundancies	**(23)**	18
Curtailment gain on sale of gas distribution networks	**(168)**	–
Settlement on sale of gas distribution networks	**(589)**	–
Gains on settlement	**(20)**	–
Special termination benefits	**43**	–
Curtailment cost – augmentations	**5**	–
Employee contributions	**8**	11
Benefits paid	**(582)**	(563)
Closing defined benefit obligation	**13,267**	12,662
Changes in the fair value of plan assets		
Opening fair value of plan assets	**11,853**	11,243
Expected return on plan assets	**694**	683
Actuarial gains/(losses)	**1,274**	386
Assets distributed on settlements and transfers	**(609)**	–
Employer contributions	**100**	93
Employee contributions	**8**	11
Benefits paid	**(581)**	(563)
Closing fair value of plan assets	**12,739**	11,853
Expected contributions to defined benefit plans in the following year	**45**	71

8. Pensions and other post-retirement benefits (continued)

The major categories of plan assets as a percentage of total plan assets were as follows:

	Pensions	
	2006 %	2005 %
Equities	**38.4**	39.6
Corporate bonds	**20.4**	18.0
Gilts	**31.0**	33.0
Property	**8.6**	8.0
Other	**1.6**	1.4
Total	**100.0**	100.0

The principal assumptions used were:		
Discount rate (i)	**4.9**	5.4
Expected return on plan assets	**5.8**	6.2
Rate of increase in salaries (ii)	**3.9**	3.9
Rate of increase in pensions in payment and deferred pensions	**3.0**	3.0
Rate of increase in Retail Price Index	**2.9**	2.9

(i) For the year ended 31 March 2006, a 0.1% reduction in the discount rate would increase the current service cost by £2m and reduce the interest on liabilities by £1m.
(ii) A promotional age related scale has been used where appropriate.
(iii) The assumptions allow for future improvements in mortality.

The expected long-term rate of return on assets has been set reflecting the price inflation expectation, the expected real return on each major asset class and the long-term asset allocation strategy adopted for the plan. The expected real returns on specific asset classes reflect historical returns, investment yields on the measurement date and general future return expectations, and have been set after taking advice from the scheme's actuaries. The long-term target asset allocation for the scheme is 40% equities, 52% bonds and 8% property and other.

9. Finance income and costs

	2006 £m	2005 £m
Interest income on financial instruments held at amortised cost	**86**	20
Interest income and similar income	**86**	20
Interest expense on financial liabilities held at amortised cost	**(261)**	(327)
Exceptional debt redemption costs	**(11)**	–
Interest on derivatives	**(2)**	–
Other interest	**(13)**	(25)
Unwinding of discount on provisions	**(1)**	(2)
Less: interest capitalised	**7**	9
Interest expense	**(281)**	(345)
Net (losses)/gains on derivative financial instruments:		
On derivatives designated as fair value hedges	**(14)**	–
On derivatives designated as cash flow hedges	**3**	–
On derivatives not designated as hedges or ineligible for hedge accounting	**(3)**	–
Net losses on derivative financial instruments	**(14)**	–
Interest expense and other finance costs	**(295)**	(345)
Net finance costs	**(209)**	(325)
Comprising:		
Interest income and similar income	**86**	20
Interest expense and other finance costs		
Before exceptional items and remeasurements	**(270)**	(345)
Exceptional items and remeasurements	**(25)**	–
	(209)	(325)

Interest income on financial instruments held at amortised cost comprises interest income from bank deposits and other financial assets.

Interest expense on financial liabilities held at amortised cost comprises interest on bank loans and overdrafts £16m (2005: £18m), interest on other borrowings £246m (2005: £308m) and interest on finance leases £1m (2005: £1m).

Interest on the funding attributable to assets in the course of construction was capitalised during the year at a rate of 6.0% (2005: 5.6%).

Ineffectiveness on fair value hedges includes a net loss of £13m from derivatives designated as fair value hedges and a net loss of £1m from the fair value adjustments to the carrying value of debt.

Net gains on derivatives designated as cash flow hedges includes net gains of £3m transferred from equity.

10. Taxation

Taxation on items charged/(credited) to the income statement

	2006 £m	2005 £m
United Kingdom		
Corporation tax at 30%	**135**	40
Adjustment in respect of prior years (i)	**(32)**	(47)
Deferred tax	**34**	97
	137	90
Overseas		
Corporate tax	**(1)**	1
	(1)	1
Taxation	**136**	91
Comprising:		
Taxation – excluding exceptional items and remeasurements	**152**	122
Taxation – exceptional items and remeasurements (note 5)	**(16)**	(31)
	136	91

(i) The UK corporation tax adjustment in respect of prior years includes £nil (2005: £5m) that relates to exceptional items.

Taxation on items charged to equity

	2006 £m	2005 £m
Deferred tax credit on revaluation of cash flow hedges	**(1)**	–
Deferred tax credit on share options	**(4)**	(2)
	(5)	(2)

10. Taxation (continued)

The tax charge for the period is lower (2005: lower) than the standard rate of corporation tax in the UK (30%). The differences are explained below:

	Before exceptionals and remeasure-ments 2006 £m	**After exceptionals and remeasure-ments 2006 £m**	Before exceptionals and remeasure-ments 2005 £m	After exceptionals and remeasure-ments 2005 £m
Profit before taxation				
Before exceptional items and remeasurements	**678**	**678**	433	433
Exceptional items and remeasurements	**–**	**(52)**	–	(109)
Profit before taxation from continuing operations	**678**	**626**	433	324
Profit on continuing operations multiplied by rate of corporation tax in the UK of 30% (2005: 30%)	**203**	**187**	130	97
Effects of:				
Adjustments in respect of current income tax of previous years	**(32)**	**(32)**	(47)	(47)
Expenses not deductible for tax purposes	**6**	**6**	7	4
Non-taxable income	**(10)**	**(10)**	–	–
Impact of employee share options	**(3)**	**(3)**	(1)	(1)
Other	**(12)**	**(12)**	33	38
Total taxation (continuing operations)	**152**	**136**	122	91
	%	**%**	%	%
At the effective income tax rate	**22.4**	**21.7**	28.2	28.1

Factors that may affect future tax charges

The Group has no brought forward non-trading deficits (2005: £39m), which could reduce taxable profits in future years.

11. Discontinued operations

On 1 June 2005, the Group disposed of its holdings in four of the eight regional gas distribution networks. The results of these operations were previously included within the UK gas distribution segment, when reported under UK GAAP.

Results of discontinued operations

	2006 £m	2005 £m
Revenue	**168**	1,102
Operating costs	**(122)**	(666)
Operating profit before exceptional items	**61**	510
Exceptional items (i)	**(15)**	(74)
Total operating profit from discontinued operations	**46**	436
Profit before tax from discontinued operations	**46**	436
Taxation	**(18)**	(140)
Profit after tax from discontinued operations	**28**	296
Gain on disposal of gas distribution networks (ii)	**2,447**	–
Gain on disposal of discontinued operations before tax	**2,447**	–
Taxation	**19**	–
Gain on disposal of discontinued operations	**2,466**	–
Total profit for the year from discontinued operations		
– Before exceptional items	**43**	357
– Exceptional items	**2,451**	(61)
	2,494	296

(i) The operating exceptional item for the year ended 31 March 2006 related to a fine incurred in respect of a breach of the Health and Safety at Work Act arising from a gas explosion at Larkhall in Scotland in December 1999. Exceptional items for the year ended 31 March 2005 related to restructuring costs (£70m) and environmental costs (£4m).

(ii) The gain on disposal of the gas distribution networks resulted from proceeds of £5,760m comprising cash and cash equivalents, which was significantly in excess of the £3,294m net book value of the net assets disposed of.

12. Dividends

The following table shows the dividends paid to equity shareholders:

	2006 pence (per ordinary share)	**2006 £m**	2005 pence (per ordinary share)	2005 £m
Ordinary dividends				
Interim dividend for the year ended 31 March 2005	**–**	**–**	12.68	500
Interim dividend for the year ended 31 March 2006	**7.86**	**310**	–	–
	7.86	**310**	12.68	500

In addition, the directors are proposing a final dividend for 2006 of 38.03p per share which will absorb £1,500m of shareholders' funds.

13. Intangible assets

	Software £m	Emissions £m	Total £m
Cost at 1 April 2004	41	–	41
Additions	28	–	28
Cost at 31 March 2005	69	–	69
Additions	11	41	52
Disposals	(4)	–	(4)
Cost at 31 March 2006	76	41	117
Amortisation at 1 April 2004	(11)	–	(11)
Amortisation charge for the year	(16)	–	(16)
Amortisation at 31 March 2005	(27)	–	(27)
Amortisation charge for the year	(19)	–	(19)
Disposals	4	–	4
Amortisation at 31 March 2006	(42)	–	(42)
Net book value at 31 March 2006	**34**	**41**	**75**
Net book value at 31 March 2005	42	–	42

Software comprises internally developed assets and related licences.

