Company Number 2006000

Annual Report and Accounts 2006/07
National Grid Gas plc

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Operating and Financial Review

This Operating and Financial Review describes the main trends and factors underlying our development, performance and position during the year ended 31 March 2007 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.

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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 in the UK, and comprise the transmission and distribution of gas and the provision of gas metering services.

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 adopted as our brand name, with 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
Gas Transmission	UK Gas Transmission	Owner and operator of the gas national transmission system in Great Britain and storage facilities for liquefied natural gas (LNG).
Gas 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.
National Grid Metering	UK Gas Metering	The provision of regulated gas metering and meter reading services in Great Britain.
Corporate activities	Other activities	Corporate activities.

All of our businesses and activities are undertaken within Great Britain.

External market environment

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

The supply of natural gas in the UK is competitive in that consumers can contract with different suppliers to obtain the gas they need. Those suppliers are then responsible for sourcing that gas from gas extractors or importers as appropriate, as well as arranging for that gas 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 alternative methods of receiving natural gas.

Natural gas delivery

Natural gas is transported through the gas national transmission system to regional gas distribution networks that then deliver that gas to consumers on behalf of suppliers. Certain end customers, primarily large industrial users, receive gas direct from the national transmission system.

We are the owner and operator of the gas national transmission system and of four of the eight regional gas distribution networks in Great Britain.

The gas distribution networks in Scotland and southern England are owned by Scotia Gas Networks, in the north of England by Northern Gas Networks, and in Wales and the west of England by Wales & West Utilities.

Other markets in which we operate

We also operate in gas related markets in Great Britain which are directly connected to our regulated businesses described above.

We participate in the competitive market for the provision of LNG storage services in Great Britain.

Although there is now a competitive market for metering services in the UK, we do not participate in this competitive market, but are the owner of a legacy portfolio of gas meters comprising the majority of the gas meters in operation in Great Britain. As the competitive market for metering services expands, this portfolio will decline as our gas meters are replaced.

Regulation

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.

Our businesses are regulated 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.

We have two price controls for our gas transmission operations, one in our role as transmission owner and the other as system operator. For gas distribution operations, we have four price controls, one for each of our four regional gas distribution networks.

These price controls are based around incentives. We have a financial incentive to invest, receiving a return on efficiently incurred capital expenditure through it increasing our regulatory asset base, and we can gain or lose through incentive arrangements for our performance in managing system operation, internal costs and pass-through costs.

The last price control period for our gas transmission operations ended on 31 March 2007. A new price control period commenced on 1 April 2007 and is planned to last until 31 March 2012. The current price control period for our gas distribution operations has been extended until 31 March 2008. The next price control period is expected to last until 31 March 2013.

Our businesses are subject to safety legislation which is enforced by the Health and Safety Executive (HSE). Our 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. As a consequence, we are regulated by the Financial Services Authority in the UK and by the US Securities and Exchange Commission.

More information about the regulatory environment in which we operate, and on the nature of our price controls, is provided in the business discussions on pages 21 to 27.

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. 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 agreed performance targets. The period of these arrangements is significant to us in that they provide stability to our operations and allow us to plan ahead and invest in the confidence that we will obtain financial returns. Our price controls typically cover periods of five years.
Multi-year contractual arrangements	Revenues from metering services are determined by contractual arrangements, which are usually long-term and with ‘blue chip’ customers.
Safety and reliability	Our ability to operate safely and reliably is very important to us, our employees, our contractors, 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 regulator, Ofgem, 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 National Grid’s shareholders.
Capital investment	Capital investment is a significant driver for organic growth. In our regulated gas 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.
Disposals	Disposals can crystallise value for shareholders, where we believe that the price on offer is better than the long-term return we can obtain ourselves.
Relationships and responsibility	Our reputation is vitally 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:

Weather and 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 and consumer demand 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 revenues, with a corresponding increase or decrease in revenue in future periods.
Pass-through costs	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.
Commodity 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.
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 are linked to retail price inflation, as are a proportion of our borrowings.
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. Seasonality does not have a significant impact on our other 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.

Current and future developments

External market developments

Market structure and ownership

There have been no significant changes in the structure of the UK gas infrastructure market since 2005, when we sold four of our regional gas distribution networks to other operators.

Energy market developments

The UK is in a period of changing energy supply patterns, as more reliance is placed on imported gas. The decline in UK continental shelf gas reserves means we continue to see a trend toward greater use of imported gas for both consumption and use in power generation.

This change is expected to impact on our gas transmission and distribution networks. In particular, significant investment is planned in our gas transmission and distribution networks to link gas import facilities with domestic, business and industrial consumers and with new power plants.

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 the UK's import capability has involved the development of new import infrastructure by National Grid and other market participants. During the year, a number of significant infrastructure projects were commissioned, including the Langeled pipeline from Norway, connecting at Easington and providing annual capacity of 25 billion cubic metres (bcm) of gas; enhancements to the Belgian interconnector increasing annual import capacity from 17.5 to 25 bcm; and the BBL pipeline at 15 bcm capacity, linking the UK market at Bacton with the Netherlands. In addition, Excelerate Energy commissioned its 4 bcm peak capability LNG facility at Teesside, using onboard ship re-gasification technology, and we are currently building a large pipeline through South Wales to connect new LNG importation facilities at Milford Haven.

Following development of the UK gas daily summary report during winter 2005/06, it became clear how important the delivery of key information was to the operation of the market. For winter 2006/07, we worked with Ofgem and the industry to enhance the quality of information that is available to the market, to further promote industry participant response to the gas supply/demand position. Of particular note is the introduction of the quality of information incentives, which have been placed on National Grid Gas to improve the timeliness and accuracy of the information being made available to the market, and the introduction of longer term demand forecasts.

Regulatory developments

During the year ended 31 March 2007, there were no significant changes in the legislative and regulatory framework in the UK.

In January 2007, the European Commission published its final report on its energy sector competition inquiry, concluding that further action is required to improve energy markets in the European Union. It focused on problems from high levels of market concentration as well as vertical integration of supply, generation and infrastructure leading to a lack of equal access to, and sufficient investment in infrastructure. The report also called for improvement in the regulatory framework to remove gaps in regulation, address concerns with market concentration and increase transparency in market operations.

Price controls

The previous price control arrangements for our gas transmission business ceased on 31 March 2007 and have been replaced by new price controls which cover the period from 1 April 2007 to 31 March 2012.

We have accepted Ofgem's final proposals in respect of the price control covering our role as owner of the gas national transmission system. The key elements of these proposals are a 4.4% post-tax real rate of return on our regulatory asset value, a £0.9 billion baseline five year capital expenditure allowance and a £0.3 billion five year controllable operating expenditure allowance. Since our acceptance in principle of the final proposals, we have been working closely with Ofgem to agree the necessary licence amendments. This process should be completed during the first half of 2007. We have also accepted Ofgem's final proposals for the system operator schemes to apply for one year from 1 April 2007.

The current price controls for our gas distribution networks were extended for one year until 31 March 2008. We are currently in discussions with Ofgem on the next five year price control for the period from 1 April 2008 to 31 March 2013.

Legal and related matters

Metering competition investigation

In June 2005, Ofgem announced that it was going to investigate certain aspects of the domestic gas metering business under the Competition Act 1998 and information requested as part of this investigation has been provided to Ofgem. No findings have been issued with respect to this investigation. However, a supplemental statement of objections was issued by Ofgem in April 2007 to which we will respond shortly.

Environmental remediation

In last year's Annual Report and Accounts we noted that we, together with the Environment Agency, had sought judicial review to clarify the legal position with regard to the remediation of a site in Bawtry, Yorkshire, a former gas site that was not part of the assets that formed part of the gas privatisation in 1986 and therefore had never been owned by National Grid Gas. On 17 May 2006, the High Court found in favour of the Environment Agency. However, the judgement concluded that the matters raised in the proceedings were of considerable general importance and permission to apply for leave to appeal directly to the House of Lords was granted.

A hearing before the House of Lords took place on 21 May 2007 and a judgement is expected in the summer of 2007.

As described in note 30(e) to the accounts, we remain convinced of our case that National Grid Gas has no legal liability with respect to the site in Bawtry, nor for other former UK gas sites which did not form part of the assets we acquired at the time of privatisation, and we believe that our position will be upheld by the House of Lords.

Objectives and strategy

Strategic review

National Grid has undertaken a thorough and disciplined strategic review of its business which will set our direction for the next 5 to 10 years. In conducting this review, National Grid considered market trends and opportunities that exist in the utility sector, our market position, how we derive value from our businesses and the views of the capital markets. National Grid announced its conclusions in November 2006 and we have updated our objectives accordingly.

Focus

National Grid's future is about becoming more focused – a clear business model based on the ownership and operation of large scale asset intensive businesses, focusing on its principle growth markets, including gas infrastructure in the UK.

Integration

We aim to run our businesses in a more integrated way – organising our activities along lines of business, supported by effective and efficient shared services and information systems. This involves deploying proven processes, common systems and best practices within each business, supported by common operating principles, and safety and environmental standards. In this way, we will maximise the competitive advantages that come from being part of an international organisation. However, it is critical that we balance this with the need to provide excellent service to customers and to maintain and build local relationships with other key stakeholders.

Discipline

We plan to be more disciplined in the application of best practice. Increasingly, we will standardise our approach, applying even greater rigour to financial discipline, ensuring that we have the capital to grow, but maintaining the investor confidence that comes from a disciplined approach to our balance sheet.

Objectives

Our primary objective is to grow our businesses in order to create value for National Grid's shareholders. We can only create value if we achieve operational excellence and continue to improve our financial performance, we invest for the future and are financially disciplined, and we develop, recruit and retain skilled, talented and motivated people. In each area, we aim to increase our focus, benefit from improved integration and be disciplined in our approach.

As consequence, we have identified specific objectives in the following areas:

Performance	We aim for operational excellence by operating to the highest standards of safety, reliability and efficiency. We aim to continue to improve our financial performance.
Investment	We will invest in our existing businesses to generate future growth. We will be financially disciplined in the way we invest and in the way we manage our balance sheet.
Talent	We aim to maximise the contribution made by our employees by motivating our people to strive for continued improvement, developing their skills and talents, and by promoting a culture that recognises and respects inclusion and diversity.

Our strategy is underpinned by our commitments to developing strong and valued relationships with our customers, regulators, suppliers and the communities in which we operate and to acting responsibly, including specific commitments to reducing our environmental impact and to corporate governance and business ethics.

Relationships	We aim to improve our relationships with customers, regulators, suppliers and the communities in which we operate by focusing on the areas that are important to them, such as the quality of service we provide to customers, the quality of information we provide to regulators, by investing in local communities and by the way we address the concerns of, and interact with, all our stakeholders.
Responsibility	We believe operating responsibly is essential to the way we conduct our operations, invest, develop our people and manage our relationships and so responsibility underpins everything we do. We are committed to taking positive action to reduce our contribution to climate change and our other impacts on the environment. We want to operate to the highest standards of corporate governance and we believe in strong business ethics, based around our core values of respect, integrity and ownership.

Risk

Our principal risks relate to the achievement of our objectives and strategy, as we believe that by delivering on these objectives we will achieve our principal objective of delivering growth to drive shareholder value. We set out how we intend to achieve our objectives below and we describe our performance during the year against those objectives on pages 14 to 20.

In considering the opportunities we have to grow and develop our business, we have identified a number of risks and uncertainties in achieving 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, including regulatory targets and delivering anticipated cost and efficiency savings;
- regulatory treatment of commodity costs passed through to consumers;
- reputation damage from disruptions to supply, even if outside our control;
- fluctuations in exchange rates and interest rates and their impact on borrowings and derivatives;
- increases in interest rates;
- restrictions in borrowings and changes in credit ratings or in tax rates;
- future funding requirements of pension schemes; and
- changes in accounting standards.

These are described in more detail on pages 9 and 10.

Shareholder value

By achieving our objectives around performance, growth, talent, relationships and responsibility we aim to deliver sustainable growth to create value for National Grid's shareholders.

The following pages set out some of the specific objectives we have set ourselves in these areas in order to support our overall goals. Our objectives are set in the context of our strategy of increasing our focus, seeking to benefit from improved integration and being disciplined in our approach.

Performance

Our aim is for operational excellence, performing to the highest standards of safety, reliability and efficiency and continuing to improve our financial performance:

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; to deliver a working environment where there are zero work-related injuries or illnesses; to reduce gas leaks on our distribution networks; and to improve the health of our employees so they are fit for work every day.

Measures we use to monitor our performance against our safety objectives include: members of the public injured as a direct result of our operations; employee lost time injury frequency rate; standards of service for responding to gas escapes; kilometres of gas distribution mains replaced; and employee sickness absence rate.

Reliability

Our principal operations are critical to the functioning of the UK economy. The reliability of our gas infrastructure networks and the delivery of gas to our customers, are, therefore, our next highest priorities after safety.

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.

We use business-specific reliability performance indicators to measure our reliability performance.

Efficiency

By improving efficiency, we can constrain the cost of our operations borne by customers and improve returns to shareholders. We review our operations continually 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.

Our primary method of measuring improvements in efficiency is through our financial performance as described below.

Financial performance

If we achieve our objectives, we should be able to deliver continued improvements in financial performance. This will contribute to National Grid delivering on its commitment to growing its dividend by 7% per annum until 31 March 2008.

The principal measures we use to monitor financial performance are adjusted operating profit* and operating cash flows.

* Adjusted operating profit is operating profit before exceptional items and remeasurements.

Growth

Investment and financial discipline are critical to our plans to grow our businesses.

Investment	We invest in our existing businesses in order to grow those businesses. Measures we use to monitor investment include capital expenditure.
Generate value from our investment	We aim to generate value from our investment by improving the operating performance of our networks and by selecting investments that will provide the best return. Measures we use to monitor the value we generate from our investments include our return on investment.
Financial discipline	In order to deliver sustainable growth we must be disciplined in the way we manage our balance sheet. This means that cash will be returned to National Grid's shareholders to the extent that it is not required for our investment objective.

Talent

National Grid Gas depends on the talents, skills and motivation of our employees. We aim to maximise the contribution made by our employees by developing their skills and talents, by motivating and driving continued improvement and by promoting a culture that recognises and respects inclusion and diversity and where all our employees share our core values of respect, integrity and ownership. In addition to obtaining the views of employees on an ongoing basis, we periodically carry out employee surveys to identify areas where we can improve the way we develop and interact with them.

Motivation and performance	We plan to improve our operational performance and the service we provide to our customers by motivating our employees to strive for continued improvement. Our aim is for a world-class performance management system, involving integrated common performance processes, a single set of performance criteria, pay linked to leadership qualities as well as operational and financial performance and greater differentiation between levels of performance.
Development of talent and skills	Critical to our success is identifying, recruiting and developing talented people and helping our management and employees to operate to the best of their abilities.
Inclusion and diversity	In order to develop, recruit and retain talented people we aim to achieve a more inclusive and diverse culture. A number of priority action areas have been identified to help achieve our vision of developing and operating our business in a way that results in a more inclusive and diverse culture, reflecting the composition of the communities in which we operate, and to be seen as an employer of choice across diverse communities. Performance measures we use to monitor our objective of promoting inclusion and diversity include the percentage of female employees and the percentage of black and minority ethnic employees.
Values	Our aim is for all our people to be proud to work for National Grid Gas, to share our core values of respect, integrity and ownership.

Relationships

We have a diverse range of external stakeholders including employees, customers, regulators, government and local communities. We strive to be open and constructive in our dealings with external audiences.

Our relationships with stakeholders are critical to our future success. Our strategy involves improving these relationships by focusing on the areas that are important to them, such as the quality of service we provide to customers, the quality of information we provide to regulators and the way we address the concerns of, and interact with, all our stakeholders.

Customer service	Our objective is to impress our customers with the quality of the services we provide, with our responsiveness when things go wrong and with our dedication to continued improvement. We plan to improve the way we interact with our customers by enhancing or replacing the systems we use, through providing our employees with the training, empowerment and support they need to deliver and by improving the quality of our communications with customers and internally. We use business-specific service quality performance indicators to measure our performance in this area.
Regulatory relationships	Our regulators' primary responsibilities are to gas consumers. Hence, the foundation of our relationship with regulators is based on the safety, reliability and efficiency of our operations and the quality of our customer service. Our strategic focus on operational excellence and on customer relationships plays a critical part in improving relationships with our regulators. The other critical element in our regulatory relationships is in building trust. This involves being responsive to the need of our regulators for high quality information, complying with rules and regulations, operating in an ethical way and, most importantly, delivering on our promises.

Suppliers

We aim to work in partnership with our suppliers, developing constructive relationships and working together effectively. Our objective is to develop contractual arrangements with our suppliers that align their interests with our own, as far as possible, and share financial risks appropriately.

We expect our suppliers to be as equally committed as ourselves to safety, reliability and efficiency and to acting responsibly. In turn, we aim to respect the capabilities and views of our suppliers and to treat them fairly in all our dealings with them.

Community involvement

National Grid Gas's role as a good corporate citizen supports our strategic ambitions, and is delivered through a sustained and consistent approach.

In all our community investment we aim to develop our business, support our employees, support communities and enhance our reputation. Our approach is based on two principles: 'Investment in our Communities, Investment in our People', and continues to be centred on three key themes: energy and environment; education and skills; and community development.

Sharing of best practice across our business and working collaboratively with key partners and stakeholders enables us to maximise how communities benefit from our activities.

Responsibility

We are committed to operating in a responsible way and this underpins our commitments to performance, growth, talent and relationships as discussed above.

As an asset intensive business, our operations have an impact on the environment. The most significant of these are climate change and historically contaminated land. We also take actions to minimise other environmental impacts of our operations, we are committed to strong governance and ethical standards and we are committed to protecting human rights.

Climate change

Climate change is possibly one of the greatest challenges facing society in the 21st Century. National Grid's public position statement on energy delivery and climate change sets out our approach to delivering energy while playing our role in minimising any impact our operations may have on the climate.

National Grid's target is to reduce its carbon emissions by 60% compared with a verified baseline, ahead of the Government's target of 2050.

Our biggest greenhouse gas emission is methane leakage from our gas networks. A major ongoing programme of replacing old cast iron pipes with modern polyethylene pipe is reducing leakage from our distribution system year on year. A programme to install new compressors at key sites will also reduce emissions from our gas transmission system.