Emissions consists of emissions trading credits.

Intangible assets have been analysed as current and non-current as follows:

	2006 £m	2005 £m
Current	**41**	–
Non-current	**34**	42
	75	42

14. Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Assets in the course of construction £m	Motor vehicles and office equipment £m	Total £m
Cost at 1 April 2004	76	16,985	121	697	17,879
Additions	6	818	84	42	950
Disposals	–	(31)	–	(4)	(35)
Reclassifications	3	127	(50)	(80)	–
Cost at 31 March 2005	85	17,899	155	655	18,794
Additions	11	610	254	28	903
Disposal of Group undertakings	(26)	(7,062)	(15)	(172)	(7,275)
Disposals	(1)	(69)	–	(2)	(72)
Reclassifications	–	73	(111)	38	–
Cost at 31 March 2006	69	11,451	283	547	12,350
Depreciation at 1 April 2004	(23)	(5,036)	–	(413)	(5,472)
Depreciation charge for the year	(4)	(476)	–	(67)	(547)
Disposals	–	31	–	4	35
Depreciation at 31 March 2005	(27)	(5,481)	–	(476)	(5,984)
Depreciation charge for the year	(4)	(358)	–	(46)	(408)
Disposal of Group undertakings	11	1,873	–	117	2,001
Disposals	1	67	–	2	70
Depreciation at 31 March 2006	(19)	(3,899)	–	(403)	(4,321)
Net book value at 31 March 2006	**50**	**7,552**	**283**	**144**	**8,029**
Net book value at 31 March 2005	58	12,418	155	179	12,810

The net book value of land and buildings comprised:

	2006 £m	2005 £m
Freehold	**46**	53
Long leasehold (over 50 years)	**1**	1
Short leasehold (under 50 years)	**3**	4
	50	58

The cost of property, plant and equipment at 31 March 2006 included £27m (2005: £21m) relating to interest capitalised.

The net book value of property, plant and equipment held under finance leases and included within motor vehicles and office equipment was £12m at 31 March 2006 (2005: £34m).

Included within trade and other payables and other non-current liabilities at 31 March 2006 are contributions to the cost of property, plant and equipment amounting to £27m (2005: £48m) and £907m (2005: £1,656m) respectively.

During the course of the year, some of our businesses have reviewed the useful lives of some of their assets. These changes have resulted in a net reduction in the depreciation charge of £9m.

15. Deferred tax assets and liabilities

The following are the major deferred tax liabilities and assets recognised by the Group, and the movements thereon, during the current and prior reporting periods:

Deferred tax (assets)/liabilities

	Accelerated tax depreciation £m	Employee share options £m	Mark to market £m	Other net temporary differences £m	Total £m
Deferred tax assets at 1 April 2004	–	(4)	–	(51)	(55)
Deferred tax liabilities at 1 April 2004	2,438	–	–	84	2,522
At 1 April 2004	2,438	(4)	–	33	2,467
Charged/(credited) to income statement	91	(4)	–	59	146
Credited to equity	–	(2)	–	–	(2)
At 31 March 2005	2,529	(10)	–	92	2,611
Deferred tax assets at 31 March 2005	–	(10)	–	(19)	(29)
Deferred tax liabilities at 31 March 2005	2,529	–	–	111	2,640
At 31 March 2005	2,529	(10)	–	92	2,611
First time adoption of IAS 39	–	–	15	(53)	(38)
At 1 April 2005	2,529	(10)	15	39	2,573
Charged/(credited) to income statement	55	(1)	(3)	(17)	34
Credited to equity	–	(4)	(1)	–	(5)
Disposals of Group undertakings	(1,068)	–	–	9	(1,059)
At 31 March 2006	**1,516**	**(15)**	**11**	**31**	**1,543**
Deferred tax assets at 31 March 2006	–	(15)	–	(22)	(37)
Deferred tax liabilities at 31 March 2006	1,516	–	11	53	1,580
	1,516	(15)	11	31	1,543

At the balance sheet date there were no material current deferred tax assets or liabilities.

There are no income tax consequences attached to the payment of dividends by National Grid Gas plc to its shareholder.

16. Other non-current receivables

	2006 £m	2005 £m
Amounts owed by immediate parent undertaking	**5,611**	2,644
Other receivables	**3**	4
	5,614	2,648

17. Financial investments

	2006 £m	2005 £m
Current		
Loans and receivables	**42**	12

There is no significant interest rate or currency rate risk on financial investments.

18. Financial instruments

The Group's treasury policy, described in the Operating and Financial Review on pages 22 and 23, includes details of the objectives, policies and strategies of the Group associated with financial instruments.

The Group's counterparty exposure under derivative financial contracts at 31 March 2006 was £145m (2005: £119m).

The Group had no significant exposure to either individual counterparties or geographical groups of counterparties at 31 March 2006.

Book and fair values of financial instruments at 31 March

	2006		2005	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Borrowings	**(3,712)**	**(3,716)**	(5,276)	(5,703)
Cash and cash equivalents	**223**	**223**	4	4
Financial investments				
Loans and receivables	**42**	**42**	12	12
Trade and other receivables				
Loans and receivables	**6,039**	**6,039**	2,788	2,788
Trade and other payables	**(620)**	**(620)**	(893)	(893)
Derivative financial assets	**213**	**213**	–	139
Derivative financial liabilities	**(104)**	**(104)**	–	(70)

Market values, where available, have been used to determine fair values. Where market values are not available, fair values have been calculated by discounting cash flows at prevailing interest rates. Due to their short maturities, the fair value of short-term receivables and payables approximates to their book value.

Currency and interest rate composition of financial assets and liabilities

The following tables set out the carrying amount, by contractual maturity, of the Group's non-derivative financial instruments that are exposed to interest rate risks before taking into account currency and interest rate swaps.

At 31 March 2006

Fixed rate	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
Liabilities							
Other bonds							
Sterling	(254)	(229)	(211)	(294)	–	(638)	(1,626)
Euro	(397)	(12)	(7)	(205)	–	–	(621)
US dollar	(205)	–	–	–	–	(484)	(689)
Other	(49)	–	(207)	(7)	–	(127)	(390)
Bank							
Sterling	(17)	–	–	–	–	–	(17)
Finance leases							
Sterling	(4)	(2)	–	(1)	–	–	(7)
	(926)	(243)	(425)	(507)	–	(1,249)	(3,350)

At 31 March 2006

Floating rate	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
Liabilities							
Other bonds							
Sterling	–	–	(39)	–	–	–	(39)
Euro	–	(29)	–	–	–	–	(29)
US dollar	–	(6)	–	–	–	–	(6)
Other	(11)	–	–	–	–	–	(11)
Bank							
Sterling	(64)	–	–	–	–	(200)	(264)
Borrowings from fellow subsidiary undertakings							
Sterling	(13)	–	–	–	–	–	(13)
	(88)	(35)	(39)	–	–	(200)	(362)

18. Financial instruments (continued)

Liquidity analysis

The following is an analysis of contractual cash flows payable by National Grid Gas under financial liabilities by remaining contractual maturities at the balance sheet date:

	Due within 1 year			Due between 1 and 2 years		
	Fixed interest £m	Floating interest £m	Repayment £m	Fixed interest £m	Floating interest £m	Repayment £m
Non-derivative financial liabilities						
Other bonds	(149)	(4)	(837)	(127)	(3)	(283)
Bank loans	–	(10)	(64)	–	(10)	–
Finance lease liabilities	–	–	(4)	–	–	(2)
Other non-interest bearing liabilities	–	–	(596)	–	–	(46)
	(149)	(14)	(1,501)	(127)	(13)	(331)
Derivative liabilities (net)						
Cross currency interest rate swap	(3)	–	(21)	(4)	–	(1)
Foreign exchange forward contracts	–	–	(3)	–	–	–
Interest rate swaps	(6)	(4)	–	(2)	(3)	–
	(9)	(4)	(24)	(6)	(3)	(1)
Derivative assets (net)						
Cross currency interest rate swaps	15	–	49	14	–	(4)
Foreign exchange forward contacts	–	–	1	–	–	–
Interest rate swaps	1	–	–	1	–	–
	16	–	50	15	–	(4)
Total at 31 March 2006	**(142)**	**(18)**	**(1,475)**	**(118)**	**(16)**	**(336)**

	Due between 2 and 3 years			Due 3 years and beyond		
	Fixed interest £m	Floating interest £m	Repayment £m	Fixed interest £m	Floating interest £m	Repayment £m
Non-derivative financial liabilities						
Other bonds	(101)	(1)	(484)	(867)	–	(2,260)
Bank loans	–	(10)	–	–	(31)	(200)
Finance lease liabilities	–	–	(1)	–	–	–
Other non-interest bearing liabilities	–	–	–	–	–	–
	(101)	(11)	(485)	(867)	(31)	(2,460)
Derivative liabilities (net)						
Cross currency interest rate swap	(2)	–	(2)	(10)	–	(21)
Foreign exchange forward contacts	–	–	–	–	–	–
Interest rate swaps	7	(4)	–	8	(23)	–
	5	(4)	(2)	(2)	(23)	(21)
Derivative assets (net)						
Cross currency interest rate swap	13	–	15	42	–	159
Foreign exchange forward contracts	–	–	–	–	–	–
Interest rate swaps	–	–	–	42	–	–
	13	–	15	84	–	159
Total at 31 March 2006	**(83)**	**(15)**	**(472)**	**(785)**	**(54)**	**(2,322)**

Sensitivity analysis at 31 March 2006

Financial instruments affected by market risk include borrowings, deposits, derivative financial instruments and commodity contracts. The following analysis, required by IFRS 7, is intended to illustrate the sensitivity to changes in market variables, being UK interest rates.

The analysis also excludes the impact of movements in market variables on the carrying value of provisions.

The sensitivity analysis has been prepared on the basis that the amount of net debt, the ratio of fixed to floating interest rates of the debt and derivatives portfolio and the proportion of financial instruments in foreign currencies are all constant and on the basis of the hedge designations in place at 31 March 2006. As a consequence, this sensitivity analysis relates to the position as at 31 March 2006 and is not representative of the year then ended as all of these varied during the course of 2005/06.

18. Financial instruments (continued)

The following assumptions were made in calculating the sensitivity analysis:

- the sensitivity to interest rates relates only to derivative financial instruments, as debt and deposits are carried at amortised cost and so their carrying value does not change as interest rates move;
- the sensitivity of accrued interest to movements in interest rates is calculated on net floating rate exposures on debt, deposits and derivative instruments with no sensitivity assumed for RPI-linked debt;
- changes in the carrying value of derivatives from movements in interest rates designated as cash flow hedges are assumed to be recorded fully within equity;
- changes in the carrying value of derivative financial instruments designated as fair value hedges from movements in interest rates have an immaterial effect on the income statement and equity due to compensating adjustments in the carrying value of debt;
- changes in the carrying value of derivative financial instruments not in hedging relationships only affect the income statement;
- all other changes in the carrying value of derivative financial instruments designated as hedges are fully effective with no impact on the income statement;
- debt with a maturity below one year is floating rate for the accrued interest part of the calculation; and
- the floating leg of any swap or any floating rate debt is treated as not having any interest rate already set, therefore a change in interest rates affects a full 12-month period for the accrued interest portion of the sensitivity calculations.

Using the above assumptions, the following table shows the illustrative effect on the income statement and equity that would result from movements in changes in UK interest rates.

	Income statement +/- £m	Equity +/- £m
UK interest rates +/- 0.10%	8	–

Derivative financial instruments

The Group's hedging policies are set out on page 23. The Group has entered into a number of derivative financial instruments as detailed below, which are designated as follows:

Fair value hedges

The Group maintains interest rate and currency swap contracts as fair value hedges of the interest rate and currency risk on fixed rate debt issued by the Group. Change in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk. The gain or loss relating to the effective portion of interest rate swaps hedging fixed rate borrowings is recognised in the income statement within interest expense and other finance costs. The gain or loss relating to the ineffective portion is recognised in the income statement within net (losses)/gains on derivative financial instruments. Changes in the fair value of the hedged fixed rate borrowings attributable to interest rate risk are recognised in the income statement within interest expense and other finance costs.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount is amortised to the income statement under the effective interest rate method.

Cash flow hedges

The Group maintains interest rate swaps and cross currency swaps that qualify for hedge accounting as designated cash flow hedges relating to future interest payments on debt. The revaluation of these swaps is included in the cash flow hedge reserve and is recycled to the income statement as the interest charge relating to the debt is recorded.

The Group uses forward foreign currency contracts to hedge anticipated and committed future purchases. Where designated, these contracts qualify for hedge accounting and are designated as cash flow hedges. When the underlying purchase is recorded, the associated gains and losses deferred in equity are removed and included in the initial cost of the asset.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Derivatives not in a formal hedge relationship

The Group's policy is not to use derivatives for trading purposes, however, due to the complex nature of hedge accounting under IAS 39 some derivatives may not qualify for hedge accounting, or are specifically not designated as a hedge where natural offset is appropriate.

18. Financial instruments (continued)

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement within net (losses)/gains on derivative financial instruments.

The maturity of derivative assets and liabilities measured at fair value at 31 March 2006 can be analysed as follows:

	Maturity less than 1 year £m	Maturity 1-2 years £m	Maturity 2-3 years £m	Maturity 3-4 years £m	Maturity 4-5 years £m	Maturity over 5 years £m	Total fair value 2006 £m
Derivative financial assets							
Interest rate swaps	28	–	–	–	–	45	73
Cross currency interest rate swaps	66	3	25	17	–	28	139
Foreign exchange forward contracts	1	–	–	–	–	–	1
Total at 31 March 2006	**95**	**3**	**25**	**17**	**–**	**73**	**213**
Derivative financial liabilities							
Interest rate swaps	(16)	–	(3)	(3)	–	(13)	(35)
Cross currency interest rate swaps	(28)	(1)	(2)	(1)	–	(34)	(66)
Foreign exchange forward contracts	(3)	–	–	–	–	–	(3)
Total at 31 March 2006	**(47)**	**(1)**	**(5)**	**(4)**	**–**	**(47)**	**(104)**

The notional amounts of the above derivatives liabilities can be analysed as follows:

	Maturity less than 1 year £m	Maturity 1-2 years £m	Maturity 2-3 years £m	Maturity 3-4 years £m	Maturity 4-5 years £m	Maturity over 5 years £m	Total fair value 2006 £m
Derivative financial assets							
Interest rate swaps	146	65	–	52	–	300	563
Cross currency interest rate swaps	340	35	164	189	–	451	1,179
Foreign exchange forward contracts	38	–	–	–	–	–	38
Total at 31 March 2006	**524**	**100**	**164**	**241**	**–**	**751**	**1,780**
Derivative financial liabilities							
Interest rate swaps	429	50	290	323	–	428	1,520
Cross currency interest rate swaps	268	7	21	8	–	169	473
Foreign exchange forward contracts	13	–	–	–	–	–	13
Total at 31 March 2006	**710**	**57**	**311**	**331**	**–**	**597**	**2,006**

At 31 March 2006	Assets Fair value £m	Assets Notional amount £m	Liabilities Fair value £m	Liabilities Notional amount £m
Fair value hedge derivative instruments				
Interest rate swaps	24	(237)	(7)	(817)
Cross currency interest rate swaps	84	(763)	(58)	(444)
	108	(1,000)	(65)	(1,261)
Cash flow hedge derivative instruments				
Interest rate swaps	39	(155)	(12)	(343)
Cross currency interest rate swaps	55	(411)	(5)	(22)
Foreign exchange forward contracts	1	(38)	(3)	(41)
	95	(604)	(20)	(406)
Other derivative instruments				
Interest rate swaps	10	(171)	(16)	(360)
Cross currency interest rate swaps	–	(5)	(3)	(7)
Foreign exchange forward contracts	–	–	–	28
	10	(176)	(19)	(339)
Total	**213**	**(1,780)**	**(104)**	**(2,006)**
Analysed as follows:				
Current	95	(524)	(47)	(710)
Non-current	118	(1,256)	(57)	(1,296)
	213	**(1,780)**	**(104)**	**(2,006)**

18. Financial instruments (continued)

Gains and losses recognised in cash flow hedge reserve (note 27) on interest rate swap contracts as of 31 March 2006 will be continuously released to the income statement until the bank borrowings are repaid (note 22).

The amount of cash flow hedge reserve due to be released from reserves to the income statement within the next year is £20m, with the remaining amount due to be released with the same maturity profile as borrowings in note 22.

Financial instruments disclosures for the year ended 31 March 2005

The following information for 2005 shows certain of the disclosures required by UK GAAP (FRS 13 ‘Derivatives and other financial instruments: disclosures’).