We plan to reduce emissions relating to our own energy use, saving at least 5% in energy consumption, and use the resultant cost savings to enable us to procure all of the electricity we use from renewable sources by the end of 2010.

The key performance indicator we use to monitor our performance in this area is the percentage reduction in our greenhouse gas emissions.

Historically contaminated land

National Grid Gas has an inherited portfolio of historically contaminated land including former manufactured gas plants and former gas holder stations. Sites can have a complex mix of contamination dating back over 100 years.

The main focus of our remediation programme is on managing the environmental risk and returning land to beneficial use. Our goal is to return these sites to productive public or private use.

Protecting the environment

We are committed to continuous improvement in our environmental performance.

Our objective is to help protect the environment for future generations. In addition to aiming to actively reduce our contribution to climate change, we are committed to:

- being efficient in our use of natural resources;
- keeping our waste to a minimum and increasing the economic value of any waste we produce;
- acting to prevent environmental incidents; and
- improving, where we can, the environmental status of the land on which we operate.

We have implemented environmental management systems certified to the international standard ISO 14001 in all our businesses to help us deliver improvements in these areas.

Key performance indicators that we monitor in this area comprise the number of significant direct environmental incidents and the total value of fines from prosecutions.

Corporate governance

We believe strong corporate governance is essential to operating responsibly and achieving our goals. National Grid's approach to corporate governance is described on pages 77 to 85 of its Annual Report and Accounts 2006/07.

Business ethics

Not only are we committed to ensuring that all our behaviours are lawful and that we comply with our policies and licences, we also expect all of our employees to live up to our core values of respect, integrity and ownership.

Human rights

National Grid's public position statement sets out our commitment to protect human rights within our sphere of influence and ensure our own operations are a force for good, wherever we operate.

Principal risks and uncertainties

Risk management

Understanding and managing risks is integral to the way we run our business. We have a well established enterprise-wide risk management process that ensures risks are consistently assessed, recorded and reported in a visible, structured and continuous manner, the outputs of which are primarily used as a management tool. A secondary and natural output from this process is information that provides assurance to management at all levels and thus helps safeguard our assets and reputation. It is designed to manage rather than eliminate material risks to the achievement of our strategic and business objectives while also recognising that any such process can provide only reasonable, and not absolute, assurance against material misstatement or loss. This process complies with the Turnbull working party guidance (revised October 2005) and, in addition, contributes toward our compliance with our obligations under the Sarbanes-Oxley Act as well as other internal assurance activities.

Risk management in National Grid Gas has become further embedded over time and our experience of this has enabled us to identify a number of key success criteria linked to both the risk management framework and process that, if in place, will help ensure the process continues to remain embedded.

The risk management process continues to be based on both bottom-up and top-down assessments of operational, financial and other business or project risks. From the bottom-up, our business units prepare and maintain risk registers that capture their key risks and the actions being taken to manage them. These risk registers are regularly reviewed and discussed by the executive committees for those business units. The key element in the top-down assessments of the enterprise-wide risk profile is the involvement of Directors and other senior management at critical stages in the review process. Their review and debate of bottom-up assessments produces the overall evaluations of the risks that are faced by National Grid Gas. In addition, the Executive, the Risk & Responsibility and the Audit Committees of National Grid plc review National Grid's overall risk profile twice a year. The Audit Committee of National Grid plc also reviews the risk management process at least once during each year and reports on this to the Board of National Grid plc.

During the year we have continued to derive benefits from this process through ongoing interaction with National Grid plc's Internal Audit function and Sarbanes-Oxley teams. The external benchmarking exercise of National Grid as a whole has continued with other FTSE 100 companies and public sector organisations to measure the effectiveness of our own approach and exchange ideas on best practice. With the move to a line of business operating model, the opportunity is being taken to restructure risk and compliance management services to ensure approaches are consistent across businesses and continue to provide value to business operations, including major projects.

Risk factors

Our risk management process has identified the following risk factors which could have a material adverse effect on our business, financial condition, results of operations and reputation, as well as the value and liquidity of our securities. Not all of these factors are within our control. In addition, other factors besides those listed below may have an adverse effect on National Grid Gas. Any investment decision regarding our securities and any forward-looking statements made by us should be considered in the light of these risk factors.

Changes in law or regulation could have an adverse effect on our results of operations.

Our principal businesses are utilities or networks that are subject to regulation by the Government and other authorities. Consequently, changes in law or regulation could adversely affect us. Regulatory decisions concerning, for example, whether licences or approvals to operate are granted or are renewed, whether market developments have been satisfactorily implemented and whether there has been any breach of the terms of a licence or approval, the level of permitted revenues for our businesses and proposed business development activities could have an adverse impact on our results of operations, cash flows, the financial condition of our businesses and the ability to develop those businesses in the future. For further information, see the 'External market environment' and 'Regulation' sections of this Operating and Financial Review.

Breaches of, or changes in, environmental or health and safety laws or regulations could expose us to claims for financial compensation and adverse regulatory consequences, as well as damaging our reputation.

Aspects of our activities are potentially dangerous, such as the transmission and distribution of natural gas. Gas utilities also typically use and generate in their operations hazardous and potentially hazardous products and by-products. In addition, there may be other aspects of our operations which are not currently regarded or proved to have adverse effects but could become so. We are subject to laws and regulations relating to pollution, the protection of the environment, and how we use and dispose of hazardous substances and waste materials. We are also subject to laws and regulations governing health and safety matters protecting the public and our employees. Any breach of these obligations, or even incidents that do not amount to a breach, could adversely affect our results of operations and our reputation. For further information about environmental and health and safety matters relating to our businesses, see the 'Our Responsibility' section of National Grid's website at www.nationalgrid.com.

Network failure or the inability to carry out critical non-network operations may have significant adverse impacts on both our financial position and our reputation.
We may suffer a major network failure or may not be able to carry out critical non-network operations. Operational performance could be adversely affected by a failure to maintain the health of the system or network, inadequate forecasting of demand or inadequate record keeping. This could cause us to fail to meet agreed standards of service or be in breach of a licence or approval, and even incidents that do not amount to a breach could result in adverse regulatory and financial consequences, as well as harming our reputation. In addition to these risks, we may be affected by other potential events that are largely outside of our control such as the impact of weather or unlawful acts of third parties. Weather conditions can affect financial performance and severe weather that causes outages or damages infrastructure will adversely affect operational and potentially business performance. Terrorist attack, sabotage or other intentional acts may also physically damage our businesses or otherwise significantly affect corporate activities and as a consequence adversely impact the results of operations.

Our results of operations depend on a number of factors relating to business performance including performance against regulatory targets and the delivery of anticipated cost and efficiency savings.
Earnings maintenance and growth from our regulated gas businesses will be affected by our ability to meet or better efficiency targets set by or agreed with Ofgem and other regulators. Earnings from our regulated businesses will be affected by our ability to recover incurred expenditure. Levels of earnings also depend on meeting service quality standards set by regulators. In addition, from time to time, we also publish cost and efficiency savings targets for our businesses. We are also reorganising our operations along lines of business. To meet these targets and standards, we must continue to improve operational performance, service reliability and customer service. If we do not meet these targets and standards, we are not able to recover incurred expenditure, or we do not implement this reorganisation as envisaged, we may not achieve the expected benefits, our business may be adversely affected and our performance, results of operations and our reputation may be harmed.

Changes to the regulatory treatment of commodity costs may have an adverse effect on the results of operations.
Changes in commodity prices could potentially impact our gas transmission and distribution businesses. Current regulatory arrangements in the UK provide the ability to pass-through virtually all of the increased costs related to commodity prices to consumers. However, if Ofgem were to restrict this ability, it could have an adverse effect on our operating results.

Our reputation may be harmed if consumers of energy suffer a disruption to their supply even if this disruption is outside our control.
Our gas transmission and distribution businesses are responsible for transporting available gas. We consult with and provide information to regulators, governments and industry participants about future demand and the availability of supply. However, where there is insufficient supply, our role is to manage the relevant network safely, which in extreme circumstances may require us to disconnect consumers.

Fluctuations in exchange rates and interest rates could have a significant impact on our results of operations because of the significant proportion of our borrowings, and derivative financial instruments that may potentially be affected by such fluctuations.
Our results of operations may be impacted because a significant proportion of our borrowings and derivative financial instruments are affected by changes in exchange rates and interest rates. For further information about this and how we mitigate this risk, see the ‘Financial position and financial management’ section of this Operating and Financial Review.

The nature and extent of our borrowings means that an increase in interest rates could have an adverse impact on our financial position and business results.
A significant proportion of our borrowings are subject to variable interest rates which may fluctuate with changes to prevailing interest rates. Increases in these interest rates could therefore increase our costs and diminish our profits. For further information about this, see the ‘Financial position and financial management’ section of this Operating and Financial Review.

Our financial position may be adversely affected by a number of factors including restrictions in borrowing and debt arrangements, changes to credit ratings and effective tax rates.
We are subject to certain covenants and restrictions in relation to our listed debt securities and our bank lending facilities. We are also subject to restrictions on financing which have been imposed by regulators. These restrictions may hinder us in servicing the financial requirements of our businesses. Our debt is rated by credit rating agencies and changes to these ratings may affect both our borrowing capacity and the cost of those borrowings. The effective rate of tax we pay may be influenced by a number of factors including changes in law and accounting standards and our overall approach to tax planning, the results of which could increase that rate.

Future funding requirements of pension schemes could adversely affect our results of operations.
Substantially all of our employees our members of a defined benefit scheme where the scheme assets are held independently of our own financial resources. Estimates of the amount and timing of future funding for the scheme is based on various actuarial assumptions and other factors including, among other things, the actual and projected market performance of the scheme assets, future long-term bond yields, average life expectancies and relevant legal requirements. The impact of these assumptions and other factors may result in a requirement for additional contributions to the pension scheme. Our legal obligations to the scheme are limited to paying the employers' contribution rate set by the trustees of the scheme. However, circumstances may require that we make additional contributions. To the extent that any increases in contributions are not recoverable under our price controls, our results of operations could be adversely affected.

New or revised accounting standards, rules and interpretations by the UK, or international accounting standard setting boards and other relevant bodies could have an adverse effect on our reported financial results.
The accounting treatment under International Financial Reporting Standards (IFRS), as adopted by the European Union, of replacement expenditure, pension and post retirement benefits, derivative financial instruments and commodity contracts significantly affect the way we report our financial position and results of operations. As a body of practice develops for IFRS, the application and interpretation of accounting principles to our circumstances, and to those areas in particular, could result in changes in the financial results and financial position that we report. In addition, new standards, rules or interpretations may be issued which could also have significant effects.

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. Where relevant, KPIs are used as our primary measures of whether we are achieving our objectives. However, the scale and size of our operations mean we use many other detailed performance measures in addition to KPIs. We also use KPIs to measure performance against our primary objective of growing our businesses to create value for National Grid's shareholders. We use qualitative assessments to judge progress against our objectives in areas where numerical measures are less relevant.

The majority of our KPIs are unchanged from last year; however, we have increased the number of KPIs presented in the table below by including business-specific reliability KPIs.

Value	KPI	Description	Target	Results
Performance – safety	Injuries to the public	Members of the public injured as a direct result of our operations[1]	Zero	2006/07: 20 2005/06: 11
	Employee lost time injury frequency rate	Injuries resulting in employees taking time off work (per 100,000 hours worked)	Zero	2006/07: 0.18 2005/06: 0.20
	Gas safety-related service standards	Proportion of uncontrolled gas escapes attended within one hour	97%	2006/07: 98.51% 2005/06: 97.97%
	UK Gas Distribution mains replacement	Kilometres of gas main decommissioned	2006/07: 1,824 km 2005/06: 1,724 km	2006/07: 1,850 km 2005/06: 1,724 km
	Sickness absence rate	Proportion of available work days which are lost due to sickness	Zero work-related sickness[2]	2006/07: 2.20% 2005/06: 2.20%
Performance – reliability	UK Gas Transmission system reliability	Gas delivered by the gas transmission system as a proportion of gas demanded	100%	2006/07: 100% 2005/06: 100%
	UK Gas Distribution network reliability	The proportion of total customer days without unplanned customer interruptions	99.999%	2006/07: 99.999% 2005/06: 99.999%
Performance – efficiency and financial performance	Adjusted operating profit[4]	Operating profit from continuing operations excluding exceptional items and remeasurements	To increase sufficiently to support 7% growth in National Grid's dividend through to March 2008	2006/07: £792 million 2005/06: £862 million
	Operating cash flows	Cash generated from continuing operations		2006/07: £1,407 million 2005/06: £1,055 million
Growth – investment	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.	2006/07: £1,200 million 2005/06: £914 million
Growth – value from our investments	Return on investment	Adjusted regulatory profit[5] for UK Gas Transmission and UK Gas Distribution as a percentage of regulatory asset value	To achieve a minimum return of 5.05% from 1 April 2007 consistent with the return projected by Ofgem for the 5-year price control period commencing 1 April 2007.	2006/07: 5.5% 2005/06: 6.3%
Talent – inclusion and diversity	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	2006/07: 20.0 2005/06: 19.4
	Percentage of black and minority ethnic employees	Proportion of employees who are black and minority ethnic		2006/07: 4.5 2005/06: 4.5
Responsibility – climate change	Reduction in greenhouse gas emissions[6]	CO_2 equivalent emissions estimated to be caused by our operations	Year on year reduction	2006/07: 9%

Value	KPI	Description	Target	Results
Responsibility – protect the environment	Significant direct environmental incidents	Own fault and contractor related environmental incidents	Zero	2006/07: 3, 13 2005/06: 1, 0
	Total value of fines from environmental prosecutions	Financial amount of fines imposed	Zero	2006/07: Zero 2005/06: Zero

1 Injuries comprise fatalities, injuries that require the person to receive hospital treatment and other injuries reported under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR).
2 The sickness absence rate includes absences resulting from both work-related and non-work related illnesses. Our target relates to work-related illnesses, however, we do not have a measure that excludes non work-related illnesses sufficiently accurately.
3 The KPI for a 30% reduction in controllable costs by 31 March 2007 in our Gas Distribution business is no longer included as it was achieved by 31 March 2006.
4 Operating profit from continuing operations including exceptional items and remeasurements fell from £ 835 million in 2005/06 to £778 million in 2006/07.
5 The calculation of adjusted regulatory profit is explained on page 14.
6 The KPI we use for measuring reduction in greenhouse gas emissions has been changed from last year's measure of greenhouse gas emissions per £m revenue to a measure that aligns with National Grid's target of a 60% reduction in emissions.

Performance during the year

Our performance against our objectives in the areas of performance, investment, talent, relationship and responsibility is described below and on the following pages. Our financial results are described on pages 17 to 20 and more information on the performance and financial results of each business are included in the business sections on pages 21 to 27.

Performance

Safety

Aspects of our safety performance deteriorated in 2006/07 compared with 2005/06, which is disappointing after the significant improvement we recorded last year. Our aim in 2007/08 is to improve our safety performance in line with our goal of zero injuries.

In September 2006, managers from National Grid Gas participated in National Grid's first combined UK and US safety, health and environment conference involving participants from across National Grid. The conference provided the opportunity to review our Safety and Occupational Health Policy, and our Vision for Safety and develop strategies to meet the challenges facing the business over the next few years.

Public safety

20 members of the public were injured as a result of our operations compared with 11 during 2005/06.

Employee safety

During 2006/07, 29 of our employees received injuries that resulted in them taking time off work, compared with 33 in 2005/06, excluding the regional gas distribution networks sold in June 2005. As a consequence, employee lost time injuries per 100,000 hours worked fell to 0.18 in 2006/07 compared with 0.20 in the previous year.

In National Grid's 2006 employee opinion survey, 89% of respondents considered that National Grid has a clear commitment to operating safely and 89% considered that employees take safety seriously and do their best to prevent injuries and accidents compared with 86% on both these questions in the 2004 survey. 79% of respondents in 2006 felt confident safety concerns or issues raised would be addressed, up from 75% in the 2004 survey.

Contractor safety

There was an increase in contractor lost time injuries from 41 in 2005/06 to 46 in 2006/07.

Employee health

We continue to focus on our employees' health and well being. Resulting from an action coming out of the September 2006 safety, health and environment conference, later in 2007/08 we will launch a new 'Vision for Wellness', setting out how we aim to help and support our employees in the maintenance of good physical and mental health through proper diet, exercise and habits. We also participate in the UK's Business in the Community Business Action on Health programme, at both a leadership team and practitioner level. The objectives of this programme are to raise the profile of health issues in companies and to quantify and track best practice workplace health activities.

Around 2.20% of available work days were lost due to sickness absence in 2006/07, the same as the previous year. This equates to 5.8 days of sickness per employee per year. The UK Confederation of British Industry's 2007 sickness absence survey reported that average annual sickness for UK company employees was 7.0 days.

Reliability

Our gas transmission and distribution operations performed reliably during the year. Further detail on the reliability of our operations is discussed in the business sections on pages 21 to 27.

Efficiency

We continued to institute measures during the year to improve efficiency, with the implementation of a shared services function to support our Gas Transmission and Gas Distribution businesses, our business process review in Gas Transmission and other business process projects.

Financial performance

Operating profit from continuing operations, before exceptional items and remeasurements fell from £862 million in 2005/06 to £792 million in 2006/07. Operating profit from continuing operations fell from £835 million in 2005/06 to £778 million in 2006/07.

Earnings from continuing operations before exceptional items and remeasurements fell from £526 million in 2005/06 to £310 million in 2006/07. Earnings from continuing operations fell from £490 million in 2005/06 to £275 million in 2006/07.

Cash flows generated by continuing operations increased from £1,055 million in 2005/06 to £1,407 million in 2006/07.

More information on our financial performance is contained under financial results on pages 17 to 20 and in the business sections on pages 21 to 27.

Growth

Capital investment

Our capital investment continues to increase as changing sources of gas and the renewal of our networks require increased investment in infrastructure and we invested £1,200 million in the form of capital investment during 2006/07, compared with £914 million in 2005/06.

In the UK, there is increasing dependency on gas imports. The transmission price controls for the next five years include an allowance of £0.9 billion for investment in our gas transmission network. This investment is to respond to changing sources of gas and to replace ageing assets.