Gains and losses on hedges for year ended 31 March 2005

	Unrecognised gains £m	Unrecognised losses £m	Unrecognised net gain £m	Deferred gains £m	Deferred losses £m	Deferred net (loss)/gain £m
Gains/(losses) on hedges at 1 April 2004	253	(91)	162	88	(80)	8
(Gains)/losses arising in previous years recognised in the year	(20)	9	(11)	(10)	12	2
Gains/(losses) arising in previous years not recognised in the year	233	(82)	151	78	(68)	10
Gains/(losses) arising in the year	(138)	10	(128)	18	(5)	13
Gains/(losses) on hedges at 31 March 2005	95	(72)	23	96	(73)	23
Of which:						
Gains/(losses) expected to be recognised within one year	1	–	1	11	(12)	(1)
Gains/(losses) expected to be recognised after one year	94	(72)	22	85	(61)	24

Currency and interest rate composition of financial assets and liabilities at 31 March 2005

The currency and interest rate composition of the Group’s financial assets are shown in the table below after taking into account currency and interest rate swaps:

			Fixed rate assets		
	Total £m	Non-interest bearing £m	Fixed rate £m	Weighted average interest rate %	Weighted average period for which rate is fixed years
At 31 March 2005					
Sterling	12	12	–	–	–
US dollars	3	–	3	2.8	–
Other currencies	1	–	1	2.0	–
Cash and investments	16	12	4	–	–
Other financial assets (sterling)	2,644	2,644	–	–	–
	2,660	2,656	4	–	–

Cash and investments earned interest at local prevailing rates for maturity periods generally not exceeding 12 months. Other financial assets at 31 March 2006 related to an amount due from the immediate parent undertaking.

			Fixed rate liabilities		
	Total £m	Variable rate £m	Fixed rate £m	Weighted average interest rate %	Weighted average period for which rate is fixed years
At 31 March 2005					
Sterling					
Borrowings	5,276	3,686	1,590	6.5	8
Other financial liabilities	16	16	–	–	–
	5,292	3,702	1,590	6.5	8

18. Financial instruments (continued)

The maturity profile of the Group's financial assets and liabilities are shown in the table below after taking into account currency and interest rate swaps:

Maturity of financial assets and liabilities at 31 March 2005

	Assets £m	Liabilities £m
In one year or less	16	1,887
In more than one year, but not more than two years	–	846
In more than two years, but not more than three years	–	345
In more than three years, but not more than four years	–	459
In more than four years, but not more than five years	–	498
In more than five years or no maturity date	2,644	1.257
	2,660	5,292

At 31 March 2005 the weighted average interest rate on short-term borrowings of £1,880m was 4.3%.

Other sterling financial liabilities at 31 March 2005 comprised onerous leases of £16m.

Substantially all the variable rate borrowings are subject to interest rates which fluctuate with LIBOR (London Inter Bank Offered Rate).

In calculating the weighted average number of years for which interest rates are fixed, swaps which are cancellable at the option of the swap provider are assumed to have a life based on the earliest date at which they can be cancelled.

19. Inventories

	2006 £m	2005 £m
Raw materials and consumables	**22**	30

The Group charged £8m of inventories within operating costs during the year (2005: £15m).

20. Trade and other receivables

	2006 £m	2005 £m
Trade receivables	**61**	37
Amounts owed by fellow subsidiary undertakings	**286**	61
Other receivables	**78**	42
Prepayments and accrued income	**171**	216
	596	356

Other receivables includes £44m relating to the sales of the four gas distribution networks which was received in April 2006.

Provision for doubtful debts

	£m
At 1 April 2004	9
Release of provision	(4)
Uncollectable amounts written off net of recoveries	1
At 31 March 2005	6
Release of provision	(5)
Uncollectable amounts written off net of recoveries	2
At 31 March 2006	**3**

21. Cash and cash equivalents

	2006 £m	2005 £m
Cash at bank and in hand	**–**	4
Short-term deposits	**223**	–
Cash and cash equivalents	**223**	4

22. Borrowings

The following table analyses the Group's total borrowings, excluding bank overdrafts:

	2006 £m	2005 £m
Current		
Bank loans	**81**	117
Commercial paper	**–**	1,103
Other bonds	**916**	242
Finance leases	**4**	15
Borrowings from fellow subsidiary undertakings	**13**	403
	1,014	1,880
Non-current		
Bank loans	**200**	239
Other bonds	**2,495**	3,147
Finance leases	**3**	10
	2,698	3,396
Total borrowings	**3,712**	5,276

	2006 £m	2005 £m
Total borrowings are repayable as follows:		
In one year or less	**1,014**	1,880
In more than one year, but not more than two years	**278**	843
In more than two years, but not more than three years	**464**	343
In more than three years, but not more than four years	**507**	458
In more than four years, but not more than five years	**–**	497
In more than five years other than by instalments	**1,449**	1,255
	3,712	5,276

None of the Group's borrowings are secured by charges over the assets of the Group.

The notional amount of borrowings outstanding as at 31 March 2006 was £4,097m (2005: £5,273m).

Undrawn committed borrowing facilities

	2006 £m	2005 £m
Expiring:		
In one year or less	**25**	2,320
In more than one year, but not more than two years	**–**	–
In more than two years	**840**	–
	865	2,320

All of the unused facilities at 31 March 2006 and at 31 March 2005 were held as back-up to commercial paper and similar borrowings.

23. Trade and other payables

	2006 £m	2005 £m
Trade payables	**408**	348
Amounts owed to fellow subsidiary undertakings	**188**	368
Social security and other taxes	**93**	167
Other payables	**11**	161
Deferred income	**99**	165
	799	1,209

Other payables at 31 March 2005 include interest payable of £139m. In 2006, interest payable is included in borrowings in accordance with IAS 39.

24. Other non-current liabilities

	2006 £m	2005 £m
Other payables	**3**	–
Deferred income	**950**	1,690
	953	1,690

25. Provisions

	Environmental £m	Emissions £m	Restructuring £m	Other £m	Total provisions £m
At 1 April 2004	85	–	36	–	121
Additions	9	5	174	–	188
Unwinding of discount	2	–	–	–	2
Utilised	(7)	–	(119)	–	(126)
At 31 March 2005	89	5	91	–	185
Additions	–	18	60	30	108
Unwinding of discount	1	–	–	–	1
Utilised	(2)	–	(118)	(2)	(122)
Disposal of Group undertakings	(44)	–	–	–	(44)
At 31 March 2006	**44**	**23**	**33**	**28**	**128**

Provisions have been analysed between current and non-current as follows:

	2006 £m	2005 £m
Current	**66**	94
Non-current	**62**	91
	128	185

Environmental provision

The environmental provision represents the net present value of the estimated statutory decontamination costs of old gas manufacturing sites owned and managed by the Group (discounted using a nominal rate of 5.25%). The anticipated timing of the cash flows for statutory decontamination cannot be predicted with certainty, but it is expected to be incurred over the period 2007 to 2057 with some 33% of the spend projected to be spent over the next five years.

There are a number of uncertainties that affect the calculation of the provision for gas site decontamination, including the impact of regulation, the accuracy of the site surveys, unexpected contaminants, transportation costs, the impact of alternative technologies and changes in the discount rate. The Group has made its best estimate of the financial effect of these uncertainties in the calculation of the provision, but future material changes in any of the assumptions could materially impact on the calculation of the provision and hence the income statement.

The undiscounted amount of the provision at 31 March 2006 relating to gas site decontamination was £72m (2005: £127m), being the undiscounted best estimate of the liability having regard to the uncertainties referred to above.

Emissions provision

The provision for emission costs will be settled using emission allowances granted to the Group which are reported as an intangible asset.

Restructuring provision

At 31 March 2006, £10m of the total restructuring provision (2005: £16m) consisted of provisions for the disposal of surplus leasehold interests and rates payable on surplus properties. The expected payment dates for property restructuring costs remain uncertain. The remainder of the restructuring provision related to business reorganisation costs, largely to be paid within the next financial year.

Other provisions

Other provisions at 31 March 2006 include £28m (2005: £nil) in respect of the sales of four gas distribution networks and are related to property transfer costs. £14m is expected to be paid within one year with the remainder over the following four years.

26. Share capital

	Allotted, called up and fully paid millions	£m
At 31 March 2005 and 2006	**3,944**	**45**

At 31 March 2005 and 31 March 2006 the authorised share capital of the Group was £69m (6,052m ordinary shares of $1\frac{2}{15}$ pence each).

27. Group statement of movements in total equity

	Called-up share capital £m	Share premium account £m	Cash flow hedge reserve £m	Other reserves £m	Retained earnings £m	Total equity £m
At 31 March 2004	45	204	–	1,332	3,292	4,873
Profit for the year	–	–	–	–	529	529
Equity dividends	–	–	–	–	(500)	(500)
Tax on employee share option scheme issues	–	–	–	–	2	2
At 31 March 2005	45	204	–	1,332	3,323	4,904
First time adoption of IAS 39	–	–	(44)	–	(15)	(59)
At 1 April 2005	45	204	(44)	1,332	3,308	4,845
Net expense recognised directly in equity	–	–	(17)	–	–	(17)
Profit for the year	–	–	–	–	2,984	2,984
Equity dividends	–	–	–	–	(310)	(310)
Employee share option scheme issues	–	–	–	–	(1)	(1)
Tax on employee share option scheme issues	–	–	–	–	4	4
Tax on items taken directly to or transferred from equity	–	–	1	–	–	1
At 31 March 2006	**45**	**204**	**(60)**	**1,332**	**5,985**	**7,506**

Other reserves represent the difference between the carrying value of Group undertakings, investments and their respective capital structures following the 1999 Lattice refinancing.