Acquisitions and disposals

There were no significant acquisitions or disposals completed during the year ended 31 March 2007.

During the year ended 31 March 2006, we sold four of our regional gas distribution networks, comprising approximately half of the gas distribution network in Britain, for net cash proceeds of £5.8 billion.

Generating value from our investments

This year we are reporting for the first time a return on investment measure, the purpose of which is to allow us to monitor how we are performing in generating value from our businesses and from the investments we make. Return on investment has been calculated using the measure developed by Ofgem when setting our transmission price controls for the 5 year period commencing 1 April 2007. If we perform in accordance with Ofgem's projections for the 5 year price control period, then we would earn an average annual return of 5.05% using Ofgem's measure. For 2006/07, our return on investment using this measure is 5.5%, compared with 6.3% in 2005/06. These returns are higher than Ofgem's projected return of 5.05%, due to operating costs savings achieved compared to Ofgem's original projections for those two years. Return on investment has declined between 2005/06 and 2006/07 due to the reduction in the Gas Distribution business adjusted operating profit which is discussed on page 25.

The following table shows how return on investment has been calculated:

	Years ended 31 March	
	2007	2006
	£m	£m
UK Gas Transmission adjusted operating profit[1]	**312**	287
UK Gas Distribution adjusted operating profit[1]	**409**	483
Less operating profit of LNG storage business	**(35)**	(35)
Adjustment of operating costs onto a price control basis[2]	**(21)**	(12)
Investment adjustment[3]	**(117)**	(104)
Excess of regulatory value depreciation over accounting depreciation and amortisation	**(83)**	(65)
Regulatory operating profit	**465**	554
Notional current taxation on a price control basis[4]	**3**	(40)
Regulatory return	**468**	514
Estimated average regulatory value[5]	**8,591**	8,152
Return on investment – regulatory return as a percentage of regulatory value	**5.5%**	6.3%

1 Adjusted operating profit is operating profit before exceptional items and remeasurements.
2 Adjustments to operating costs primarily comprise an allocation of corporate centre costs which are reported in these financial statements within other activities and expenditure against the environmental provision which is treated as an operating cost for price control purposes.
3 The investment adjustment is in respect of the 50% of replacement expenditure which is treated as an operating cost for price control purposes, but as capital investment for accounting purposes.
4 Notional current taxation is an allocation of the actual current tax for the year, excluding prior year items and adjusted for the effect of actual interest payments being less than would result from the gearing assumed by Ofgem when setting the price control.
5 Regulatory values have been restated from previous estimates to reflect the outcome of the extension price control review for the year to 31 March 2008 and are average values for each year.

Talent

Motivation and performance

In July 2006, National Grid conducted a company-wide employee opinion survey. 58% of employees took part in the process – a 9% increase on the response rate compared with the 2004 survey. For over 90% of the questions asked, a more favourable response rate was received than in 2004. The survey demonstrated that the workforce better understand our strategy and the need for change. Our employees believe that the business is heading in the right direction and are willing to do their jobs differently to help National Grid improve. Respect and integrity, two of our three core values, are also becoming embedded in the culture of the organisation and safety continues to be recognised as one of National Grid's key strengths.

Areas which the survey results highlighted as needing improvement included general management behaviours around communication with employees and performance management. Action plans have been developed by each of the businesses to address their key priorities for improvement.

Greater use is being made of electronic communication channels with the new Chief Executive of National Grid outlining the new strategy for all employees via video and issuing a New Year video message to all employees.

Development of talent

Development and recruitment of employees is undertaken on an integrated basis for all National Grid's UK businesses, with approximately 64% of National Grid's UK employees working in National Grid Gas's businesses.

Our focus on developing the talent of our current and future business leaders has intensified, with participants in our leadership and management development programmes more than doubled over last year. Specific areas of focus include leadership, communication, end user computing, project management and problem solving.

We continue to invest in the recruitment and development of skilled employees for the future and, in the past year, National Grid recruited 160 trainees onto the apprentice, foundation engineer, graduate and student programmes in which we participate. National Grid's UK Foundation Engineering Programme, launched in early 2006, is designed to facilitate the entrance, training and progression of talented people into key engineering roles. In conjunction with Aston University and Energy Utility Skills, our industry sector skills council in the UK, National Grid has also designed an industry specific foundation degree.

Through its 'e-futures' strategy, National Grid actively organises and sponsors a number of educational initiatives in the UK. These initiatives are designed to increase the number and diversity of young people interested in engineering careers and, ultimately, to create and sustain a greater pool of skilled talent from which we can recruit. Over the last four years, well over 15,000 young people have participated in these initiatives. Key to this success has been the dedicated involvement of our employees.

In the UK, National Grid was externally recognised as Graduate Employer of the Year at the Target National Graduate Recruitment awards and was highly commended by the National Council for Work Experience. The quality of National Grid's apprentice programmes has also been recognised by the Adult Learning Inspectorate, placing us in the top 10% of training providers in the UK.

Inclusion and diversity

Several employee interest networks have been established focusing on gender, ethnicity and faith and disability. The networks provide a mutually beneficial relationship for our employees by providing opportunities for employees to network with each other and senior management, to attain career building skills and to provide a better understanding of National Grid.

Working groups have been established with senior executive sponsors focusing on recruitment and employee development, employee engagement, communications and measuring the impact of our inclusion and diversity policies. We have also initiated a field force pilot programme in the UK to explore the development of inclusion and diversity best practices examples that can be replicated across our operational sites.

At 31 March 2007, 20.0% of employees were female and 4.5% were from black and ethnic minority groups compared with 19.4% and 4.5% respectively at 31 March 2006.

Our progress has already received external recognition. National Grid achieved The Times Top 50 UK 'where women want to work' status.

In the 2006 employee opinion survey, 83% (2004: 81%) of respondents considered they are treated fairly by National Grid without regard for race, age, ethnic background, gender, religion, disabilities or sexual orientation, while 66% (2004: not measured) considered that National Grid does a good job of treating them with fairness and respect.

Relationships

Customer service

We continue to aim for improvements in the service we provide to our customers and customer service is high on the agenda for the management teams in each of our businesses. In addition, we are supporting our businesses through the establishment of a shared services function in the UK.

Regulatory relationships

We continue to work very closely with Ofgem on the renewal of our gas transmission and gas distribution networks and in expanding those networks to meet new and changing demand. In addition, we seek to maintain a professional approach with Ofgem in areas where we disagree, in particular with respect to their investigation into metering services in the UK as discussed on page 4.

Suppliers

We continue to make progress in improving the quality of our relationships with suppliers. A particular focus has been on the investment programmes in our gas transmission and distribution operations, where we have worked with a number of suppliers to create alliances where we work in combined teams to deliver construction projects, and where we and suppliers share in the financial risk associated with these projects.

Community investment

Our policy on community investment provides a framework for ensuring that investment delivers benefits for our business and the communities we serve. During the year we reviewed our social policy to ensure our approach to community investment remains relevant to, and supports, society's wider social and environmental priorities. This review has included analysis of existing activities and best practice, both across National Grid Gas and externally. We continue to use the model developed by the London Benchmarking Group to provide a framework for measuring and reporting our community investment contributions, by capturing, in accordance with the model, spend against our key themes. On this basis we invested some £0.7 million in support of community initiatives and relationships across our operations in 2006/07.

In the 2006 employee opinion survey, 68% (2004: 63%) of respondents considered National Grid makes a positive contribution to the communities in which we operate.

Responsibility

We continue to enjoy external endorsement of our responsible business approach. National Grid is 'sector leader 'of the multi-utilities sector of the Dow Jones Sustainability World Index and one of only two companies listed. National Grid also continues to feature in the FTSE4Good Index and is one of 29 companies regarded as a 'Platinum' company in the Business in the Community 2006 Corporate Responsibility Index, confirming that our approach to responsible business is indeed world class.

Climate change

National Grid as a whole has committed to reducing its greenhouse gas emissions by 60% against a verified baseline, in advance of the target date of 2050 set by the UK Government.

The vast majority of our emissions fall within Scope 1 of the World Resources Institute' greenhouse gas protocol initiative. This comprises direct emissions such as methane leaking from our gas distribution networks and gas used to fuel compressors on our gas transmission network. Scope 2 emissions comprise indirect emissions, such as those resulting from purchased electricity.

During 2006/07, our Scope 1 and Scope 2 emissions amounted to some 3.4 million tonnes CO_2 equivalent, a 9% reduction compared with emissions of 3.7 million tonnes in 2005/06.

Total Scope 1 and 2 emissions per £million of revenue amounted to some 1,524 tonnes CO2 equivalent compared with 1,529 tonnes in 2005/06. Our largest direct emission is methane leakage from our gas networks, accounting for some 69% of our Scope 1 emissions. During the year, we replaced approximately 1,850 kilometres of old cast iron pipes, the largest source of these emissions.

Historically contaminated land
National Grid Property manages land contamination issues on our behalf, in respect of our currently owned sites previously used for gas production.

As described on page 4, a case is before the House of Lords regarding a former gas site, which was not part of the assets that formed part of the gas privatisation in 1986 and, therefore, had never been owned by National Grid Gas. We remain convinced of our case that National Grid Gas has no legal liability with respect to this site, or other former UK gas sites which did not form part of the assets we acquired at the time of privatisation, and believe that our position will be upheld by the House of Lords.

Protecting the environment
All of our employees work to certified ISO 14001 environmental management systems.

The number of significant environmental incidents in 2006/07 arising directly from our operations was 16. This includes 13 contractor–related incidents. In 2005/06, there was 1 incident. There were no prosecutions by enforcing bodies resulting from these incidents.

In National Grid's 2006 employee opinion survey, 73% (2004: 72%) of respondents considered National Grid acts responsibly in all its business dealings, including environmental management.

Business ethics
In March 2007, National Grid published its Standards of Ethical Business Conduct, replacing its UK Code of Business Conduct. The new Standard provides a common set of practical guidelines to ensure our behaviours are lawful, we comply with our policies and licences and we follow the values set out in our Framework for Responsible Business and our core values of respect, integrity and ownership.

In the 2006 employee opinion survey, 65% (2004: 56%) of respondents considered something would be done if they reported an inappropriate business practice or an ethical issue while 65% (2004: 61%) believe National Grid is a good company for customers to do business with.

Human rights
A review in 2004 of potential human rights risks highlighted the need to better understand our increasingly international supply chain. To improve control in this area, we have worked with other UK utilities to develop the UK's utilities vendor database supplier pre-qualification programme to include labour rights-related questions – this was introduced in 2006. To further strengthen controls, we have also carried out an assessment of the full range of materials and services purchased by our operations and identified those most likely to pose human rights risks to our operations. In 2007/08, we will further develop our purchasing strategies and processes to manage these potential risks.

Financial results

We report our financial results and position in accordance with International Financial Reporting Standards (IFRS) as adopted in the European Union.

Continuing and discontinued operations
The financial results of our business segments (as described on page 1) and of other activities are presented within continuing operations.

The results of the four gas distribution networks sold on 1 June 2005 in the previous financial year are presented as discontinued operations.

Measurement of financial performance and use of adjusted profit measures
In considering the financial performance of our businesses and segments, we analyse each of our primary financial measures of operating profit, profit before tax and profit for the year into two components, comprising firstly 'business performance' which excludes exceptional items and remeasurements and secondly 'exceptional items and remeasurements'. Exceptional items and remeasurements are excluded from the measures of business performance used by management to monitor financial performance as they are considered to distort the comparability of our reported financial performance from year to year.

Measures of business performance are referred to in this Annual Report as adjusted profit measures in order to clearly distinguish them from the comparable total profit measures of which they are a component. Adjusted operating profit, adjusted profit before tax and adjusted earnings differ from total operating profit, profit before tax and profit for the year respectively by the exclusion of exceptional items and remeasurements.

Exceptional items and remeasurements are items of income and expenditure that, in the judgment of management, should be disclosed separately on the basis that they are material, either by their nature or their size, and are relevant to an understanding of our financial performance. Items of income or expense that are considered by management for designation as exceptional items include such items as significant restructurings, write-downs or impairments of non-current assets, material changes in environmental provisions and gains or losses on disposals of businesses or investments. Remeasurements comprise gains or losses recorded in the income statement arising from changes in the fair value of derivative financial instruments. These fair values increase or decrease as a consequence of changes in financial indices and prices over which we have no control.

Adjusted profit measures are limited in their usefulness compared with the comparable total profit measures, as they exclude important elements of our underlying financial performance, namely exceptional items and remeasurements. We believe that in separately presenting financial performance in two components it is easier to read and interpret financial performance between periods, as adjusted profit measures are more comparable by excluding the distorting effect of exceptional items and remeasurements, and exceptional items

and remeasurements are more clearly understood if separately identified and analysed. The presentation of these two components of financial performance is additional to, and not a substitute for, the comparable total profit measures presented.

Management uses adjusted profit measures as the basis for monitoring financial performance and in communicating financial performance to investors in external presentations and announcements of financial results. Internal financial reports, budgets and forecasts are primarily prepared on the basis of adjusted profit measures, although planned exceptional items, such as significant restructurings, are also reflected in budgets and forecasts. Management compensates for the limitations inherent in the use of adjusted profit measures through the separate monitoring and disclosure of exceptional items and remeasurements as a component of our overall financial performance.

Operating financial performance

	Years ended 31 March	
	2007	2006
Continuing operations	**£m**	£m
Revenue	**2,199**	2,244
Operating costs excluding exceptional items and remeasurements	**(1,407)**	(1,382)
Adjusted operating profit	**792**	862
Exceptional items	**(14)**	(27)
Total operating profit	**778**	835

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

Revenue by business segment

	Years ended 31 March	
	2007	2006
Continuing operations	**£m**	£m
UK Gas Transmission	**736**	751
UK Gas Distribution	**1,189**	1,222
UK Gas Metering	**346**	342
Total segment revenues	**2,271**	2,315
Less: sales between business segments	**(72)**	(71)
Revenue	**2,199**	2,244

Segmental operating profit before exceptional items and remeasurements

	Years ended 31 March	
	2007	2006
Continuing operations	**£m**	£m
UK Gas Transmission	**312**	287
UK Gas Distribution	**409**	483
UK Gas Metering	**107**	107
Other activities	**(36)**	(15)
Adjusted operating profit	**792**	862

Segmental operating profit after exceptional items and remeasurements

	Years ended 31 March	
	2007	2006
Continuing operations	**£m**	£m
UK Gas Transmission	**307**	287
UK Gas Distribution	**400**	456
UK Gas Metering	**107**	107
Other activities	**(36)**	(15)
Operating profit	**778**	835

Details of the financial performance of business segments, including information on exceptional items and remeasurements, are included in the business segment reviews on pages 21 to 27.

Revenue, operating costs and operating profit

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

	Revenue	Operating costs	Operating profit
Continuing operations	£m	£m	£m
2005/06 results	2,244	(1,409)	835
Add back 2005/06 exceptional items and remeasurements	-	27	27
2005/06 adjusted results	2,244	(1,382)	862
UK Gas Transmission	(15)	40	25
UK Gas Distribution	(33)	(41)	(74)
UK Gas Metering	4	(4)	-
Other activities	-	(21)	(21)
Sales between businesses	(1)	1	-
2006/07 adjusted results	2,199	(1,407)	792
2006/07 exceptional items and remeasurements	-	(14)	(14)
2006/07 results	2,199	(1,421)	778

Revenue was £45 million lower than in 2005/06, primarily as a result of lower UK Gas Distribution revenue. Operating costs excluding exceptional items and remeasurements increased by £25 million as a result of higher operating costs in the UK Gas Distribution business and a £21 million increase in the costs of other activities. As a consequence, adjusted operating profit was £70 million lower than 2005/06.

Net operating exceptional charges of £14 million in 2006/07 were £13 million lower than 2005/06. They relate to restructuring costs and in 2006/07 include the establishment of a UK shared services function and the business process review undertaken in Gas Transmission.

As a result of the £70 million decrease in adjusted operating profit, partly offset by the £13 million reduction in operating exceptional charges and remeasurements, total operating profit fell by £57 million from 2005/06 to 2006/07.

Earnings from continuing operations

Adjusted earnings

Continuing operations	Years ended 31 March 2007 £m	2006 £m
Adjusted operating profit	**792**	862
Net finance costs excluding exceptional items and remeasurements	**(243)**	(184)
Adjusted profit before taxation	**549**	678
Taxation excluding taxation on exceptional items and remeasurements	**(239)**	(152)
Adjusted profit from continuing operations	**310**	526

Earnings

Continuing operations	Years ended 31 March 2007 £m	2006 £m
Total operating profit	**778**	835
Net finance costs	**(271)**	(209)
Profit before taxation	**507**	626
Taxation	**(232)**	(136)
Profit from continuing operations	**275**	490

Net finance costs

Net interest excluding exceptional finance costs and remeasurements increased by £59 million from 2005/06 to 2006/07. This was primarily explained by an increase in average debt balances.

Exceptional finance costs and remeasurements

Exceptional finance costs of £32 million in 2006/07 and £11 million in 2005/06 relate to the early repayment of debt.

Financial remeasurements relate to net gains on derivative financial instruments of £4 million, compared with net losses of £14 million in 2005/06.

Taxation

A net charge of £232 million arose in 2006/07, compared with £136 million in 2005/06. This includes net tax credits in respect of exceptional items and remeasurements amounting to £7 million and £16 million in 2006/07 and 2005/06 respectively. The effective tax rate was 46% for 2006/07 and 22% for 2005/06.

Excluding the effect of net tax credits on exceptional items and remeasurements, the effective tax rate for 2006/07 and 2005/06 was 44% and 22% respectively, compared with a standard UK corporation tax rate of 30% for both years. These effective tax rates reflected a prior year tax charge in 2006/07 equivalent to an effective tax rate of 12% and a prior year tax credit in 2005/06 equivalent to 5%. These prior year items arose from the settlement of outstanding prior year tax issues.

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 9 to the accounts.

Profit for the year from continuing operations

Profit for the year from continuing operations fell from £490 million in 2005/06 to £275 million in 2006/07 as a consequence of the above changes.

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

Continuing operations	Years ended 31 March 2007 £m	2006 £m
Adjusted operating profit	**792**	862
Exceptional operating items	**(14)**	(27)
Total operating profit	**778**	835

Adjusted operating profit is presented on the face of the Consolidated 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 2007 £m	2006 £m
Adjusted profit before taxation	**549**	678
Exceptional operating items	**(14)**	(27)
Exceptional finance costs	**(32)**	(11)
Financial remeasurements	**4**	(14)
Total profit before taxation	**507**	626

Adjusted profit before taxation is presented on the face of the Consolidated 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 2007 £m	2006 £m
Adjusted earnings	**310**	526
Exceptional operating items	**(14)**	(27)
Exceptional finance costs	**(32)**	(11)
Financial remeasurements	**4**	(14)
Tax on exceptional items and remeasurements	**7**	16
Earnings	**275**	490

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

Discontinued operations

	Years ended 31 March	
	2007	2006
	£m	£m
Revenue	**-**	168
Operating costs before exceptional items	**-**	(107)
Adjusted operating profit	**-**	61
Exceptional items	**-**	(15)
Operating profit	**-**	46
Taxation	**-**	(18)
Profit from discontinued operations	**-**	28
Gain on disposal of discontinued operations	**13**	2,466
Profit for the year	**13**	2,494

Discontinued operations comprise the four regional gas distribution networks we sold on 1 June 2005.

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 gain on disposal of discontinued operations in 2005/06 and 2006/07 relates to the sales of the gas distribution networks.

Net profit for the year

Net profit from both continuing and discontinued operations was £288 million in 2006/07 compared with £2,984 million in 2005/06.

Cash flows

Cash flows from operating activities

Cash generated from continuing operations was £1,407 million in 2006/07 compared with £1,055 million in 2005/06. This included cash outflows relating to exceptional items of £27 million and £79 million respectively. After reflecting cash flows relating to discontinued operations and tax paid, net cash inflow from operating activities was £1,417 million, compared with £751 million in 2005/06.

In 2006/07, there was a net corporate tax repayment of £10 million compared with a payment of £282 million in 2005/06.

Cash inflows from investing activities

Cash outflows from continuing operations investing activities fell from £3,692 million in 2005/06 to £1,501 million in 2006/07. This was fall was primarily a result of an interest free loan in 2005/06 of £2,967 million to our immediate parent company, National Grid Gas Holdings plc, representing part of the £5,750 million cash received from the sales of four of our gas networks. Cash outflows to purchase property, plant and equipment and intangible fixed assets, net of disposal proceeds, increased to £1,163 million in 2006/07 from £695 million in 2005/06, as a result of the increase in capital investment. Cash outflows to acquire financial investments increased from £30 million in 2005/06 to £338 million in 2006/07.

Cash flows in 2005/06 relating to discontinued operations included £5,750 million of disposal proceeds and £115 million of cash outflows from investing activities.

Cash flows from financing activities

Net cash related to financing activities changed from an outflow of £2,475 million in 2005/06 to an inflow of £1 million in 2006/07. The position in 2006/07 reflects payments to providers of finance, in the form of net interest and dividends, of £2,177 million and inflows from additional net borrowings of £2,191 million. The cash outflow in 2005/06 arose from repayment of debt of £1,937 million using part of the £5,750 million cash proceeds from the sales of the four networks and payments to providers of finance of £538 million in 2005/06.

Net interest cash outflows, excluding exceptional debt redemption costs, increased from £217 million in 2005/06 to £295 million in 2006/07, due to higher average net debt. Exceptional debt redemption costs increased from £11 million in 2005/06 to £32 million in 2006/07 as a consequence of restructuring our debt portfolio.

Dividends

Dividends in respect of the financial year

	2007	2006
	£m	£m
Interim	**350**	310
Final	**-**	1,500
Total	**350**	1,810

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

In accordance with IFRS, dividends are reported in the financial statements for the year in which they are approved. As a consequence, the final dividend for 2005/06 of £1,500 million is reported in the current year.

Gas Transmission

About the business

The external and regulatory environments in which our Gas Transmission business operates are described on pages 1 and 2, our business drivers are described on pages 2 and 3 and our objectives and strategy are set out on pages 5 to 8. Further information relevant to an understanding of our Gas Transmission business is included below.

Our Gas Transmission business comprises the following principal activities:

Gas transmission owner	We own the gas national transmission system in Great Britain. This comprises approximately 4,326 miles of high pressure pipe and 26 compressor stations, connecting to 8 distribution networks and to third party independent systems for onward transportation of gas to end consumers.
Gas system operator	We operate the gas national transmission system. 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.

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, efficient delivery, in real-time, of secure and reliable energy. We ensure the system is balanced with supply and demand at the end of each day. We are also 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 Company holds a gas transporter licence in respect of the gas national transmission system. Detailed arrangements for the gas industry are provided through the Uniform Network Code, which is approved by Ofgem and defines the obligations, responsibilities and roles of the industry participants. 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 in our role as gas transmission owner through charges to shippers for entry and exit capacity and in our role as gas system operator through commodity charges.

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 last price controls for our gas transmission activities ended on 31 March 2007, having commenced as five year price controls on 1 April 2002. The new five-year price control periods for gas transmission activities commenced on 1 April 2007.

Our LNG storage business is managed as a separate business from the gas transmission business. However, it is regulated under our gas transporter licence. A portion of LNG storage capacity is set aside to support network operating requirements, with the remaining capacity sold to gas shippers.

Price controls

The charges that we can make for access to our gas transmission system are determined by a formula linked to the retail price index (RPI). Up until 31 March 2007, this was 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 rate of return up until 31 March 2007 was set at a real pre-tax rate of 6.25% on our regulatory asset value for our gas network.

Our regulatory asset value as of 31 March 2007 is estimated as approximately £3.3 billion (£2.8 billion at March 2006).

Where Ofgem determines that our capital investment is efficiently invested, we obtain a rate of return on that investment. The new price control allows a return of 4.4% post tax real rate of return on our regulatory asset value.

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 eight incentive schemes covering activities such as cost of investment for additional capacity, managing constraints, market information provision, 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

In addition to the current and future developments described on pages 3 and 4, the following developments are relevant to the Gas Transmission business.

Price controls

The previous price control arrangements for our gas transmission network in the UK ceased on 31 March 2007 and the next price control covers the period from 1 April 2007 to 31 March 2012.

We have accepted in principle Ofgem's final proposals in respect of our role as owner of gas transmission networks. The key elements of these proposals are a 4.4% post-tax real rate of return on our regulatory asset value, a £0.9 billion baseline five year capital expenditure allowance and a £0.3 billion five year controllable operating expenditure allowance. Following our acceptance in principle of the proposals we have worked closely with Ofgem to agree the necessary licence amendments to enact the final proposals. This process should complete during the first half of 2007. We have also accepted Ofgem's final proposals for the system operator scheme to apply for one year from 1 April 2007.

Other developments

A number of gas pipeline and compressor projects are being progressed to respond to new import pipelines and gas import facilities. Around 90 miles of gas pipeline has been constructed from Ganstead to Asselby in the region of Humberside and from

Pannal in North Yorkshire to Nether Kellet in Lancashire, to enable increased imports at Easington. Around 200 miles of new pipeline is being built in South Wales and Gloucestershire to cater for the Milford Haven importation facility. Following the decision of the High Court to set aside the planning consent granted by Neath Port Talbot Council for Cilfrew pressure reduction installation on the Milford Haven pipeline, work on the installation was suspended. On 10 April 2007, we issued a force majeure notice, under our contract with the shippers, as this event, which was outside of our control, may result in us not being able to provide, or be delayed in providing the full amount of capacity that has been allocated to gas shippers using the Milford Haven facility. On 15 May 2007, the Neath Port Talbot Council held a revote on our planning application which was then approved. We are now assessing the actual delay (if any) of providing the full amount of capacity that has been allocated to shippers. On 1 June 2007, we issued injunctive proceedings at Cardiff Crown Court and a possession order for land at Penpont on the pipeline route.

Emissions trading

The second year of Phase 1, from 1 January 2005 to 31 December 2007, of the European Union emissions trading scheme commenced on 1 January 2006. 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 total carbon dioxide emissions between 1 January and 31 December 2006, for installations captured by the scheme, were below our allocation and so the scheme did not have a material financial effect on our results in 2006/07. We similarly do not expect the scheme to have a significant impact on our results in 2007 or 2008. The national allocation plan detailing installation level allowances for Phase 2 of the European Union emissions trading scheme, covering the period from 1 January 2008 to 31 December 2012, has now been published by Department of the Environment and Rural Affairs. Our allocation of allowances for Phase 2 of the scheme is lower than for Phase 1 of the scheme, but in line with expectations.

Performance during the year

2006/07 saw a maximum demand for gas of 436 mcm on 8 February 2007. This increase on the previous year's peak of 411 mcm was partly due a particularly cold snap at the beginning of February.

Descriptions of our progress against our overall objectives in the areas of performance, investment, talent, relationships (including customer service) and responsibility are set out on pages 13 to 16. We include below further information specific to Gas Transmission with respect to our performance, investment and customer service objectives.

Performance

Our progress against our operating objectives during the year includes the following:

Objective	Performance
Safety	During 2006/07 there were 5 lost time injuries compared with 8 in 2005/06. The lost time injury frequency rate was 0.29 in 2006/07 compared to 0.57 in 2005/06.
Reliability	Gas compressor fleet performance during 2006/07 declined slightly, with the average time between compressor failures at 6% below our five-year average, compared with 10% above the five-year average time between failures in 2005/06.
Efficiency	We have been undertaking a number of internal business process reviews to seek out further savings without compromising our other objectives. Efficiency is reflected in our financial performance, which is discussed below.
Financial performance	Adjusted operating profit of £312 million is 9% higher than 2005/06.

Growth

Investment

Investment in gas transmission systems is, by its nature, variable and is largely driven by changing sources of supply and asset replacement requirements. Our gas transporter licence also 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 Gas Transmission business has embarked on a significant increase in investment and network renewal.

Capital investment in the replacement, reinforcement and extension of the UK gas transmission systems in 2006/07 was £628 million compared with £319 million in 2005/06.

2006/07 has seen a substantial increase in the level of capital investment in gas pipeline projects, some £244 million higher than 2005/06.

	2007 £m	2006 £m
Property, plant and equipment	**622**	311
Intangible assets	**6**	8
Capital investment	**628**	319

Financial results

The results for the UK gas transmission segment for the years ended 31 March 2007 and 2006 were as follows:

	Years ended 31 March	
	2007	2006
	£m	£m
Revenue	**736**	751
Operating costs excluding exceptional items and remeasurements	**(424)**	(464)
Adjusted operating profit	**312**	287
Exceptional items	**(5)**	-
Total operating profit	**307**	287

The principal movements between 2005/06 and 2006/07 can be summarised as follows:

	Revenue £m	Operating costs £m	Operating profit £m
2005/06 results	751	(464)	287
Add back 2005/06 exceptional items	-	-	-
2005/06 adjusted results	751	(464)	287
LNG storage revenue	13	-	13
Timing of recoveries	(28)	-	(28)
Gas purchases	-	26	26
Transmission owner depreciation	-	9	9
Other	-	5	5
2006/07 adjusted results	736	(424)	312
2006/07 exceptional items	-	(5)	(5)
2006/07 results	736	(429)	307

The £15 million decrease in UK Gas Transmission revenue comparing 2006/07 with 2005/06 was due to relative timing of recoveries of allowed revenues, with repayment in 2006/07 of amounts over-recovered in 2005/06, partly offset by an increase in revenues from LNG storage auctions.

Operating costs, excluding exceptional items, fell by £40 million in 2006/07 compared to 2005/06. This was primarily due to a £26 million fall in gas purchases, mainly due to the warmer weather resulting in lower volumes, and a £9 million reduction in transmission owner depreciation, as a result of accelerated asset write-downs in 2005/06.

The £25 million increase in adjusted operating profit comparing 2006/07 with 2005/06 reflects the movement in revenue and operating costs, excluding exceptional items, as described above.

The £5 million exceptional charge in 2006/07 arises from the establishment of a shared services function and the implementation of a review of our business processes.

Operating profit was £20 million higher than 2005/06, as a result of the increase in adjusted operating profit of £25 million and the £5 million increase in exceptional charges.

Gas Distribution

About the business

The external and regulatory environments in which our Gas Distribution business operates are described on pages 1 and 2, our business drivers are described on page 2 and 3, and our objectives and strategy are set out on pages 5 to 8. Further information relevant to an understanding of our Gas Distribution business is included below.

Our Gas Distribution business comprises almost half of Great Britain's gas distribution system, comprising four of the eight regional gas distribution networks in the UK. Our networks consist of approximately 82,000 miles of distribution pipelines and we transport gas on behalf of approximately 34 active gas shippers, from the gas national transmission system to around 11 million consumers.

We also manage the national emergency number (0800 111 999) for all of the gas distribution networks and for other gas transporters in the UK. During 2006/07 we handled approximately 2.3 million calls to the national emergency number.

Detailed arrangements for transporting gas are provided through the Uniform Network Code as approved by Ofgem, which defines the obligations, responsibilities and roles of the industry participants. We hold a single gas distribution transporter licence, which authorises us to operate our four gas distribution networks. However, each of our four networks has its own separate price control, which establishes the prices we can charge for the services provided by that network.

The price controls that applied to our gas distribution networks up until 31 March 2007, took 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).

Ofgem has extended 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. The next full price control period will now cover the period from 1 April 2008 to 31 March 2013, as described on page 4. As at 31 March 2007, our regulatory asset value is estimated at approximately £6.0 billion. Each network's separate regulatory asset value associated with its distribution assets was originally allocated to it using an estimate of the Gas Distribution business's regulatory asset value as at 1 April 2002. The allocation was aimed at minimising unnecessary regional differentials in transportation charges.

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 in future periods.

Replacement expenditure maintains the safety and the reliability of the network, by replacing 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.

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 attending 97% of reports of a gas escape or other gas emergency within the required timescale; connections standards of service that require us to provide connections to consumers to agreed timescales after an unplanned interruption; and guaranteed standards of service for our other transportation services. Compensation is paid to customers for any failure to meet guaranteed or connections standards of service.

Current and future developments

In addition to the current and future developments described on pages 3 and 4, the following developments are relevant to the Gas Distribution business.

Price controls

Ofgem has extended 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. The outcome of the formal review is an increase of 11% in allowed revenues for 2007/08. In addition, the balance between fixed and variable elements has changed, which will reduce the impact that volumes changes, including weather, have on our revenue in 2007/08.

The next full price control period will now cover the period from 1 April 2008 to 31 March 2013. Initial proposals will be published at the end of May 2007 and we will be working closely with Ofgem up to the final proposals in December 2007.

Performance during the year

Actual gas consumption fell to 303 TWh in 2006/07, compared with 347 TWh in 2005/06, mainly due to very mild weather in 2006/07. Underlying levels of gas demand, excluding the effects of weather, also fell from 347 TWh in 2005/06 to 331 TWh in 2006/07, thought to be mainly due to the high levels of gas supply prices during 2006/07 affecting usage. The reduction was particularly noticeable for larger users.

Descriptions of our progress against our overall objectives in the areas of performance, investment, talent, relationships (including customer service) and responsibility are set out on pages 13 to 16. We include below further information specific to Gas Distribution with respect to our performance, investment and customer service objectives.

Performance

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

Objective	Performance
safety	There were no employee related fatalities during 2006/07 compared with one in 2005/06. Lost time injuries for the retained networks fell 12% in 2006/07 to 21, compared with 24 in 2005/06. The lost time injury frequency rate fell from 0.17 to 0.16 over the same period.
	We again exceeded our targets on safety-related standards set by Ofgem with more than 98% of 'uncontrolled' gas escapes (where the gas leak cannot be controlled by turning the gas supply off at the meter) attended within one hour, and more than 99% of 'controlled' gas escapes (where the gas leak can be controlled at the meter) attended within two hours.
	We have decommissioned approximately 1,850 km of gas pipes in 2006/07, exceeding the HSE target this year, compared with 1,724 km in 2005/06.
Reliability	Over the year we have achieved all our standards of service set by Ofgem.
Efficiency	We have continued to drive operational efficiency through the streamlining of processes and best practice sharing with National Grid's US operations.
Financial performance	Our adjusted operating profit was £409 million in 2006/07 compared with £483 million in 2005/06 Further information on the financial results of UK Gas Distribution are provided below.

Our performance during 2006/07 under the current distribution network exit incentive scheme and the mains replacement incentive scheme was broadly neutral.

A series of strategic development initiatives have been delivered in support of our aim to be the most efficient gas distribution network in the UK. 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. Centralising our asset management, job scheduling and dispatch processes has exploited our economies of scale while also maintaining alignment of our operational workforce across the network to satisfy consumer requirements.

Having completed our Way Ahead transformation, we are now concentrating on driving further process alignment across our business. The use of new technology and materials is being evaluated to identify opportunities to increase worker productivity, such as keyhole excavation utilising core boring, already used by National Grid's US distribution operations.

Growth

Capital investment

Gross investment in the reinforcement, extension and replacement of the gas distribution network was £490 million in 2006/07 compared with £444 million in 2005/06. This excludes the investment in the four regional gas distribution networks that were sold on 1 June 2005.

Continuing operations	**2007 £m**	2006 £m
Reinforcement and extension	**157**	149
Replacement expenditure	**333**	295
Capital investment	**490**	444

Reinforcement and extension expenditure increased from £149 million in 2005/06 to £157 million in 2006/07 reflecting continued investment in the reinforcement of high pressure pipelines, together with higher information technology expenditure to replace obsolete equipment in system control, operational and support activities.

Replacement expenditure increased from £295 million in 2005/06 to £333 million in 2006/07 in line with the planned increase in the long-term iron mains replacement programme agreed with the HSE. During the second year of our alliance partnerships for Gas Distribution, we have laid approximately 1,850 km of gas mains, with an increasing proportion of our workload comprising complex replacement of large diameter mains.

Performance under the mains replacement incentive scheme has been held broadly neutral in 2006/07

Customer service

We have achieved all our connections standards of service over the year, along with all other standards of service set by Ofgem that relate to our gas transportation services. During the year ended 31 March 2007, we made around 40,000 new connections to our network (2005/06: 50,000). The proportion of service interruptions which were planned (as against unplanned) was 98.92% in 2006/07 compared with a target of 95%, while the proportion of customer complaints responded to within five working days was 94.71% in 2006/07 compared with a target of 90%.