The Company is prohibited from declaring a dividend or other distribution unless it has certified that it is in compliance in all material respects with certain regulatory obligations, including a requirement to ensure it has sufficient financial resources and facilities to enable it to carry on its business and a requirement to use all reasonable endeavours to maintain an investment grade credit rating.

28. Group cash flow statement

a) Cash flow from operating activities – discontinued operations

	2006 £m	2005 £m
Operating profit	**46**	436
Adjustments for:		
Exceptional items	**15**	74
Depreciation and amortisation	**13**	176
Changes in working capital and provisions	**(73)**	(69)
Cash flow relating to exceptional items	**(23)**	(74)
Cash flow relating to discontinued operations	**(22)**	543

b) Reconciliation of net cash flow to movement in net debt

	2006 £m	2005 £m
Movement in cash and cash equivalents	**219**	9
Increase/(decrease) in financial investments	**30**	(62)
Decrease/(increase) in borrowings and derivatives	**1,937**	(332)
Net interest paid (i)	**204**	–
Change in net debt resulting from cash flows	**2,390**	(385)
Changes in fair value of financial assets and liabilities (i)	**(31)**	–
Net interest charge (i)	**(177)**	–
Other non-cash movements	**9**	(9)
Movement in net debt (net of related derivative financial instruments) in the year	**2,191**	(394)
Net debt at start of year	**(5,260)**	(4,866)
Impact of adoption of IAS 32 and IAS 39 (i)	**(269)**	–
Net debt (net of related derivative financial instruments) at end of year	**(3,338)**	(5,260)

(i) The adoption of IAS 39 resulted in changes to the carrying value of borrowings and financial investments as at 1 April 2005 as described in note 2.

28. Group cash flow statement (continued)

c) Analysis of changes in net debt

	At 1 April 2004 £m	Cash flow £m	Other non-cash movements £m	At 31 March 2005 £m
Cash and cash equivalents	1	3	–	4
Bank overdrafts	(6)	6	–	–
	(5)	9	–	4
Financial investments	74	(62)	–	12
Borrowings	(4,935)	(332)	(9)	(5,276)
	(4,866)	(385)	(9)	(5,260)

	At 1 April 2005 £m	Impact of adoption of IAS 32 and IAS 39 (i) £m	Cash flow £m	Fair value gains and losses £m	Interest charges £m	Other non-cash movements £m	**At 31 March 2006 £m**
Cash and cash equivalents	4	–	219	–	–	–	**223**
Financial investments (ii)	12	–	(56)	–	86	–	**42**
Borrowings (ii)	(5,276)	(338)	2,219	(65)	(261)	9	**(3,712)**
Derivatives (ii)	–	69	8	34	(2)	–	**109**
	(5,260)	(269)	2,390	(31)	(177)	9	**(3,338)**

(i) There are no comparatives for net debt related derivative assets and liabilities as the Group adopted IAS 39 with effect from 1 April 2005 consistent with the requirements of IFRS 1. The adoption of IAS 39 also resulted in changes to the carrying value of borrowings and financial investments as at 1 April 2005 (see note 2).
(ii) Includes interest.

29. Related party transactions

Transactions with related parties were in the normal course of business and are summarised below.

	Parent undertaking		Other related parties		Total	
	2006 £m	2005 £m	**2006 £m**	2005 £m	**2006 £m**	2005 £m
Sales:						
Goods and services supplied	**–**	–	**19**	48	**19**	48
Expenditure:						
Services received	**–**	–	**150**	302	**150**	302
Corporate services received	**–**	–	**14**	23	**14**	23
Charges in respect of pensions costs	**–**	–	**17**	30	**17**	30
Charges in respect of share based payments	**–**	–	**2**	9	**2**	9
Interest paid on borrowings from group undertakings	**8**	22	**17**	–	**25**	22
	8	22	**200**	364	**208**	386
Outstanding balances at 31 March in respect of sales and expenditure:						
Amounts receivable	**–**	–	**286**	61	**286**	61
Amounts payable	**–**	–	**188**	368	**188**	368
Amount payable by parent undertaking and due after more than one year:						
At 1 April	**2,644**	2,544	**–**	–	**2,644**	2,544
Advances	**2,967**	100	**–**	–	**2,967**	100
At 31 March	**5,611**	2,644	**–**	–	**5,611**	2,644
Borrowings from group undertakings (amounts due within one year):						
At 1 April	**242**	490	**161**	–	**403**	490
Advances	**–**	–	**–**	161	**–**	161
Repayments	**(240)**	(248)	**(150)**	–	**(390)**	(248)
At 31 March	**2**	242	**11**	161	**13**	403

Amounts receivable from or payable to related parties in respect of sales and expenditure are ordinarily settled one month in arrears. The amount receivable from the parent undertaking and due after more than one year is not subject to any specific settlement terms and does not bear interest. Borrowings from group undertakings are repayable on demand and bear interest at commercial rates.

No amounts have been provided at 31 March 2006 (2005: £nil) and no expense recognised during the year (2005: £nil) in respect of bad or doubtful debts for related party transactions.

Details of guarantees provided in respect of related parties are provided in note 30(c).

Details of key management compensation are provided in note 6(c).

30. Commitments and contingencies

a) Future capital expenditure

	2006 £m	2005 £m
Contracted for but not provided	**767**	313

b) Lease commitments

At 31 March 2006, the Group's operating lease commitments for the financial year ending 31 March 2007 amounted to £14m (2005: £17m) and are analysed by lease expiry date as follows:

	Land and buildings		Other		Total	
	2006 £m	2005 £m	2006 £m	2005 £m	2006 £m	2005 £m
Within one year	**–**	–	**1**	–	**1**	–
Between two and five years	**2**	2	**4**	8	**6**	10
After five years	**7**	7	**–**	–	**7**	7
	9	9	**5**	8	**14**	17

Total Group commitments under non-cancellable operating leases were as follows:

	2006 £m	2005 £m
In one year or less	**14**	17
In more than one year, but not more than two years	**12**	15
In more than two years, but not more than three years	**9**	11
In more than three years, but not more than four years	**8**	9
In more than four years, but not more than five years	**7**	8
In more than five years	**45**	50
	95	110

c) Other commitments, contingencies and guarantees

The value of other Group commitments, contingencies and guarantees at 31 March 2006 amounted to £154m (2005: £140m), including performance guarantees amounting to £4m (2005: £5m), relating to certain property obligations of a National Grid group undertaking, and BG Group related commitments and contingencies amounting to £7m (2005: £13m).

d) Parent Company loan guarantees on behalf of Group undertakings

The Company has guaranteed the repayment of principal sums, any associated premium and interest on specific loans due from its financial subsidiary undertakings to third parties. At 31 March 2006, the sterling equivalent amounted to £1,430m (2005: £961m).

31. Ultimate parent company

National Grid Gas plc's immediate parent company is National Grid Gas Holdings plc. The ultimate parent company, and controlling party, is National Grid plc, which is registered in England and Wales. Both National Grid Gas Holdings plc and National Grid plc consolidate the accounts of National Grid Gas plc. Copies of the consolidated accounts of National Grid Gas Holdings plc and copies of the consolidated accounts of National Grid plc may be obtained from the Company Secretary, 1-3 Strand, London WC2N 5EH.

32. Group undertakings and joint ventures

Principal Group undertakings

The principal Group undertakings included in the Group accounts at 31 March 2006 are listed below. These undertakings are incorporated in Great Britain, unless otherwise indicated.

	Principal activity	Holding
National Grid Metering Limited	Gas metering services	100%
British Transco International Finance B.V. (Incorporated in The Netherlands)	Financing	100%
British Transco Finance Inc. (incorporated in the US)	Financing	100%
British Transco Capital Inc. (incorporated in the US)	Financing	100%
Xoserve Limited	Gas transportation billing services	56.57%

A full list of all Group and associated undertakings is available from the Group Company Secretary and General Counsel.

Company Accounting Policies

(a) Basis of preparation of Company financial statements
These Company financial statements have been prepared in accordance with applicable UK accounting and financial reporting standards and the Companies Act 1985.

The Company financial statements have been prepared on a historical cost basis, except for the revaluation of financial instruments from 1 April 2005 onwards.

These Company financial statements are presented in pounds sterling.