Financial results

The results for the UK Gas Distribution segment for the years ended 31 March 2007 and 2006 were as follows:

	Years ended 31 March	
Continuing operations	**2007 £m**	2006 £m
Revenue	**1,189**	1,222
Operating costs excluding exceptional items and remeasurements	**(780)**	(739)
Adjusted operating profit	**409**	483
Exceptional items	**(9)**	(27)
Total operating profit	**400**	456

The principal movements between 2005/06 and 2006/07 can be summarised as follows:

Continuing operations	Revenue £m	Operating costs £m	Operating profit £m
2005/06 results	1,222	(766)	456
Add back 2005/06 exceptional items	-	27	27
2005/06 adjusted results	1,222	(739)	483
Price changes	73	-	73
Weather and volumes	(69)	-	(69)
Timing on recoveries	(32)	-	(32)
Depreciation and amortisation	-	(9)	(9)
Business rates	-	(23)	(23)
Other revenues and costs	(5)	(9)	(14)
2006/07 adjusted results	1,189	(780)	409
2006/07 exceptional items	-	(9)	(9)
2006/07 results	1,189	(789)	400

Revenue for UK Gas Distribution fell by £33 million in 2006/07 compared to 2005/06. Net formula income was up by £4 million, with the benefit of an average price increase of 8.8% implemented on 1 October 2006 giving rise to a £73 million increase in revenue This was largely offset by delivery volumes being significantly lower than the prior year, reducing revenue by £69 million.

The weather in 2006/07 was significantly warmer than 2005/06 lowering consumption by 28 TWh, which, combined with the impact of underlying volumes being lower by 16 TWh (caused principally by the continuing effect of high wholesale gas prices), led to an under-recovery of income of £42 million in 2006/07. Together with a £10 million under-recovery in 2005/06, this resulted in a net year-on-year timing impact on the recovery of income of £32 million.

Operating costs were £41 million higher in 2006/07 compared to 2005/06. Depreciation and amortisation costs were £9 million higher reflecting the increased capital investment in the distribution network. There was a £23 million increase in business rates following the changes in rateable values introduced from 1 April 2005. The remaining increase in operating costs of £9 million was mainly driven by workload, including significant investment in maintenance and other safety-related activities.

Adjusted operating profit was £74 million lower in 2006/07 than 2005/06, a reduction of 15%.

The exceptional charge of £9 million in 2006/07 related to the costs associated with the creation of the new shared services organisation. The exceptional charge in 2005/06 of £27 million related to restructuring costs under the Way Ahead programme.

Operating profit was £56 million lower in 2006/07 than 2005/06, a reduction of 12%. In summary, revenue was £33 million lower, operating costs were £41 million higher and exceptional charges were £18 million lower.

National Grid Metering

About the business

The external and regulatory environments in which the National Grid Metering business operates are described on pages 1 and 2, our business drivers are described on pages 2 and 3, and our objectives and strategy are set out on pages 5 to 8. Further information relevant to an understanding of the National Grid Metering business is included below.

The National Grid Metering business provides installation, maintenance and meter reading services to gas suppliers in the regulated gas market. It provides services to an asset base of around 19 million domestic, industrial and commercial gas meters, situated throughout Great Britain.

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

Although National Grid Metering operates within the parameters set out within our two gas transporter licences and hence is subject to price controls with respect to its meters, the pricing for the majority of meters are specified by long-term contracts.

The majority of National Grid Metering's domestic meters are covered by long-term contracts with gas suppliers. These contracts provide gas suppliers with the flexibility to replace our meters whilst reducing our risk of asset stranding.

Current and future developments

Metering competition investigation

As described on page 4, 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 and information requested as part of this investigation has been provided to Ofgem. No findings have been issued with respect to this investigation. However, a supplemental statement of objections was issued by Ofgem in April 2007 to which we will respond in due course.

Performance during the year

Descriptions of our progress against our overall objectives in the areas of performance, investment, talent, relationships (including customer service) and responsibility are set out on pages 13 to 16. We include below further information specific to the National Grid Metering business with respect to our performance, investment and customer service objectives.

Performance

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

Objective	Performance
Safety	There was an increase in the total number of employee lost time injuries from 1 in 2005/06 to 3 in 2006/07.
Financial performance	Our financial performance in the year was maintained at the same level as the previous year.

Growth

Capital investment

In addition to providing meters for new gas connections and replacing older meters, National Grid Metering is investing in technology such as smart metering and automated meter reading systems in response to customer requirements.

Capital expenditure in 2006/07 amounted to £82 million, an increase of £18 million compared with £64 million in 2005/06.

Financial results

The results for the UK Gas Metering segment for the years ended 31 March 2007 and 2006 were as follows:

	Years ended 31 March	
	2007	2006
	£m	£m
Revenue	**346**	342
Operating costs excluding exceptional items and remeasurements	**(239)**	(235)
Adjusted operating profit	**107**	107
Exceptional items	**-**	-
Total operating profit	**107**	107

The principal movements between 2005/06 and 2006/07 can be summarised as follows:

	Revenue	Operating costs	Operating profit
	£m	£m	£m
2005/06 results	342	(235)	107
Add back 2005/06 exceptional items	-	-	-
2005/06 adjusted results	342	(235)	107
Meter reading	4	(4)	-
2006/07 adjusted results	346	(239)	107
2006/07 exceptional items	-	-	-
2006/07 results	346	(239)	107

Revenue for UK Gas Metering has risen by £4 million from 2005/06 to 2006/07 as a result of increased provision of meter reading services.

Operating costs have increased by £4 million from 2005/06, also a result of the increased provision of meter reading services.

Operating profit was maintained at the same level as the previous year.

Other activities

About other activities

Other activities include corporate overheads that are not borne by individual businesses.

Performance during the year

Financial results

The principal movements between 2005/06 and 2006/07 can be summarised as follows:

	Revenue £m	Operating costs £m	Operating loss £m
2005/06 results	-	(15)	(15)
Add back 2005/06 exceptional items	-	-	-
2005/06 adjusted results	-	(15)	(15)
Transfer of employee liabilities	-	(17)	(17)
Other corporate overheads	-	(4)	(4)
2006/07 adjusted results	-	(36)	(36)
2006/07 exceptional items	-	-	-
2006/07 results	-	(36)	(36)

The operating cost of other activities increased by £21 million from £15 million in 2005/06 to £36 million in 2006/07. This was largely as a result of National Grid Gas accepting responsibility for £17 million of employee related liabilities, which were previously underwritten by another subsidiary of National Grid plc.

Discontinued operations

About discontinued operations

Discontinued operations comprise the results of the four regional gas distribution networks sold in the previous financial year, on 1 June 2005.

Performance during the year

Financial results

	Years ended 31 March	
	2007 £m	2006 £m
Revenue	**-**	168
Operating costs excluding exceptional items and remeasurements	**-**	(107)
Adjusted operating profit	**-**	61
Exceptional items	**-**	(15)
Total operating profit	**-**	46

Exceptional charges in 2005/06 of £15 million relate 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.

Financial position and financial management

Going concern

Having made enquiries, the Directors consider that the Company and its subsidiaries 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.

Financial position

Balance sheet

Our balance sheet at 31 March 2007 can be summarised as follows:

	Assets £m	Liabilities £m	Net assets £m
Property, plant and equipment and non-current intangible assets	8,861	-	8,861
Other non-current assets and liabilities	5,614	(1,087)	4,527
Current assets and liabilities	363	(974)	(611)
Deferred tax	-	(1,626)	(1,626)
Total before net debt	14,838	(3,687)	11,151
Net debt	640	(5,824)	(5,184)
Total as at 31 March 2007	15,478	(9,511)	5,967
Total as at 31 March 2006	14,814	(7,308)	7,506

The reduction in net assets from £7,506 million at 31 March 2006 to £5,967 million at 31 March 2007 resulted from dividends paid of £1,850 million partly offset by the profit for the year from continuing operations of £275 million and discontinued operations of £13 million, net income recognised directly in equity of £11 million and other changes in equity of £12 million.

Net debt and gearing

Net debt increased by £1.9 billion from £3.3 billion at 31 March 2006 to £5.2 billion at 31 March 2007, as a result of additional borrowings of £2.2 billion, partly offset by a £0.3 billion increase in financial investments.

The composition of net debt at 31 March 2007 is shown in note 28(c) to the accounts.

Gearing at 31 March 2007 and 31 March 2006, calculated as net debt at that date expressed as a percentage of net debt plus net assets shown in the balance sheet, amounted to 46% and 31% respectively. By comparison, the gearing ratio, adjusted for the inclusion of regulated gas transmission and distribution businesses at their estimated regulatory asset values (adjusted gearing ratio), amounted to 40% at 31 March 2007 compared with 27% 31 March 2006. The adjusted gearing ratio at 31 March 2006 has been restated to reflect the impact of the outcomes of the gas transmission and gas distribution price control reviews on estimates of regulatory asset values.

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

	2007 £m	2006* £m
Net assets per balance sheet	**5,967**	7,506
Adjustments for regulatory asset values	**2,380**	2,260
Deferred tax	**(714)**	(678)
Adjusted net assets	**7,633**	9,088

* The regulatory adjustments at 31 March 2006 have been restated as described above.

Equity shareholders' funds

Equity shareholders' funds fell from £7,506 million at 31 March 2006 to £5,967 million at 31 March 2007. The decrease was mainly explained by equity dividends paid of £1,850 million being greater than the profit for the year to 31 March 2007 of £288 million.

Liquidity and treasury management

Cash flow

Cash flows from our operations are largely stable over a period of years, but they do depend on the timing of customer payments. Our gas transmission and distribution operations are subject to multi-year price control agreements with the regulator, Ofgem. Significant changes in volumes, for example as a consequence of weather conditions, can affect cash flows in those businesses, with abnormally mild or cold weather driving volumes down or up respectively. Subject to, this we have essentially stable cash flows.

Cash flow forecasting

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

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

Credit facilities and unutilised Commercial Paper and Medium Term Note Programmes

We have both committed and uncommitted facilities that are available for general corporate purposes. At 31 March 2007, 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 (€5.9 billion unissued).

At 31 March 2007, the Company had £840 million of long term committed facilities (undrawn) and around £840 million of uncommitted borrowing facilities (undrawn).

In addition to the above facilities, National Grid Gas plc signed a loan agreement in 2006/07 for £370m with the European

Investment Bank. At 31 March 2007, £190m of this remained to be drawn and this remaining £190m was drawn in May 2007.

Regulatory restrictions
As part of our regulatory arrangements, our operations are subject to a number of restrictions on the way we can operate. These include a regulatory 'ring-fence' that require us to maintain adequate financial resources and restricts our ability to transfer funds or levy charges between the Company and other companies in the National Grid group of companies.

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

There is a separate financing programme for National Grid Gas. The Finance Committees of both National Grid plc 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 plc. 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.

We had borrowings outstanding at 31 March 2007 amounting to £5,717 million (31 March 2006: £3,712 million). The table in note 22 shows the expected maturity of these borrowings.

Appropriate committed facilities are in place, such that we believe that the maturing amounts in respect of our contractual obligations, as shown in 'Commitments and Contingencies', can be met from these facilities, operating cash flows and other refinancings that we reasonably expect to be able to secure in the future. Our financial position and expected future operating cash flows are such that we can borrow on the wholesale capital and money markets and most of our borrowings are through public bonds and commercial paper.

We place 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 cash, short-term investments and other financial assets at 31 March 2007 are shown in notes 16 and 21 to the accounts.

As of 31 March 2007, the long-term senior unsecured debt and short-term debt credit ratings respectively provided by Moody's, Standard & Poor's (S&P) and Fitch were as follows:

Moody's	A2/P1
Standard & Poor's (S&P)	A/A1
Fitch	A+/F1

In connection with the proposed acquisition of KeySpan Corporation by National Grid, our ratings have been moved to 'creditwatch with negative implications' by S&P. Moody's have placed our ratings on 'review for downgrade' and Fitch have placed our ratings on 'rating watch negative'.

It is a condition of the regulatory ring-fence around the Company that it uses reasonable endeavours to maintain an investment grade credit rating. At these ratings, we should have good access to the capital and money markets for future funding when necessary.

The main risks arising from our financial activities are set out below, as are the policies for managing these risks, which are agreed and reviewed by the Board of National Grid plc and the Finance Committee of that Board.

Refinancing risk management
The Board of National Grid plc controls refinancing risk mainly by limiting the amount of financing obligations (both principal and interest) arising on borrowings in any financial year. This policy is intended to prevent National Grid and its subsidiaries from having an excessively large amount of debt to refinance in a given time-frame.

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

The performance of the Treasury function in interest rate risk management is measured by comparing the actual total financing costs of our debt with those of a passively-managed benchmark portfolio. More information on the interest rate profile of our debt is included in note 18 to the accounts.

Foreign exchange risk management
We have a policy of hedging certain contractually committed foreign exchange transactions over a prescribed minimum size. This 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.

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 plc 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 our exposure to credit risk of that counterparty. At the present time, we use 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 our business operations, we are exposed to risks arising from fluctuations in interest rates and exchange rates. We use financial instruments, including derivatives, to manage exposures of this type and they are a useful tool in reducing risk. Our policy is not to use derivatives for trading purposes. Derivative transactions can, to varying degrees, carry both counterparty and market risk.

We enter 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, we enter into bought and written option contracts on interest rate swaps. These contracts are known as swaptions. We also enter 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.

We enter 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 17 to the accounts.

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

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

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

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

Details of the sensitivity of the income statement and equity to changes in the UK Retail Prices Index and UK interest rates are set out in note 18(d) to the accounts. Under the assumptions set out in note 18(d), a 0.50% change in the UK Retail Prices Index would affect the income statement by £8 million, but would have no effect on equity, while a 0.50% change in UK interest rates would affect the income statement by £11 million and equity by £15 million.

Commodity contracts

Commodity derivatives
In the normal course of business, we are party to commodity derivatives. These have included gas futures, gas options and gas forwards that are used to manage commodity prices associated with our gas delivery operations. This includes the buying back of capacity rights already sold in accordance with our gas transporter licences and Uniform Network Code obligations.

These financial exposures are monitored and managed as an integral part of our financial risk management policy. At the core of this policy is a condition that we will engage in activities at risk only to the extent that those activities fall within commodities and financial markets to which we have a physical market exposure, in terms and volumes consistent with our core business. We do not issue, or intend to hold, derivative instruments for trading purposes, and hold such instruments consistent with our various licence and regulatory obligations.

Commodity trading
In our 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 predefined 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 our Gas Transmission business 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

Commitments and contingencies outstanding at 31 March 2007 and 2006 are summarised in the table below:

	2007 £m	2006 £m
Future capital expenditure contracted but not provided for	**753**	767
Total operating lease commitments	**48**	95
Other commitments and contingencies	**213**	154

Information regarding obligations under pension and other post-retirement benefits is given below under the heading 'Retirement arrangements'.

We propose to meet all of our commitments from operating cash flows, existing credit facilities, future facilities and other financing that we reasonably expect to be able to secure in the future.

Details of material litigation as at 31 March 2007

Other than the environmental remediation case currently before the House of Lords as described on page 4, we were not party to litigation that we considered to be material as at 31 March 2007.

As described on page 4, we are subject to an investigation by Ofgem with respect to metering services in the UK.

Retirement arrangements

The substantial majority of our employees are members of the National Grid UK Pension Scheme, (the Scheme), which is operated by Lattice Group plc, an intermediate holding company of National Grid Gas.

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.

As there is no contractual arrangement or stated policy for charging the net defined benefit cost of the scheme to National Grid Gas, we account for the Scheme as if it were a defined contribution scheme and do not recognise any share of the assets and liabilities of the Scheme.

The last completed full actuarial valuation of the Scheme was as at 31 March 2006. This concluded that the pre-tax deficit was £371 million (£260 million net of tax) 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 March 2006 valuation will need to be provided to the Scheme until the outcome of the interim actuarial assessment 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. 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, including administrative expenses, are currently being made at a rate of 32.7% of pensionable payroll.

We do not provide post-retirement benefits other than pensions.

Related party transactions

We provide services to and receive services from related parties. In the year ended 31 March 2007, we charged £51 million and received charges of £201 million from related parties (other than Directors and key managers), compared with £19 million and £208 million respectively in 2005/06.

Further information relating to related party transactions is contained within note 29 to the accounts. Details of key management compensation and amounts paid to Directors are included within note 5(c) and note 6 to the accounts respectively.

Accounting policies

Basis of accounting

The consolidated financial statements present our results for the years ended 31 March 2007 and 2006 and our financial position as at 31 March 2007 and 2006. They have been prepared using the accounting policies shown, in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union.

Choices permitted under IFRS

Since 1 April 2005, we have presented our consolidated financial statements in accordance with IFRS. We were required to make a number of choices on the adoption of IFRS and in addition we continue to choose from certain options that are available within accounting standards.

The principal choices made on the adoption of IFRS, which cannot be changed, were as follows:

Option	Choice adopted
Transition date	Our opening IFRS balance sheet was established as at 1 April 2004. We used certain balances in our previous UK GAAP financial statements as the basis for our opening IFRS balance sheet.
Business combinations	Business combinations prior to 1 April 2004 were not changed retrospectively.
Financial instruments	We adopted IAS 39 on 1 April 2005. As a consequence the opening balances at 1 April 2005 are presented using different accounting policies for financial instruments from those used for 2005/06 and 2006/07.
Carrying value of assets at transition	In most cases we used brought forward depreciated cost, as adjusted for changes in accounting policies to conform to IFRS, to be the opening carrying value under IFRS.
Share-based payments	We recognised all active grants retrospectively.
Cumulative translation differences	We chose to present cumulative translation differences arising since 1 April 2004 only.

Significant choices that we continue to make on an ongoing basis include the following:

Option	Choice adopted
Presentation formats	We use the nature of expense method for our income statement and total our balance sheet to net assets and total equity. In the income statement, we present subtotals of total operating profit, profit before tax and profit from continuing operations, together with additional subtotals excluding exceptional items and remeasurements. Exceptional items and remeasurements are presented on the face of the income statement.
Pensions	We recognise transactions with the defined benefits section of the National Grid UK Pension Scheme as if it were a defined contribution scheme, and do not recognise any of the scheme assets and liabilities or actuarial gains and losses.
Capitalised interest	We capitalise interest into the cost of assets that we construct.
Capital contributions	Contributions received towards capital expenditure are recorded as deferred income and amortised in line with the depreciation on the associated asset.
Financial instruments	We normally opt to apply hedge accounting in most circumstances where this is permitted.
Use of UK GAAP or IFRS in individual accounts	We have not adopted IFRS and so continue to use UK GAAP, in the individual financial statements of National Grid Gas plc and of its UK subsidiary companies.

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 management responsibilities that existed at 31 March 2007. 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. Discontinued operations include the results of the four gas distribution networks sold on 1 June 2005.

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 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 our accounting policies set out in our consolidated 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 £10 million and £391 million respectively in 2006/07 and £19 million and £395 million respectively in 2005/06.

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 2007 were £15,478 million, including £8,817 million of property, plant and equipment, £46 million of intangible assets and £5,611 million owed by National Grid Gas'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 our reported results.

Our estimates of unbilled revenues amounted to £130 million at 31 March 2007 compared with £136 million at 31 March 2006.

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.

Pensions

Defined benefit pension obligations are accounted for as if the Scheme were a defined contribution scheme. This accounting treatment is based on there not being any contractual arrangements or a stated policy under which the Company is charged for the costs of providing pensions.

A change in these arrangements may lead to the Company recognising the cost of providing pensions on a different basis, together with a proportion of the actuarial gains and losses and of the assets and liabilities of the pension scheme.

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 2005.

The results of these operations are classified as discontinued operations.

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 and remeasure-ments

Exceptional items and remeasurements are items of income and expenditure that, in the judgment of management, should be disclosed separately on the basis that they are material, either by their nature or their size, to an understanding of our financial performance between periods.

Items of income or expense that are considered by management for designation as exceptional items include such items as significant restructurings, write-downs or impairments of non-current assets, material changes in environmental provisions, gains or losses on disposals of businesses or investments. Remeasurements comprise gains or losses recorded in the income statement arising from changes in the fair value of derivative financial instruments. These fair values increase or decrease as a consequence of changes in financial indices and prices over which we have no control.

Provisions

Provision is made for liabilities that are uncertain in estimates. These include provisions for the cost of environmental restoration and remediation, restructuring and employer and public liability claims.

Calculations of these provisions are based on estimated cash flows relating to these costs, discounted at an appropriate rate where the impact of discounting is material. The total costs and timing of cash flows relating to environmental liabilities are based on management estimates supported by the use of external consultants.

At 31 March 2007, we have recorded provisions totalling £106 million (2006: £128 million), including £44 million (2006: £44 million) in respect of environmental liabilities.

Tax estimates	Our 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 useful economic lives	An increase in the useful economic lives of assets of one year on average would reduce our annual depreciation charge on property, plant and equipment by £12 million and our annual amortisation charge on intangible assets by £1 million.
Revenue accruals	A 10% change in our estimate of unbilled revenues at 31 March 2007 would result in an increase or decrease in our recorded net assets and profit for the year by approximately £13 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 £2 million.
Hedge accounting	If the gains and losses arising on derivative financial instruments during the year ended 31 March 2007 had not achieved hedge accounting then the profit for the year would have been £40 million lower than that reported net of tax and net assets would have been £39 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

IFRS accounting standards and interpretations adopted in 2006/07

In preparing our consolidated financial statements for 2006/07, we have complied with International Financial Reporting Standards, International Accounting Standards and interpretations applicable for periods beginning on or after 1 April 2006. The following amendments to standards and interpretations were adopted during 2006/07, none of which resulted in a material change to our consolidated results, assets or liabilities in 2006/07 or in those of previous periods.

Leases	International Financial Reporting Interpretations Committee (IFRIC) 4 on leases provides guidance on determining when other forms of contractual arrangements should also be accounted for as leases.
Financial instruments	Amendments to IAS 39, IFRS 4, and IAS 21 allow for financial liabilities to be designated as fair value through profit and loss in certain circumstances, for certain financial guarantees to be recorded in the balance sheet at their fair value and permitted inter-company exchange gains and losses to be taken to equity reserves on consolidation in certain circumstances.
Other interpretations	IFRIC 5, IFRIC 6 and IFRIC 7 contain guidance on accounting for decommissioning, restoration and environmental funds, for waste electrical and electronic equipment and for subsidiaries in hyperinflationary economies.

Forthcoming changes in IFRS

The following accounting standards and interpretations have not yet been adopted, but are expected to be adopted in future periods.

Segment reporting	IFRS 8 on segment reporting changes the requirements for segmental reporting. Assuming that it is adopted by European Union, it will apply with effect from 1 April 2009. If IFRS 8 had been adopted in 2006/07, there would have been no change in business segments reported.
Service concessions	IFRIC 12 on service concessions, effective from 1 April 2008, requires assets operated on behalf of a public authority as a concession, where the asset reverts back to the public authority at the conclusion of the arrangement, to be recognised as a financial or intangible asset, depending on whether income is recovered from the public authority or from users. This is not expected to affect the majority of our assets and liabilities. However, we have not yet completed our assessment of this interpretation, so it is possible that there may be an impact on our assets and liabilities as a consequence of the adoption of this interpretation.
Borrowing costs	An amendment of IAS 23 on borrowing costs will require interest to be capitalised into the cost of assets we construct. We already adopt this policy and so this will have no impact.
Other interpretations	IFRIC 8, IFRIC 9, IFRIC 10 and IFRIC 11 contain guidance on accounting for share-based exchange transactions, embedded derivatives, impairments in half yearly reports and share-based payments. These interpretations are not expected to have a material impact on our results, assets or liabilities.

Directors' Report

Board of Directors

Steve Holliday (50)
Appointed to the Board of the Company in October 2002 and Chief Executive in April 2003. He is also the Chief Executive of National Grid plc. 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 has 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.

Mark Fairbairn (48)
Appointed to the Board of the Company in June 2003, he is also Executive Director of National Grid plc with responsibility for gas distribution. He joined National Grid in 1989 from BNFL. He was awarded an OBE in 2001 for his services to the electrical industry in respect of his leadership of the fundamental changes implemented for the introduction of the New Electricity Trading Arrangements. As Chief Operating Officer of the Company, he has played a key role in helping to restructure the UK gas distribution market through the gas networks sales and the creation of National Grid's new gas distribution business.

Steve Lucas (53)
Appointed to the Board of the Company in December 1999, he is also Finance Director of National Grid plc and is additionally responsible for National Grid's UK and US shared services. He had been Executive Director, Finance of Lattice Group plc since its demerger from BG Group plc in 2000. Previously, he was Treasurer of BG Group plc having joined British Gas plc in 1994. Prior to this, he was with Shell International Petroleum Company for 11 years, occupying a number of finance management positions and treasury roles, including seven years in Africa and the Far East. Steve is also a Non-executive Director of Compass Group plc. He is a Chartered Accountant.

Chris Murray (51)
Appointed to the Board of the Company in June 2005, he is also Director of Asset Management for National Grid UK Transmission. Prior to this, he held senior directorships in National Grid, Phoenix Natural Gas and Accord Energy. He is a Fellow of the Energy Institute, Companion of the Institution of Gas Engineers and Managers and is a Member of the Institute of Directors.

Adam Wiltshire (41)
Appointed to the Board of the Company in July 2006 as Finance Director, he is responsible for all financial aspects and corporate governance matters within the Company. A Chartered Accountant, he joined the Company in 1999 and has held a number of posts in finance.

Nick Winser (46)
Appointed to the Board of the Company in July 2003, he is also Executive Director of National Grid plc responsible for transmission. He was previously Chief Operating Officer of the US transmission business of 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 the following directors resigned: Colin Buck, Finance Director, resigned on 30 June 2006 and Roger Urwin, Chairman, on 31 December 2006.

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

Principal activities and business review

The principal activities of the Company and its subsidiaries during the year were the transmission and distribution of gas and the provision of gas metering services.

The Directors consider that the requirement to produce a business review is fulfilled by the inclusion in this Annual Report and Accounts of an Operating and Financial Review (on pages 01 to 34).

Substantial shareholders

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

Directors' interests

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 of the Company, including options over the Company's shares.

Steve Holliday, Mark Fairbairn, 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 below.

Directors' beneficial interests

All interests are in shares in National Grid plc, the Company's ultimate parent company. Interests include shares acquired pursuant to the National Grid Share Incentive Plan, the National Grid Share Matching Scheme and the Lattice Group All Employee Share Ownership Plan.

	At 1 April 2006 or appointment	At 31 March 2007
Chris Murray	9,182(i)	9,514
Adam Wiltshire	1,825(ii)	2,069

(i) Chris Murray's interests as at 1 April 2006 have been restated to include shares acquired pursuant to the National Grid Share Incentive Plan, the National Grid Share Matching Scheme and the Lattice Group All Employee Share Ownership Plan omitted in error in the prior year, increasing his reported holdings by 3,777 shares.
(ii) Interests held on appointment.
(iii) On 1 August 2005 National Grid ordinary shares were subject to a 43 for 49 capital consolidation in conjunction with alternative elections involving its 65p per share return of capital. Options to ordinary shareholders also included a 'B share election', the rights of which are set out in the Circular to shareholders dated 6 June 2005. Following this, Chris Murray held 2,053 "B" shares and Adam Wiltshire held 2,006 "B" shares at 31 March 2007.

Performance Share Plan (PSP) and Deferred Share Plan (DSP) interests

All interests are in shares in National Grid plc and are held in accordance with the National Grid Performance Share Plan or Deferred Share Plan details of which are given in the annual report and accounts of that company.

		Beneficial holding at 1 April 2006 or on appointment	Awards lapsed during year (ii)	Awarded in year	Beneficial holding at 31 March 2007	Release date
Chris Murray	PSP	40,964	(12,954)	13,946	41,956	June 2008 - June 2010
	DSP	-	-	4,623	4,623	June 2009
Adam Wiltshire	PSP	12,046(i)	-	-	12,046	June 2008 - June 2010

(i) Interests held on appointment.
(ii) For PSP awards granted in 2003, the performance condition was not satisfied at the end of the three year performance period. As a result, the award has lapsed in full.

Director's interests in share options

All interests are in shares in National Grid plc. Options were granted under the Executive Share Option Schemes and the Sharesave Schemes operated by National Grid plc, and details of these schemes are given in the annual report and accounts of that company.

	Beneficial holding at 1 April 2006 or on appointment	Granted	Exercised	Beneficial holding at 31 March 2007	Weighted average exercise price per share (pence)	Normal exercise period
Chris Murray	9,211	2,934	-	12,145	464.1	December 2005 – December 2012
Adam Wiltshire	2,910(i)	1,940	-	4,850	413.4	April 2007 – September 2012

(i) Interests held on appointment.

Directors' interests in Share Matching Awards

All interests are in shares in National Grid plc. Options were granted under the Share Matching Scheme operated by National Grid plc and details of the scheme are given in the annual report and accounts of that company.

	Awards held at 1 April 2006 and at 31 March 2007	Exercise price in total	Normal exercise date
Chris Murray	1,831	£1	May 2007 to May 2014
	1,665	£1	June 2008 to June 2015

Directors' remuneration

Details of Directors' remuneration are shown in note 6 to the accounts.

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 plc Remuneration Committee, details of which may be found in that company's annual report and accounts.

Dividends

During the year a final dividend of £1,500 million in respect of the year to 31 March 2006 and an interim dividend of £350 million were paid (2005: £310 million interim dividend). The Directors have not proposed a final dividend.

Donations

Charitable donations of £732,000 were made during the year in support of community initiatives and relationships in the UK (2006: £421,000).

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

Research and development

Expenditure on research and development was £1.5 million during the year (2006: £1.7 million).

Financial instruments

Details on the use of financial instruments and financial risk management are included on pages 29 and 30.

Disabled persons

National Grid Gas remains committed to fair treatment of people with disabilities in relation to job applications, training, promotion and career development. Every effort is made to find appropriate alternative jobs for those who are unable to continue in their existing job due to disability.

Employee involvement

National Grid Gas, as a part of National Grid, has well established and effective arrangements through electronic mail, intranet and in-house publications (including videos and briefing meetings), at each business location, for communication and consultation with both employees and trade union representatives and for communication of results and significant business issues.

National Grid Gas, as a part of National Grid, recognises the importance of aligning employee and shareholder interests. We are committed to employee share ownership through participation in the National Grid plc Share Incentive Plan and Sharesave scheme.

Policy and practice on payment of creditors

It is National Grid Gas's policy to include in contracts or other agreements, terms of payment with suppliers. Once agreed, we aim to abide by these terms of payment.

The average creditor payment period at 31 March 2007 was 23 days (27 days at 31 March 2006).

Auditors

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

Audit information

Having made the requisite enquiries, so far as the Directors in office at the date of the signing of this report are aware, taking into account their periods of office, there is no relevant audit information (as defined by Section 234ZA of the Companies Act 1985) of which the Company's auditors are unaware, and the Directors have taken all the steps they ought to have taken to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Annual General Meeting

Notice of the Company's Annual General Meeting for 2007 will be issued separately to shareholders.

On behalf of the Board

Alison Kay
Company Secretary
29 May 2007

National Grid Gas plc
Registered Office:
1-3 Strand London WC2N 5EH
Registered in England and Wales No. 2006000

Statement of Directors' Responsibilities

The Directors are responsible for preparing the Annual Report and Accounts, including the consolidated financial statements and the Company financial statements, in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union, and the Company financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice). The consolidated financial statements and Company financial statements are required by law to give a true and fair view of the state of affairs of the Company on a consolidated and individual basis and of the consolidated profit of the Company for that period.

In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state that the consolidated financial statements comply with IFRS as adopted by the European Union, and with regard to the Company financial statements that applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the consolidated financial statements and Company financial statements on a going concern basis unless it is inappropriate to presume that the Company will continue in business, in which case there should be supporting assumptions or qualifications as necessary.

The Directors confirm that they have complied with the above requirements in preparing both the consolidated financial statements and the Company financial statements.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company on a consolidated and individual basis and to enable them to ensure that the consolidated financial statements comply with the Companies Act 1985 and Article 4 of the IAS Regulation and the Company financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and its subsidiaries and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Directors are responsible for ensuring that publication of financial statements on the website of the Company or of a related company is in accordance with UK legislation and for maintenance and integrity of that website. Legislation in other jurisdictions governing the preparation and dissemination of financial statements may differ from UK legislation.

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

We have audited the consolidated and Company financial statements (the 'Financial Statements') of National Grid Gas plc for the year ended 31 March 2007, which comprise of the Consolidated Income Statement, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Recognised Income and Expense, the Accounting Policies 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 consolidated 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 consolidated 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-referred from the Business Review section of the Directors' Report.

In addition, we 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, 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 consolidated 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 2007 and of its profit and cash flows for the year then ended;
- the consolidated financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the 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 2007;
- the Company financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information in the Directors' Report is consistent with the financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Birmingham
4 June 2007

Accounting Policies

for the year ended 31 March 2007

(a) Basis of preparation of consolidated financial statements
These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) adopted by the European Union. They are prepared on the basis of all IFRSs and Interpretations that are mandatory for periods ending 31 March 2007 and in accordance with applicable United Kingdom law and Article 4 of the IAS regulation. The 2006 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.

The consolidated financial statements have been prepared on an historical cost basis, except for the revaluation of certain financial instruments from 1 April 2005 onwards, the date of adoption of IAS 32 ‘Financial Instruments: Presentation and Disclosure’ and IAS 39 ‘Financial Instruments: Recognition and Measurement’.

These consolidated 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.

(b) Basis of consolidation
The consolidated financial statements incorporate the financial statements of the Company and its subsidiaries.

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 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 Company in its consolidated financial statements under IFRS. Inter-company transactions are eliminated.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated 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 Company or subsidiary 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 Company adopted the prevailing UK GAAP for hedge accounting in its consolidated financial statements 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 overseas financing operations that have a functional currency different from the Company’s presentation currency 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 consolidated 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 and emission allowances, are amortised on a straight-line basis over their estimated useful economic lives. The principal amortisation periods for categories of intangible assets are:

Amortisation periods	Years
Software	3 to 5

(e) Property, plant and equipment
Property, plant and equipment is recorded at cost or deemed cost at the date of transition to IFRS, 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 National Grid Gas’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 payables 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.

Depreciation is not provided on freehold land or 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	Years
Freehold and leasehold buildings	up to 50
Plant and machinery	
– mains, services and regulating equipment	30 to 100
– meters and metering equipment	5 to 18
Motor vehicles and office equipment	3 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 recoverable amount of the cash-generating unit to which that asset belongs is estimated.

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 Company 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, when they relate to income taxes levied by the same taxation authority and it is intended to settle current tax asset and liabilities on a net basis.

(h) Discontinued operations, assets and businesses held for sale

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

Assets and businesses 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 businesses classified as held for sale.

Assets and businesses 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 assets or businesses are available for immediate sale in their 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.

Finance income and costs are included in discontinued operations only in respect of financial assets or liabilities classified as held for sale or derecognised on sale.

(i) Inventories
Inventories, which comprise raw materials and consumables, are stated at cost less provision for damage and obsolescence. Cost comprises acquisition cost and those costs 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) Revenue
Revenue represent the sales value derived from the transmission and distribution of gas, the provision of gas metering services, and the provision of other services to customers during the year, and excludes value added tax and intra-group sales.

Revenue includes an assessment of gas transportation services supplied to customers between the date of the last meter reading and the year end.

Where revenue received or receivable exceeds the maximum amount permitted by regulatory agreement and adjustments will be made to future prices to reflect this over-recovery, a liability for the over-recovery is not recognised. Similarly, an asset is not recognised where a regulatory agreement permits adjustments to be made to future prices in respect of an under-recovery.

(l) Pensions
The substantial majority of National Grid Gas'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 National Grid Gas. Accordingly, the Scheme is recognised in these consolidated financial statements as if it were a defined contribution scheme. The pension charge for the year represents the contributions payable to the Scheme for the period.

A share of the assets and liabilities or the actuarial gains and losses of the Scheme are not recognised in these consolidated financial statements.

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

(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 consolidated assets of the Company 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 amounts due under the original payment terms will not be collected. 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 this 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 their initial fair value which normally reflects the proceeds received, net of direct issue costs, and subsequently stated at amortised cost, inclusive of accrued interest. 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.