The Company has not presented its own profit and loss account as permitted by section 230 of the Companies Act 1985. The Company has taken exemption from preparing a cash flow statement under the terms of FRS 1 (revised 1996) 'Cash Flow Statements'.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

The Company has adopted FRS 17 'Retirement Benefits', FRS 21 'Events after the Balance Sheet Date', FRS 23 'The Effects of Changes in Foreign Exchange Rates', FRS 25 'Financial Instruments: Disclosure and Presentation' and FRS 26 'Financial Instruments: Measurement'. The Company has also adopted FRS 29 'Financial Instruments: Disclosures', which replaces the disclosure requirements of FRS 25. The impact of the adoption of these standards is shown in note 1.

(b) Tangible fixed assets
Tangible fixed assets are included in the balance sheet at their cost less accumulated depreciation. Costs include payroll costs and finance costs incurred which are directly attributable to the construction of tangible fixed assets.

Tangible fixed assets include assets in which the Company's interest comprises legally protected statutory or contractual rights of use.

Additions represent the purchase or construction of new assets, extensions to, or significant increases in, the capacity of tangible fixed assets.

Contributions received towards the cost of tangible fixed assets are included in creditors as deferred income and credited on a straight-line basis to the profit and loss account over the life of the assets.

No depreciation is provided on freehold land and assets in the course of construction. Other tangible fixed assets are depreciated principally on a straight-line basis, at rates estimated to write off their book values over their estimated useful economic lives. In assessing estimated useful economic lives, which are reviewed on a regular basis, consideration is given to any contractual arrangements and operational requirements relating to particular assets. Unless otherwise determined by operational requirements, the depreciation periods for the principal categories of tangible fixed assets are, in general, as shown below:

	Years
Freehold and leasehold properties	up to 50
Plant and machinery:	
Mains, services and regulating equipment	30 to 100
Meters	10 to 18
Motor vehicles and office equipment	up to 10

c) Impairment of fixed assets
Impairments of fixed assets are calculated as the difference between the carrying values of the net assets of income generating units, including where appropriate, investments, and their recoverable amounts. Recoverable amount is defined as the higher of net realisable value or estimated value in use at the date the impairment review is undertaken. Net realisable value represents the amount that can be generated through the sale of assets. Value in use represents the present value of expected future cash flows discounted on a pre-tax basis, using the estimated cost of capital of the income generating unit.

Impairment reviews are carried out if there is some indication that impairment may have occurred, or where otherwise required to ensure that fixed assets are not carried above their estimated recoverable amounts. Impairments are recognised in the profit and loss account, and where material are disclosed as exceptional. Impairment reversals are recognised when, in management's opinion, the reversal is permanent.

d) Replacement expenditure
Replacement expenditure represents the cost of planned maintenance of mains and services assets by replacing or lining sections of pipe. This expenditure is principally undertaken to repair and maintain the safety of the network and is written off as incurred. Expenditure that enhances the performance of mains and services assets is treated as an addition to tangible fixed assets.

(e) Fixed asset investments
Investments held as fixed assets are stated at cost less any provisions for impairment. Impairments are calculated such that the carrying value of the fixed asset investment is the lower of its cost or recoverable amount. Recoverable amount is the higher of its net realisable value and its value in use.

(f) Deferred taxation
Deferred taxation is provided in full on all material timing differences, with certain exceptions. No provision for deferred taxation is made for any timing differences on non-monetary assets arising from fair value adjustments, except where there is a binding agreement to sell the assets concerned. However, no provision is made where it is more likely than not that any taxable gain will be rolled over into replacement assets.

Deferred tax assets are only recognised to the extent that they are considered recoverable.

Deferred tax balances have not been discounted.

(g) Stocks
Stocks are stated at cost less provision for deterioration and obsolescence.

(h) Environmental costs
Environmental costs, based on discounted future estimated expenditures expected to be incurred, are provided for in full. The unwinding of the discount is included within the profit and loss account as a financing charge.

(i) Turnover
Turnover primarily represents the amounts derived from the transportation of natural gas and the provision of related services. Turnover includes an assessment of transportation services supplied to customers between the date of the last meter reading and the year end, excludes inter-business and inter-company transactions and is stated net of value added tax. Where revenues received or receivable exceed the maximum amount permitted by regulatory agreement and adjustments will be made to future prices to reflect this over-recovery, no liability is recognised.

(j) Pensions
The substantial majority of the Company's employees are members of the National Grid UK Pension Scheme. The Company recognises pension costs in its profit and loss account as they are charged to the Company by Lattice. The charge from Lattice comprises the regular pension cost of the Company's employees and variations from the regular pension cost in respect of the effect of any surplus or deficit attributable to the Company. The interest element of any surplus or deficit attributable to the Company is included within the profit and loss account as a financing charge.

(k) Leases
Operating lease payments are charged to the profit and loss account on a straight-line basis over the term of the lease.

(l) Financial instruments
Financial assets, liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities and is recorded at the proceeds received, net of direct issue costs.

Trade debtors do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts. Trade creditors are not interest bearing and are stated at their nominal value.

Interest-bearing loans and overdrafts are recorded at the proceeds received, net of direct issue costs plus accrued interest less any repayments. Prior to 1 April 2005, accrued interest is presented as part of current liabilities and not combined with the principal amounts payable.

Finance charges are recognised in the profit and loss account in the period in which they are incurred.

Derivative financial instruments are recorded as described below.

(m) Hedge accounting and derivative financial instruments
The Company enters into derivative financial instruments ('derivatives') in order to manage its interest rate and foreign currency exposures. The principal derivatives used include interest rate swaps, forward rate agreements, currency swaps, forward foreign currency contracts and interest rate swaptions.

All derivative transactions are undertaken, or maintained, with a view to providing a commercial hedge of the interest or currency risks associated with the Company's underlying business activities and the financing of those activities.

With effect from 1 April 2005, derivatives are carried in the balance sheet at their fair value.

Prior to 1 April 2005, derivatives used for hedging purposes were not recorded on the balance sheet as assets or liabilities. Monetary assets and liabilities in foreign currencies were retranslated at hedged rates instead of closing rates.

As permitted by the transition provisions of FRS 26, prior year adjustments have not been made to the balance sheet as at 31 March 2005 or the profit and loss account for the year then ended.

From 1 April 2005, the accounting policy for hedge accounting is as described below. Disclosures on the impact of implementing FRS 26 at 1 April 2005 are set out in note 1.

Changes in the carrying value of financial instruments that are designated and effective as hedges of future cash flows ('cash flow hedges') are recognised directly in equity and any ineffective portion is recognised immediately in the profit and loss account. Amounts deferred in equity in respect of cash flow hedges are subsequently recognised in the profit and loss account in the same period in which the hedged item affects net profit or loss.

Changes in the carrying value of financial instruments that are designated as hedges of the changes in the fair value of assets or liabilities ('fair value hedges') are recognised in the profit and loss account. An equal and opposite amount is recorded as an adjustment to the carrying value of hedged items, with a corresponding entry in the profit and loss account, to the extent that the change is attributable to the risk being hedged and that the fair value hedge is effective.

Changes in the fair value of derivatives that do not qualify for hedge accounting are recognised in the profit and loss account as they arise.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, any cumulative gains or losses relating to cash flow hedges recognised in equity are initially retained in equity and subsequently recognised in the profit and loss account in the same periods in which the previously hedged item affects net profit or loss. For fair value hedges, the cumulative adjustment recorded to its carrying value, at the date hedge accounting is discontinued, is amortised to the profit and loss account using the effective interest method.

If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the profit and loss account immediately.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of host contracts and the host contracts are not carried at fair value with unrealised gains or losses reported in the profit and loss account.

The notional amounts relating to financial instruments held to manage interest rate risk through interest rate swaps and forward rate agreements, and currency profiles through foreign currency contracts and cross currency swaps at 31 March 2006 amounted to £2,043m and £1,296m respectively.

(n) Restructuring costs
Costs arising from the Company's restructuring programmes primarily relate to redundancy costs. Redundancy costs are charged to the profit and loss account in the period in which the Company becomes irrevocably committed to incurring the costs and the main features of the restructuring plan have been announced to affected employees.

(o) Share-based payments
Equity-settled share-based payments are made to employees of the Company. These are measured at fair value at date of grant. The fair value determined at the grant date of equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Company's estimate of shares that will eventually vest.

(p) Emission allowances
Emission allowances initially are recorded within debtors at deemed cost. For allocations of allowances granted to the Company by the UK Government, cost is measured as fair value at the date of allocation. Receipts of such grants are treated as deferred income and are recognised in the profit and loss account over the period to which they relate. A provision is recorded in respect of the Company's obligation to deliver emission allowances and charges recognised in the profit and loss account in the period in which carbon dioxide emissions are made.