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.

With effect from 1 April 2005, 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 and which 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.

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) are added to their cost. Such additions cease when the assets are substantially ready for their intended use. All other borrowing costs are recognised in the income statement in the period in which they are incurred.

Purchases and sales of financial assets are usually recognised on the trade date, being the date of commitment to purchase or sell the assets.

(o) Hedge accounting and derivative financial instruments
Both derivative financial instruments ('derivatives') and non-derivative financial instruments are entered into in order to manage 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 managing the interest, currency or commodity price risks associated with underlying business activities and the financing of those activities.

From 1 April 2005, the accounting policy for hedge accounting is as described below.

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 a non-financial asset or a non-financial 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 offsetting amount is recorded as an adjustment to the carrying value of the hedged items, with a corresponding entry in the income statement, to the extent that the adjustment to the carrying value 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 income statement as they arise, within finance costs.

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 the carrying value of the hedged item at the date hedge accounting is discontinued, is amortised to the income statement using the effective interest method.

If a hedged forecast 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 their host contracts.

Prior to 1 April 2005 and the adoption of IAS 32 and IAS 39, 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.

(p) Share-based payments
National Grid issues equity-settled share-based payments to certain employees of the Company and its subsidiaries. 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, based on an estimate of shares that will eventually vest, is recognised on a straight-line basis over the vesting period, as an operating cost and an increase in equity. Payments made by the Company to National Grid in respect of share-based payments are recognised as a reduction in equity.

(q) Business performance, exceptional items and remeasurements
Our financial performance is analysed into two components: business performance, which excludes exceptional items and remeasurements; and exceptional items and remeasurements. Exceptional items and remeasurements are excluded from the measures of business performance used by management to monitor financial performance, as they are considered to distort the comparability of our reported financial performance from year to year. Business performance measures presented on the face of the income statement or in the notes to the accounts include operating profit before exceptional items and remeasurements, profit before tax before exceptional items and remeasurements and profit for the year before exceptional items and remeasurements.

Exceptional items and remeasurements are items of income and expenditure that, in the judgment of management, should be disclosed separately on the basis that they are material, either by their nature or their size, to an understanding of our financial performance between periods. Items of income or expense that are considered by management for designation as exceptional items include such items as significant restructurings, write-downs or impairments of non-current assets, material changes in environmental provisions and gains or losses on disposals of businesses or investments. Remeasurements comprise gains or losses recorded in the income statement arising from changes in the fair value of derivative financial instruments to the extent that hedge accounting is not achieved or is not effective.

(r) Restructuring costs

Costs arising from restructuring programmes primarily relate to redundancy costs. Redundancy costs are charged to the income statement in the year in which an irrevocable commitment is made to incur the costs and the main features of the restructuring plan have been announced to affected employees.

(s) Emission allowances

Emission allowances are recorded as an intangible asset within current assets. They are initially recorded at deemed cost and subsequently at the lower of deemed cost and net realisable value. For allocations of emission allowances granted by the UK Government, deemed 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 the obligation to deliver emission allowances and charges are recognised in the income statement in the period in which carbon dioxide emissions are made. Income from emission allowances which are sold is reported as part of other operating charges.

(t) Cash and cash equivalents

Cash and cash equivalents include cash held at bank and in hand, together with short-term highly liquid investments with an original maturity of less than three months that are readily convertible to known amounts of cash and subject to an insignificant change in value.

(u) Other reserves

Other reserves have arisen as a result of the refinancing and restructuring of the Lattice Group in 1999. They represent the excess of the equity of the Company over its carrying value as at the date of the refinancing and restructuring.

As the amounts included in other reserves are not attributable to any of the other classes of equity presented, they have been disclosed as a separate classification of equity.

(v) Dividends

Dividends are recognised in the financial year in which they are approved.

(w) 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 – note 4.
- The exemptions adopted under IFRS including, in particular, those relating to business combinations – Accounting policies (a) Basis of preparation of consolidated financial statements.
- Classification of business activities as held for sale and discontinued operations – Accounting Policies (h) Discontinued operations and non-current assets and liabilities held for sale.

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 – Accounting policies (d) intangible assets other than goodwill, (e) Property, plant and equipment and (f) Impairment of assets.
- Valuation of financial instruments and derivatives – notes 17 and 18.
- Revenue recognition and assessment of unbilled revenue – Accounting policies (k) Revenue.
- Recoverability of deferred tax assets – Accounting policies (g) Taxation and note 14.
- Environmental liabilities – note 25.
- Hedge accounting and derivative financial instruments – Accounting Polices (o) Hedge accounting and derivative financial instruments.

Consolidated income statement

for the years ended 31 March

	Notes	2007 £m	2006 £m
Revenue	2(a)	**2,199**	2,244
Operating costs	3	**(1,421)**	(1,409)
Operating profit			
Before exceptional items and remeasurements	2(b)	**792**	862
Exceptional items and remeasurements	4	**(14)**	(27)
Total operating profit	2(b)	**778**	835
Interest income and similar income	8	**10**	86
Interest expense and other finance costs			
Before exceptional items and remeasurements	8	**(253)**	(270)
Exceptional items and remeasurements	4, 8	**(28)**	(25)
	8	**(281)**	(295)
Profit before taxation			
Before exceptional items and remeasurements		**549**	678
Exceptional items and remeasurements		**(42)**	(52)
Total profit before taxation		**507**	626
Taxation			
Before exceptional items and remeasurements	9	**(239)**	(152)
Exceptional items and remeasurements	4, 9	**7**	16
Total taxation	9	**(232)**	(136)
Profit from continuing operations after taxation			
Before exceptional items and remeasurements		**310**	526
Exceptional items and remeasurements	4	**(35)**	(36)
Profit for the year from continuing operations		**275**	490
Profit for the year from discontinued operations			
Before exceptional items	10	**-**	43
Exceptional items	10	**13**	2,451
	10	**13**	2,494
Profit for the year		**288**	2,984
Attributable to:			
Equity shareholders of the parent		**287**	2,984
Minority interests		**1**	-
		288	2,984

The notes on pages 49 to 82 form part of the consolidated financial statements.

Consolidated balance sheet

at 31 March

	Notes	2007 £m	2006 £m
Non-current assets			
Intangible assets	12	**44**	34
Property, plant and equipment	13	**8,817**	8,029
Other receivables	15	**5,614**	5,614
Derivative financial assets	17	**76**	118
Total non-current assets		**14,551**	13,795
Current assets			
Other intangible assets	12	**2**	41
Inventories	19	**28**	22
Trade and other receivables	20	**333**	596
Financial investments	16	**380**	42
Derivative financial assets	17	**10**	95
Cash and cash equivalents	21	**174**	223
Total current assets		**927**	1,019
Total assets	2(c)	**15,478**	14,814
Current liabilities			
Bank overdrafts	21	**(6)**	-
Borrowings	22	**(1,885)**	(1,014)
Derivative financial liabilities	17	**(14)**	(47)
Trade and other payables	23	**(903)**	(799)
Current tax liabilities		**(40)**	(69)
Provisions	25	**(31)**	(66)
Total current liabilities		**(2,879)**	(1,995)
Non-current liabilities			
Borrowings	22	**(3,832)**	(2,698)
Derivative financial liabilities	17	**(87)**	(57)
Other non-current liabilities	24	**(1,012)**	(953)
Deferred tax liabilities	14	**(1,626)**	(1,543)
Provisions	25	**(75)**	(62)
Total non-current liabilities		**(6,632)**	(5,313)
Total liabilities	2(c)	**(9,511)**	(7,308)
Net assets		**5,967**	7,506
Equity			
Called up share capital	26	**45**	45
Share premium account	27	**204**	204
Retained earnings	27	**4,435**	5,985
Cash flow hedge reserve	27	**(49)**	(60)
Other reserves	27	**1,332**	1,332
Total parent company shareholders' equity and total equity		**5,967**	7,506

These financial statements, comprising the consolidated income statement, consolidated balance sheet, consolidated statement of recognised income and expense, consolidated cash flow statement and related notes 1 to 32 were approved by the Board of Directors on 29 May 2007 and were signed on its behalf by:

Nick Winser Director

Adam Wiltshire Finance Director

Consolidated statement of recognised income and expense

for the years ended 31 March

		2007 £m	2006 (i) £m
Net gains/(losses) taken to equity in respect of cash flow hedges		**5**	(14)
Transferred to profit or loss on cash flow hedges		**12**	(3)
Tax on items taken directly to or transferred from equity	9	**(6)**	1
Net income/(expense) recognised directly in equity		**11**	(16)
Profit for the year		**288**	2,984
Total recognised income and expense for the year		**299**	2,968
Attributable to :			
Equity shareholders of the parent		**298**	2,968
Minority interests		**1**	-
		299	2,968
Effect of changes in accounting policy - IAS 39 (ii)		**-**	(59)

(i) Comparatives have been restated to correct for an error in determining the amount of tax on items taken directly to or transferred from equity in the year to 31 March 2006.

(ii) IAS 32 'Financial instruments: disclosure and presentation' and IAS 39 'Financial instruments: recognition and measurement' were adopted prospectively with effect from 1 April 2005, in accordance with the transition provisions of IFRS 1.

Consolidated cash flow statement

for the years ended 31 March

	Notes	2007 £m	2006 £m
Cash flows from operating activities			
Total operating profit		**778**	835
Adjustments for:			
Exceptional items and remeasurements		**14**	27
Depreciation and amortisation		**401**	414
Profit on disposal of property plant and equipment		**(8)**	-
Share based payment charge		**10**	-
Changes in working capital		**244**	(160)
Changes in provisions		**(5)**	18
Cash flows relating to exceptional items		**(27)**	(79)
Cash flows generated from continuing operations		**1,407**	1,055
Cash flows relating to discontinued operations	28(a)	**-**	(22)
Cash generated from operations		**1,407**	1,033
Tax received/(paid) - continuing operations		**10**	(245)
Tax paid - discontinued operations		**-**	(37)
Net cash inflow from operating activities		**1,417**	751
Cash flows from investing activities			
Purchases of intangible assets		**(20)**	(11)
Purchases of property, plant and equipment		**(1,152)**	(686)
Disposals of property, plant and equipment		**9**	2
Purchases of financial investments		**(338)**	(30)
Loan to immediate parent undertaking		**-**	(2,967)
Cash flows used in continuing operations - investing activities		**(1,501)**	(3,692)
Cash flows relating to discontinued operations - disposal proceeds		**28**	5,750
Cash flows relating to discontinued operations - other investing activities		**-**	(115)
Net cash (used in)/from investing activities		**(1,473)**	1,943
Cash flows from financing activities			
Proceeds from loans received		**3,061**	-
Repayment of loans		**(870)**	(1,160)
Net movements in short-term borrowings and derivatives		**(13)**	(777)
Interest received		**10**	86
Interest paid		**(305)**	(303)
Exceptional finance costs on repayment of debt		**(32)**	(11)
Dividends paid to shareholders		**(1,850)**	(310)
Net cash from/(used in) financing activities		**1**	(2,475)
Net (decrease)/increase in cash and cash equivalents		**(55)**	219
Cash and cash equivalents at the start of the year		**223**	4
Net cash and cash equivalents at the end of the year	21	**168**	223

Notes to the accounts

1 Adoption of new accounting standards

New IFRS accounting standards and interpretations adopted in 2006/07

During the year ended 31 March 2007, the Company has adopted the following amendments to standards and interpretations. None of these had a material impact on consolidated results or assets and liabilities:

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 with IAS 17 'Leases'.

IFRIC 5 'Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds' addresses the issues of how a contributor to such a fund should account for its interest in the fund and how obligations to make additional contributions should be accounted for.

IFRIC 6 'Liabilities arising from participating in a specific market – waste electrical and electronic equipment' relates to the European Union's Directive on waste electrical and electronic equipment, which deals with the responsibility of producers for the backlog of waste for goods sold to private households.

IFRIC 7 'Applying the restatement approach under IAS 29, Financial reporting in hyperinflationary economies' deals with what is meant by the phrase 'measuring unit, current at the balance sheet date' and also with how an entity accounts for opening deferred tax items in its restated financial statements.

Amendment to IAS 39 'Financial instruments: recognition and measurement: the fair value option' restricts the ability of entities to designate financial assets and liabilities as at fair value through profit or loss to those financial instruments that meet certain specified

Amendments to IAS 39 'Financial instruments: recognition and measurement', and IFRS 4 'Insurance contracts: financial guarantee contracts' define a financial guarantee contract and specify which accounting standard will apply to such contracts. Generally, financial guarantee contracts are within the scope of IAS 39. However, where the issuer of a financial guarantee contract has previously asserted that it regards such contracts as insurance contracts, then they may elect to apply either IAS 39 or IFRS 4 to those contracts.

Amendment to IAS 21 'The effects of changes in foreign exchange rates' clarifies the requirements of IAS 21 regarding an entity's investment in foreign operations and, in particular, the treatment of monetary items entered into as net investment hedges.

New IFRS accounting standards and interpretations not yet adopted

The Company has yet to adopt the following standards and interpretations. These will be adopted on 1 April 2007, but are not expected to have a material impact on consolidated 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.

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.

IFRIC 10 'Interim financial reporting and impairment' states that any impairment losses on goodwill and certain financial assets recognised in an interim financial statement may not be reversed in subsequent interim or annual financial statements.

IFRIC 11, 'IFRS 2 – Group and treasury share transactions' provides guidance on whether share-based transactions involving treasury shares or involving subsidiary undertakings (for instance, options over a parent's shares) should be accounted for as equity-settled or cash-settled share-based payment transactions.

1 Adoption of new accounting standards (continued)

New IFRS accounting standards and interpretations not yet endorsed by the EU

IFRS 8 ‘Operating segments’ sets out the requirements for the disclosure of information about an entity’s operating segments and about the entity’s products and services, the geographical areas in which it operates and its major customers. IFRS 8 achieves convergence with the US accounting standard, FAS 131 ‘Disclosures about segments of an enterprise and related information’ with minor differences. If this standard had been adopted in the year ended 31 March 2007, it is not expected that it would have a material impact on consolidated results or the presentation of those results.

Amendment to IAS 23 ‘Borrowing costs’ removes the option of immediately recognising as an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale. Implementation of this amendment is not expected to have any impact on consolidated results or consolidated assets and liabilities, as the Company's accounting policy is to capitalise borrowing

IFRIC 12, ‘Service concession arrangements’ applies to contractual arrangements whereby a private sector operator participates in the development, financing, operation and maintenance of infrastructure for public sector services, for example, under private finance initiative contracts (PFI) contracts. The impact of this interpretation on consolidated results or consolidated assets and liabilities has not yet been assessed.

2 Segmental analysis

Segmental information is presented in accordance with the management responsibilities and economic characteristics, including consideration of risks and returns, of business activities. The Company assesses the performance of its businesses principally on the basis of operating profit before exceptional items and remeasurements. The primary reporting format is by business. All of the Company's sales and operations take place within the UK and therefore there is no secondary reporting format.

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 activities
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.

Discontinued operations comprise the operations of the four gas distribution networks which were sold on 1 June 2005.

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

a) Revenue

	Total sales 2007 £m	**Sales between businesses 2007 £m**	**Sales to third parties 2007 £m**	Total sales 2006 £m	Sales between businesses 2006 £m	Sales to third parties 2006 £m
Business segments - continuing operations						
UK Gas Transmission	**736**	**7**	**729**	751	5	746
UK Gas Distribution	**1,189**	**62**	**1,127**	1,222	63	1,159
UK Gas Metering	**346**	**3**	**343**	342	3	339
	2,271	**72**	**2,199**	2,315	71	2,244

The table above represents revenue from continuing operations only, as disclosed in the consolidated income statement. Revenue from discontinued operations for the year ended 31 March 2006 was £168m. See note 10 for additional disclosures on discontinued operations.

2 Segmental analysis (continued)

b) Operating profit

	Before exceptional items and remeasurements		After exceptional items and remeasurements	
	2007 **£m**	2006 £m	**2007** **£m**	2006 £m
Business segments - continuing operations				
UK Gas Transmission	**312**	287	**307**	287
UK Gas Distribution	**409**	483	**400**	456
UK Gas Metering	**107**	107	**107**	107
Other activities	**(36)**	(15)	**(36)**	(15)
	792	862	**778**	835

The table above represents operating profit from continuing operations only, as disclosed in the consolidated 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 2007 was £nil (2006: £61m). Operating profit after exceptional items and remeasurements for discontinued operations for the year ended 31 March 2007 was £nil (2006: £46m). See note 10 for additional disclosures on discontinued operations.

c) Total assets and liabilities

	Total assets		Total liabilities	
	2007 **£m**	2006 £m	**2007** **£m**	2006 £m
Business segments - continuing operations				
UK Gas Transmission	**2,893**	2,406	**(358)**	(391)
UK Gas Distribution	**5,404**	5,132	**(1,192)**	(1,166)
UK Gas Metering	**813**	869	**(139)**	(126)
	9,110	8,407	**(1,689)**	(1,683)
Unallocated	**6,368**	6,407	**(7,822)**	(5,625)
	15,478	14,814	**(9,511)**	(7,308)

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

2 Segmental analysis (continued)

d) Other segmental information

	Capital expenditure		Depreciation and amortisation	
	2007 £m	2006 £m	**2007 £m**	2006 £m
Business segments - continuing operations				
UK Gas Transmission	**628**	319	**(99)**	(114)
UK Gas Distribution	**490**	444	**(170)**	(161)
UK Gas Metering	**82**	64	**(132)**	(139)
	1,200	827	**(401)**	(414)
Discontinued operations	**-**	87	**-**	(13)
	1,200	914	**(401)**	(427)

Capital expenditure comprises additions to property, plant and equipment and intangible assets amounting to £1,180m (2006: £903m) and £20m (2006: £11m) respectively.

Depreciation and amortisation includes depreciation of property, plant and equipment and amortisation of intangible assets amounting to £391m (2006: £408m) and £10m (2006: £19m) respectively.