Company Balance Sheet

at 31 March

	Notes	2006 £m	2005 (restated (i)) £m
Fixed assets			
Tangible assets	5	**5,332**	7,942
Investments	6	**17**	1,666
		5,349	9,608
Current assets			
Stocks	7	**22**	30
Debtors (amounts falling due within one year)	8	**628**	373
Debtors (amounts falling due after more than one year)	8	**5,622**	2,648
Derivative financial instruments (amounts falling due within one year)		**87**	–
Derivative financial instruments (amounts falling due after more than one year)		**101**	–
Current asset investments		**255**	201
Cash at bank and in hand		**–**	3
		6,715	3,255
Creditors (amounts falling due within one year)			
Derivative financial instruments		**(28)**	–
Borrowings		**(1,050)**	(1,869)
Other creditors		**(856)**	(2,944)
	9	**(1,934)**	(4,813)
Net current assets		**4,781**	(1,558)
Total assets less current liabilities		**10,130**	8,050
Creditors (amounts falling due after more than one year)			
Derivative financial instruments		**(54)**	–
Borrowings		**(2,678)**	(3,597)
Other creditors		**(623)**	(1,101)
	10	**(3,355)**	(4,698)
Provisions for liabilities and charges	12	**(914)**	(1,448)
Net assets employed		**5,861**	1,904
Capital and reserves			
Called up share capital	13	**45**	45
Share premium account	14	**204**	204
Cash flow hedge reserve		**(59)**	–
Other reserves	14	**1,332**	1,332
Profit and loss account	14	**4,339**	323
Equity shareholders' funds		**5,861**	1,904

(i) Amounts owed to Group undertakings have been reclassified as borrowings where they are interest bearing (see note 1).

Commitments and contingencies are shown in note 15.

The notes on pages 77 to 82 form part of the Accounts which were approved by the Board of Directors on 30 June 2006 and were signed on its behalf by:

Steve Holliday Managing Director

Colin Buck Finance Director

Notes to the Company Accounts

1. Changes in accounting policies

During the year, the Company has adopted FRS 17 'Retirement Benefits', FRS 21 'Events after the Balance Sheet Date', FRS 23 'The Effects of Changes in Foreign Exchange Rates', FRS 25 'Financial Instruments: Disclosure and Presentation', FRS 26 'Financial Instruments: Measurement', and FRS 29 'Financial Instruments: Disclosures'.

FRS 17 'Retirement Benefits'

The adoption of FRS 17 has not had any impacts on the results, assets or liabilities of the Company. Under FRS 17, the Company accounts for pensions as if the National Grid UK Pension Scheme was a defined contribution scheme. Disclosures in respect of the scheme are provided in note 8 to the Group accounts.

FRS 21 'Events after the Balance Sheet Date'

The adoption of FRS 21 has resulted in a change to the timing of recognition of the Company's proposed final dividend. Previously such dividends were recorded as a liability in the year in respect of which they are proposed by the Board of Directors for approval by the shareholders. In accordance with FRS 21, such dividends are not recorded until approved. As there was no proposed final dividend at 31 March 2005, the adoption of FRS 21 has not resulted in a prior year adjustment in accordance with FRS 3 and there is no change to net assets reported as at 31 March 2005.

FRS 23 'The Effects of Changes in Foreign Exchange Rates'
FRS 25 'Financial Instruments: Disclosure and Presentation'
FRS 26 'Financial Instruments: Measurement'
FRS 29 'Financial Instruments: Disclosures'

The adoption of FRS 23, FRS 25, FRS 26 and FRS 29 has resulted in a change to the accounting for the Company's financial instruments. Derivative financial instruments and available for sale investments are recorded in the balance sheet at fair value, whilst deferred gains and losses relating to items qualifying for hedge accounting are derecognised and instead recorded in equity (for cash flow hedges and net investment hedges) or by adjusting the carrying value of the hedged financial instrument (for fair value hedges). As permitted by the transition provisions of FRS 26, prior year adjustments have not been made to the balance sheet at 31 March 2005 or to the profit and loss account for the year then ended.

The adoption of FRS 23, FRS 25, FRS 26 and FRS 29 reduced net assets at 1 April 2005 by £52 million, as shown below:

	£m
Borrowings	(161)
Derivative financial instruments	44
Other assets and liabilities	65
Net assets	52

It is not practical to calculate the impact of the adoption of FRS 23, FRS 25, FRS 26 and FRS 29 on the results for the year ended 31 March 2006.

The Company has reclassified amounts owed to the Group undertakings as borrowings where these are interest bearing. These amounts were previously disclosed within other creditors. The impact of this change on the balance sheet as at 31 March 2005 is to increase borrowings falling due within one year and reduce other creditors falling due within one year by £657m and to increase borrowings falling due after one year and reduce other creditors falling due after one year by £840m.

2. Auditors' remuneration

Auditor's remuneration in respect of the Company is set out below:

	2006 £m	2005 £m
Statutory audit services:		
– Annual audit	**0.5**	0.4
– Regulatory reporting	**0.2**	0.2
Further audit related services	**–**	0.3
Tax advisory services	**0.2**	–

3. Number of employees

	2006 Average number	2005 Average number
United Kingdom		
Continuing operations	**6,058**	6,692
Discontinued operations	**343**	4,147
	6,401	10,839

	31 Mar 2006 number	31 Mar 2005 number
United Kingdom	**6,054**	10,743

4. Directors' emoluments

Details of Directors' emoluments are provided in note 7 to the Group Financial Statements on page 54.

5. Tangible fixed assets

	Land and buildings £m	Plant and machinery £m	Assets in the course of construction £m	Motor vehicles and office equipment £m	Total £m
Cost at 1 April 2005	85	11,275	164	702	12,226
Additions	11	242	263	28	544
Disposal of Group undertakings	(26)	(3,724)	(15)	(172)	(3,937)
Disposals	(1)	(63)	–	(2)	(66)
Reclassifications	–	73	(125)	52	–
Cost at 31 March 2006	69	7,803	287	608	8,767
Depreciation at 1 April 2005	(27)	(3,758)	–	(499)	(4,284)
Charge for the year	(4)	(288)	–	(59)	(351)
Disposal of Group undertakings	11	1,008	–	117	1,136
Disposals	1	61	–	2	64
Depreciation at 31 March 2006	(19)	(2,977)	–	(439)	(3,435)
Net book value at 31 March 2006	**50**	**4,826**	**287**	**169**	**5,332**
Net book value at 31 March 2005	58	7,517	164	203	7,942

The net book value of land and buildings comprises:

At 31 March	2006 £m	2005 £m
Freehold	**46**	53
Long leasehold	**1**	1
Short leasehold	**3**	4
	50	58

The cost of tangible fixed assets at 31 March 2006 includes £27m (2005: £21m) relating to interest capitalised.

Included in creditors (amounts falling due within one year) and creditors (amounts falling due after more than one year) are contributions to the cost of tangible fixed assets amounting to £19m (2005: £33m) and £577m (2005: £1,065m) respectively.

6. Fixed asset investments

	Shares in subsidiary undertakings £m
Cost at 1 April 2005	1,666
Disposals (i)	(1,649)
Net book value at 31 March 2006	**17**

(i) During the year, the Company disposed of its investment in four gas distribution networks for net proceeds of £5,760m. The subsidiary undertakings sold were Blackwater SC A Limited, Blackwater F Limited, Blackwater 2 Limited and Blackwater G Limited.

The names of the principal Group undertakings are included in note 31 to the Group accounts.

7. Stocks

At 31 March	2006 £m	2005 £m
Raw materials and consumables	**22**	30

8. Debtors

At 31 March	2006 £m	2005 £m
Amounts falling due within one year		
Trade debtors	**61**	37
Amounts owed by fellow subsidiary undertakings	**279**	72
Other debtors	**118**	42
Prepayments and accrued income	**170**	222
	628	373
Amounts falling due after more than one year		
Other debtors	**3**	4
Amounts owed by Group undertakings	**8**	–
Amounts owed by immediate parent undertaking	**5,611**	2,644
	5,622	2,648
Total debtors	**6,250**	3,021

9. Creditors (amounts falling due within one year)

At 31 March	2006 £m	2005 (restated (i)) £m
Derivative financial instruments	**28**	–
Borrowings (note 11)	**1,050**	1,869
Trade creditors and accruals	**395**	342
Amounts owed to Group undertakings	**16**	1,745
Amounts owed to fellow subsidiary undertakings	**182**	374
Corporation tax	**70**	22
Social security and other taxes	**93**	167
Other creditors	**10**	146
Deferred income	**90**	148
	1,934	4,813

(i) Amounts owed to Group undertakings have been reclassified as borrowings where they are interest bearing (see note 1).

10. Creditors (amounts falling due after more than one year)

At 31 March	2006 £m	2005 (restated (i)) £m
Derivative financial instruments	**54**	–
Borrowings (note 11)	**2,678**	3,597
Deferred income	**623**	1,101
	3,355	4,698

(i) Amounts owed to Group undertakings have been reclassified as borrowings where they are interest bearing (see note 1).

Deferred income mainly comprises contributions to capital projects.

11. Borrowings

The following table analyses the Company's total borrowings.

At 31 March	2006 £m	2005 (restated (i)) £m
Amounts falling due within one year:		
Bank loans and overdrafts	**81**	117
Commercial paper	**–**	594
Bonds	**700**	87
Borrowings from Group undertakings	**252**	657
Borrowings from fellow subsidiary undertakings	**13**	399
Other loans	**4**	15
	1,050	1,869
Amounts falling due after more than one year:		
Bank loans	**200**	200
Bonds	**1,830**	2,547
Borrowings from Group undertakings	**644**	840
Other loans	**4**	10
	2,678	3,597
Total borrowings	**3,728**	5,466
Total borrowings are repayable as follows:		
In one year or less	**1,050**	1,869
More than one year, but not more than two years	**274**	830
More than two years, but not more than three years	**464**	343
More than three years, but not more than four years	**308**	458
More than four years, but not more than five years	**–**	314
More than five years – other than by instalments	**1,632**	1,652
	3,728	5,466

(i) Amounts owed to Group undertakings have been reclassified as borrowings where they are interest bearing (see note 1).

None of the Company's borrowings are secured by charges over the assets of the Company.

12. Provisions for liabilities and charges

	Environmental £m	Emissions £m	Restructuring £m	Deferred taxation £m	Other £m	Total £m
At 31 March 2005	89	5	91	1,263	–	1,448
First time adoption of FRS 26	–	–	–	(38)	–	(38)
Charged to profit and loss account	–	18	60	(41)	30	67
Transferred to reserves	–	–	–	6	–	6
Utilised	(2)	–	(118)	–	(2)	(122)
Unwinding of discount	1	–	–	–	–	1
Disposal of Group undertakings	(44)	–	–	(404)	–	(448)
At 31 March 2006	**44**	**23**	**33**	**786**	**28**	**914**

The environmental provision represents the estimated environmental restoration and remediation costs relating to a number of sites owned and managed by the Company.

At 31 March 2006, the environmental provision represented the net present value of the estimated statutory decontamination costs of old gas manufacturing sites (discounted using a nominal rate of 5.25%). The anticipated timing of the cash flows for statutory decontamination cannot be predicted with certainty, but it is expected to be incurred over the period 2006 to 2057 with some 33% of the spend projected to be spent over the next five years.

There are a number of uncertainties that affect the calculation of the provision for gas site decontamination, including the impact of regulation, the accuracy of the site surveys, unexpected contaminants, transportation costs, the impact of alternative technologies and changes in the discount rate. The Company has made its best estimate of the financial effect of these uncertainties in the calculation of the provision, but future material changes in any of the assumptions could materially impact on the calculation of the provision and hence the profit and loss account.

12. Provisions for liabilities and charges (continued)

The undiscounted amount of the provision at 31 March 2006 relating to gas site decontamination was £72m (2005: £127m), being the undiscounted best estimate of the liability having regard to the uncertainties referred to above (excluding the impact of changes in discount rate).

At 31 March 2006, £10m of the total restructuring provision (2005: £16m) consisted of provisions for costs in respect of surplus leasehold properties. The expected payment dates for property restructuring costs remain uncertain. The remainder of the restructuring provision relates to business reorganisation costs.

Deferred taxation comprises:

	Provided	
At 31 March	**2006 £m**	2005 £m
Accelerated capital allowances	**797**	1,239
Other timing differences	**(11)**	24
	786	1,263

13. Share capital

At 31 March	**Number of shares 2006 millions**	Number of shares 2005 millions	**2006 £m**	2005 £m
Authorised				
Ordinary shares of 1 2/15p each	**6,052**	6,052	**69**	69
Allotted and fully paid				
Ordinary shares of 1 2/15p each	**3,944**	3,944	**45**	45

National Grid Gas is a wholly owned subsidiary undertaking of National Grid Gas Holdings plc.

14. Reserves

	Cash flow hedge reserve £m	Share premium account £m	Capital redemption reserve £m	Profit and loss account reserve £m
At 31 March 2005	–	204	1,332	323
First time adoption of FRS 26	(44)	–	–	(8)
Retained profit for the year	–	–	–	4,032
Employee share option scheme issues	–	–	–	(1)
Net expense recognised directly in reserves	(16)	–	–	–
Tax on items taken directly to or transferred from reserves	1	–	–	–
Tax on employee share option scheme issues	–	–	–	(7)
At 31 March 2006	**(59)**	**204**	**1,332**	**4,339**

The Company is prohibited from declaring a dividend or other distribution unless it has certified that it is in compliance in all material respects with certain regulatory obligations, including a requirement to ensure it has sufficient financial resources and facilities to enable it to carry on its business and a requirement to use all reasonable endeavours to maintain an investment grade credit rating.

The Company has not presented its own profit and loss account as permitted by section 230 of the Companies Act 1985.
The Company's profit after taxation, was £4,342m (2005: £267m).

15. Commitments and contingencies

a) Future capital expenditure

As at 31 March 2006, the Company had placed contracts for capital expenditure (tangible fixed assets) amounting to £763m (2005: £313m).

b) Lease commitments

At 31 March 2006, the Company's total operating lease commitments for the financial year ending 31 March 2007 amounted to £14m (2005 commitments for 2006: £17m) and are analysed by lease expiry date as follows:

	Land and buildings		Other		Total	
At 31 March	**2006 £m**	2005 £m	**2006 £m**	2005 £m	**2006 £m**	2005 £m
Expiring:						
In one year or less	**–**	–	**1**	–	**1**	–
In more than one year, but not more than five years	**2**	2	**4**	8	**6**	10
In more than five years	**7**	7	**–**	–	**7**	7
	9	9	**5**	8	**14**	17

The Company's total commitments under non-cancellable operating leases were payable as follows:

At 31 March	**2006 £m**	2005 £m
Amounts:		
In one year or less	**14**	17
In more than one year, but not more than two years	**12**	15
In more than two years, but not more than three years	**9**	11
In more than three years, but not more than four years	**8**	9
In more than four years, but not more than five years	**7**	8
In more than five years	**45**	50
	95	110

c) Other commitments and contingencies

The value of other commitments and contingencies at 31 March 2006 amounted to £154m (2005: £140m), including a performance guarantee of £4m (2005: £5m) relating to certain property obligations of a National Grid group undertaking, and BG Group related commitments and contingencies amounting to £7m (2005: £13m).

d) Parent company loan guarantees on behalf of subsidiary undertakings

The Company has guaranteed the repayment of principal sums, any associated premium and interest on specific loans due from its financial subsidiary undertakings to third parties. At 31 March 2006, the sterling equivalent amounted to £1,430m (2005: £961m).

16. Related party transactions

National Grid Gas is a wholly owned subsidiary undertaking of National Grid, which consolidates National Grid Gas within its publicly available financial statements. National Grid Gas is therefore exempt from disclosing transactions with other members of the National Grid Group.

Subsequent to the sale of the four gas networks on 1 June 2005, the Company supplied goods and services amounting to £38m to the four sold gas networks. There were no material transactions with any other related parties.

Definitions

References in the Annual Report and Accounts to the 'Company', the 'Group', 'we', 'our' and 'us' refer to National Grid Gas and its subsidiaries.

FRS
UK Financial Reporting Standard.

GAAP
Generally accepted accounting principles.

GW
Gigawatt, 10^9 watts.

GWh
Gigawatt hours.

HSE
Health and Safety Executive.

IAS
International Accounting Standard

IFRS
International Financial Reporting Standard

KPI
Key performance indicator

LNG
Liquefied natural gas

LTI
Lost Time Injury. A work-related injury that causes a person to be away from work for at least one normal shift after the shift on which the injury occurs, because the person is unfit to perform his or her duties.

mcm
Million cubic metres.

Merger
The merger of Lattice Group plc and National Grid Group plc which became effective on 21 October 2002.

National Grid
National Grid plc, formerly National Grid Transco plc.

National Grid Gas
National Grid Gas plc and/or its subsidiary undertakings or any of them as the context requires, formerly Transco plc.

NTS or National Transmission System
The gas national transmission system owned and operated by the Group.

Ofgem
The Office of Gas and Electricity Markets.

tonnes CO_2 equivalent
Measure of greenhouse gas emissions in relation to the impact of carbon dioxide.

TW
Terawatt, 10^{12} watts.

TWh
Terawatt hours.

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