3 Operating costs

	Before exceptional items and remeasurements		Exceptional items and remeasurements		Total	
	2007 £m	2006 £m	**2007 £m**	2006 £m	**2007 £m**	2006 £m
Depreciation of property, plant and equipment	**391**	395	**-**	-	**391**	395
Amortisation of intangible assets	**10**	19	**-**	-	**10**	19
Payroll costs (note 5(a))	**257**	227	**10**	21	**267**	248
Other operating charges:						
Purchases of gas	**113**	148	**-**	-	**113**	148
Rates	**211**	180	**-**	-	**211**	180
Other operating charges	**425**	413	**4**	6	**429**	419
	1,407	1,382	**14**	27	**1,421**	1,409
Operating costs include:						
Consumption of inventories					**5**	8
Research expenditure					**1**	2
Operating lease rentals						
Plant and machinery					**6**	7
Other					**12**	13
Auditors' remuneration						
Audit services						
Audit fee of parent company and consolidated financial statements					**0.4**	0.5
Other services						
Other services supplied pursuant to legislation					**0.4**	0.2
Services relating to tax advisory					**-**	0.2

Other services supplied pursuant to legislation represents fees payable for services in relation to engagements which are required to be carried out by the auditor. In particular this includes fees for audit reports on regulatory returns and fees for reports under section 404 of the US Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley).

4 Exceptional items and remeasurements

Exceptional items and remeasurements are items of income and expenditure that, in the judgment of management, should be disclosed separately on the basis that they are material, either by their nature or their size, to an understanding of our financial performance and significantly distort the comparability of financial performance between periods. Items of income or expense that are considered by management for designation as exceptional items include such items as significant restructurings, write-downs or impairments of non-current assets, material changes in environmental provisions, and gains or losses on disposals of businesses or investments. Remeasurements comprise gains or losses recorded in the income statement arising from changes in the fair value of derivative financial instruments to the extent that hedge accounting is not achieved or is not effective.

	2007	2006
	£m	£m
Exceptional items - restructuring costs (i)	**14**	27
Total exceptional items and remeasurements included within operating profit	**14**	27
Exceptional finance costs (ii)	**32**	11
Remeasurements - net (gains)/losses on derivative financial instruments	**(4)**	14
Total exceptional items and remeasurements included within finance costs	**28**	25
Total exceptional items ands remeasurements before taxation	**42**	52
Tax on restructuring costs (i)	**(4)**	(8)
Tax on exceptional finance costs (ii)	**(10)**	(3)
Tax on derivative financial instrument remeasurements (iii)	**7**	(5)
Tax on exceptional items and remeasurements	**(7)**	(16)
Total exceptional items and remeasurements after taxation	**35**	36

(i) Restructuring costs relate to planned cost reduction programmes. For the year ended 31 March 2007, these included pension curtailment costs of £5m arising as a result of redundancies (2006: £nil).

(ii) Exceptional finance costs for the year ended 31 March 2007 represent debt redemption costs related to the restructuring of our debt portfolio. For the year ended 31 March 2006 these represent costs incurred on the early redemption of debt following the disposal of the four gas distribution networks.

(iii) Remeasurements - net (gains)/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. The tax charge (2006: tax credit) includes a £4m charge (2006: £nil) in respect of prior years.

5 Payroll costs and employees

a) Payroll costs

	2007 £m	2006 £m
Wages and salaries	**234**	216
Social security costs	**22**	20
Other pension costs	**64**	61
Share-based payments	**5**	5
Severance costs	**6**	4
	331	306
Less: payroll costs capitalised	**(64)**	(58)
	267	248

Payroll costs above represent continuing operations only. Payroll costs for discontinued operations for the year ended 31 March 2007 were £nil (2006: £29m).

b) Number of employees, including Directors

	31 March 2007 Number	Average 2007 Number	Average 2006 Number
UK			
Continuing operations	6,461	6,617	6,665
Discontinued operations	-	-	686
	6,461	6,617	7,351

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

c) Key management compensation

	2007 £m	2006 £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 of Directors of the Company together with those Executive Directors of National Grid plc who have managerial responsibility for any of the businesses of National Grid Gas and who are not also Directors of the Company.

d) Share option and award plans

National Grid operates three principal forms of share option and award plans in which the employees and Directors of National Grid Gas participate (some of whom are also Executive Directors of National Grid plc). These are an employee Sharesave scheme, a Performance Share Plan (PSP) and the Deferred Share Plan.

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 plc.

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.

Under the PSP, awards have been made to Directors and approximately 110 senior employees. Awards made in 2004 are subject to National Grid’s Total Shareholder Return (TSR) performance based on a comparator group of UK and international utilities over a three-year period. For awards made in 2005 and 2006, the criteria was amended so that 50% is based on National Grid's TSR performance when compared to the FTSE 100 and 50% is based on the annualised growth of National Grid's earnings per share. Awards are delivered in National Grid plc shares. At 31 March 2007 the number of conditional awards of ordinary share equivalents outstanding under the PSP was 1,134,000 (2006: 1,149,000) of which nil (2006: nil) were exercisable. The number of conditional awards during the year ended 31 March 2007 was 419,000 (2006: 400,000) with lapses/forfeits during the year of 422,000 (2006: 263,000) and exercises of 12,000 (2006: nil).

5 Payroll costs and employees (continued)

d) Share option and award plans continued

Under the Deferred Share Plan, one half of any bonus earned by Executive Directors of National Grid plc and a predetermined part of any bonus earned by other Directors and senior employees is automatically deferred into National Grid shares. The shares are held in trust for three years before release. At 31 March 2007 the number of conditional awards of ordinary share equivalents was 44,600 of which none were available for release. The number of conditional awards during the year ended 31 March 2007 was 44,600 with none vesting during the year.

In addition, there are a number of historical plans under which awards are outstanding, but no further awards are being granted. These include the Executive Plan and the Share Matching Plan.

The Executive Plan applied to senior executives, including Executive Directors of National Grid plc. Options granted for the 1999/2000 financial year were subject to the achievement of performance targets related to National Grid's 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 National Grid's TSR 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. The 2000 awards remain unvested.

The Share Matching Plan applied to Executive Directors of National Grid plc and other Directors and senior employees whereby a predetermined part of each participant's bonus entitlement is automatically deferred into National Grid plc shares (known as qualifying shares) and a matching award may be made under the Plan after a three-year period, provided the Director or senior employee is still employed by the National Grid group. At 31 March 2007 the number of options over ordinary shares outstanding under the Share Matching Plan was 26,000 (2006: 38,000) of which nil (2006: nil) were exercisable. No options were granted during the year ended 31 March 2007 (2006: 13,000), with lapses during the year of nil (2006: nil) and exercises during the year of 12,000 (2006: 8,000).

Movement in options to subscribe for ordinary shares under the various option schemes for the two years ended 31 March 2007 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 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
Granted	5.58	2.8	-	-	2.8
Lapsed - expired	3.91	(0.3)	-	-	(0.3)
Exercised	3.30	(1.2)	-	-	(1.2)
Transfers (i)	-	-	5.01	(0.1)	(0.1)
At 31 March 2007	**4.16**	**12.4**	**4.34**	**0.1**	**12.5**

Included within options outstanding at 31 March 2007 and 31 March 2006 were the following options which were exercisable:

At 31 March 2007	**3.17**	**2.9**	**4.34**	**0.1**	**3.0**
At 31 March 2006	3.15	0.5	4.84	0.2	0.6

(i) Transfers arise from employees moving between the National Grid Gas group and other companies in the National Grid group.

5 Payroll costs and employees (continued)

d) Share option and award schemes continued

The weighted average remaining contractual life of options in the employee Sharesave scheme at 31 March 2007 was 2 years and 1 month. These options have exercise prices between £3.17 and £5.58.

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

	2007	2006
	£	£
Sharesave scheme options	**6.50**	5.89
Executive Plan options	**6.68**	5.50

Options outstanding and exercisable and their weighted average exercise prices for the respective ranges of exercise prices and years at 31 March 2007 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	4.34	70,000	4.34	70,000	434.25	2006-2013

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 2007 was £5m (2006: £7m).

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:

	2007	2006
Where the exercise price is less than the market price at the date of grant	**746.0p**	569.0p

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

	2007	2006
Where the exercise price is less than the market price at the date of grant	**558.0p**	434.0p

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

	2007	2006
Where the exercise price is less than the market price at the date of grant	**166.5p**	128.2p

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

	2007	2006
Dividend yield (%)	**4.5**	4.5
Volatility (%)	**15.6-18.9**	15.6-18.9
Risk-free investment rate (%)	**4.2**	4.2
Average life (years)	**3.6**	4.3

The fair values of awards under the Sharesave scheme have been calculated using the Black-Scholes European model for awards made prior to 1 April 2006. This is considered appropriate given the short exercise window of sharesave options. The fair values of awards made in 2007 have been calculated by reference to the prior year's Black-Scholes European model calculation.

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.

5 Payroll costs and employees (continued)

d) Share option and award schemes continued

Awards under other share scheme plans

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

	2007	2006
Average share price	**594.0p**	535.6p
Average fair value	**403.1p**	358.0p

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

	2007	2006
Dividend yield (%)	**4.4**	4.4
Volatility (%)	**19.9**	19.9
Risk-free investment rate (%)	**4.1**	4.1

Fair values have been calculated using a Monte Carlo simulation model, for awards with total shareholder return performance conditions made prior to 1 April 2006. The fair value of awards made in 2007 has been calculated by reference to the prior year's Monte Carlo simulation model calculation. 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.

6 Directors' emoluments

The aggregate amount of emoluments paid to Directors in respect of qualifying services for 2007 was £1,638,436 (2006: £2,490,520). The amount paid in respect of compensation for loss of office in 2007 was £nil (2006 £284,510l). Directors’ emoluments include amounts in respect of accrued bonus which had not yet been approved at the date of these accounts.

Two Directors exercised share options during 2007 (2006: five 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 2007, retirement benefits were accruing to six Directors under a defined benefit scheme (2006: seven - defined benefit schemes).

The aggregate emoluments for the highest paid Director were £469,743 for 2007 (2006: £572,517); and total accrued annual pension at 31 March 2007 for the highest paid Director was £64,960 (2006: £195,000).

7 Pensions and other post-retirement benefits

Substantially all National Grid Gas'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 National Grid Gas. Accordingly, the Company accounts for the scheme as if it were a defined contribution 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 was carried out by Watson Wyatt LLP at 31 March 2006. The aggregate market value of the scheme's assets was £12,743m and the value of the assets represented 97% of the actuarial value of benefits due to members, calculated on the basis of pensionable earnings and service at 31 March 2006 on an ongoing basis and allowing for projected increases in pensionable earnings. There was a funding deficit of £371m on the valuation date.

The results of the actuarial valuation carried out at 31 March 2006 showed that, based on long-term financial assumptions, the contribution rate required to meet future benefit accrual was 32% of pensionable earnings (29% employers and 3% employees). The ongoing contribution rate does not include an allowance for administration expenses. These contributions are reviewed annually. From 1 April 2007 the rate used for the recovery of administration costs was 3.7% of salary. Employers are currently, therefore, paying a total contribution rate of 32.7%.

In line with the agreement made after the 2003 valuation, no funding of the deficit identified in the 2006 actuarial valuation will need to be provided to the scheme until the outcome of the interim actuarial valuation at 31 March 2007 is known. At this point, National Grid plc will pay the gross amount of any deficit up to a maximum amount of £520m (£364m net of tax) into the scheme. Until the 31 March 2007 actuarial valuation has been completed, National Grid plc 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 plc failing to make agreed payments into the scheme.

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 consolidated financial statements of National Grid plc.

	2007 **£m**	2006 £m
Amounts recognised in the consolidated balance sheet of National Grid plc		
Present value of fund obligations	**12,814**	13,246
Fair value of plan assets	**12,865**	12,739
	51	(507)
Present value of unfunded obligations	**(14)**	(21)
Asset/(liability) in the balance sheet	**37**	(528)

	2007 **£m**	2006 £m
Changes in the present value of the defined benefit obligation		
Opening defined benefit obligation	**13,267**	12,662
Current service cost	**64**	69
Interest cost	**636**	655
Actuarial (gains)/losses	**(564)**	1,207
Curtailment gains on redundancies	**(9)**	(23)
Curtailment gain on sale of gas distribution networks	**-**	(168)
Settlement on sale of gas distribution networks	**-**	(589)
Gains on settlement	**-**	(20)
Special termination benefits	**19**	43
Curtailment cost - augmentations	**2**	5
Employee contributions	**7**	8
Benefits paid	**(594)**	(582)
Closing defined benefit obligation	**12,828**	13,267

7 Pensions and other post-retirement benefits (continued)

	2007 £m	2006 £m
Changes in the fair value of plan assets		
Opening fair value of plan assets	**12,739**	11,853
Expected return on plan assets	**643**	694
Actuarial gains/(losses)	**(9)**	1,274
Assets distributed on settlements and transfers	**-**	(609)
Employer contributions	**93**	100
Employee contributions	**7**	8
Benefits paid	**(593)**	(581)
Expenses paid	**(15)**	-
Closing fair value of plan assets	**12,865**	12,739
Expected contributions to defined benefit plans in the following year	**163**	45

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

	2007 %	2006 %
Equities	**33.2**	38.4
Corporate bonds	**19.8**	20.4
Gilts	**34.9**	31.0
Property	**8.7**	8.6
Other	**3.4**	1.6
Total	**100.0**	100.0

	2007 %	2006 %
The principal actuarial assumptions used were:		
Discount rate (i)	**5.4**	4.9
Expected return on plan assets	**5.8**	5.8
Rate of increase in salaries (ii)	**4.2**	3.9
Rate of increase in pensions in payment and deferred pensions	**3.3**	3.0
Rate of increase in Retail Prices Index	**3.2**	2.9

(i) The discount rate for pension liabilities has been determined by reference to appropriate yields prevailing in the UK and US debt markets at the balance sheet date.
(ii) A promotional age related scale has been used where appropriate.
(iii) The assumptions allow for future improvements in mortality.

The assumed life expectations for a retiree at age 65 are as follows:

	Years
Today:	
Males	20.0
Females	22.3
In 20 years:	
Males	21.2
Females	23.4

Sensitivities at 31 March 2007 - all other assumptions held constant:

- A 0.1% reduction in the discount rate would lead to an increase in the pension obligation of £200m and an increase in the annual pension cost of £2m.
- A 0.5% increase on the long-term rate of increase in salaries would lead to an increase in the pension obligation of £78m and an increase in the annual pension cost of £4m.
- An increase of one year to life expectations at age 60 would lead to an increase in the pension obligation of £403m and an increase in the annual pension cost of £2m.

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 assets 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 current target asset allocation for the scheme is 36% equities, 56% bonds and 8% property and other.

8 Finance income and costs

	2007 £m	2006 £m
Interest income on financial instruments	**10**	86
Interest income and similar income	**10**	86
Interest expense on financial liabilities held at amortised cost	**(264)**	(261)
Exceptional debt redemption costs	**(32)**	(11)
Interest on derivatives	**(3)**	(2)
Other interest	**(9)**	(13)
Unwinding of discount on provisions	**(1)**	(1)
Less: interest capitalised	**24**	7
Interest expense	**(285)**	(281)
Net gains/(losses) on derivative financial instruments:		
On derivatives designated as fair value hedges	**8**	(14)
On derivatives designated as cash flow hedges	**2**	3
On derivatives not designated as hedges or ineligible for hedge accounting	**(6)**	(3)
Net gains/(losses) on derivative financial instruments	**4**	(14)
Interest expense and other finance costs	**(281)**	(295)
Net finance costs	**(271)**	(209)
Comprising:		
Interest income and similar income	**10**	86
Interest expense and other finance costs		
Before exceptional items and remeasurements	**(253)**	(270)
Exceptional items and remeasurements	**(28)**	(25)
	(271)	(209)

Interest income on financial instruments 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 £11m (2006: £16m) and interest on other borrowings £253m (2006: £245m).

Interest on funding attributable to assets in the course of construction was capitalised during the year at a rate of 5.9% (2006: 6.0%).

Derivative net gains on fair value hedges comprise a net loss on the hedging instruments of £31m (2006: net loss of £13m) offset by a net gain of £39m from the fair value adjustments to the carrying value of debt (2006: net loss of £1m).

9 Taxation

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

	2007 £m	2006 £m
United Kingdom		
Corporation tax at 30% (i)	**62**	135
Adjustment in respect of prior years	**65**	(32)
Deferred tax (ii)	**98**	34
	225	137
Overseas		
Corporate tax (iii)	**6**	(1)
Adjustment in respect of prior years	**1**	-
	7	(1)
	232	136
Comprising:		
Taxation excluding exceptional items and remeasurements	**239**	152
Taxation exceptional items and remeasurements (note 4)	**(7)**	(16)
	232	136

(i) The UK corporation tax charge includes a tax credit of £18m (2006: credit of £11m) which relates to exceptional items and remeasurements.
(ii) The deferred tax charge includes a charge relating to prior years of £nil (2006: deferred tax credit of £9m) before exceptional items and remeasurements and £5m (2006: deferred tax credit of £9m) after exceptional items and remeasurements respectively. The 2006 amount includes a current year credit relating to exceptional items and remeasurements of £4m.
(iii) The overseas corporate tax charge of £6m relates to exceptional items and remeasurements (2006: credit of £1m relating to exceptional items and remeasurements).

Taxation on items charged/(credited) to equity

	2007 £m	2006 £m
Deferred tax charge/(credit) on revaluation of cash flow hedges	**6**	(1)
Tax charge/(credit) recognised in consolidated statement of recognised income and expense	**6**	(1)
Deferred tax credit on employee share schemes	**(2)**	(4)
Corporate tax credit on employee share schemes	**(1)**	-
	3	(5)

The tax charge for the period is higher (2006: lower) than the standard rate of corporation tax in the UK (30%). The differences are explained below:

	Before exceptionals and remeasure-ments 2007 £m	After exceptionals and remeasure-ments 2007 £m	Before exceptionals and remeasure-ments 2006 £m	After exceptionals and remeasure-ments 2006 £m
Profit before taxation				
Before exceptional items and remeasurements	**549**	**549**	678	678
Exceptional items and remeasurements	**-**	**(42)**	-	(52)
Profit before taxation from continuing operations	**549**	**507**	678	626
Profit on continuing operations multiplied by the rate of corporation tax in the UK of 30% (2006: 30%)	**165**	**152**	203	187
Effects of:				
Adjustments in respect of previous years	**66**	**72**	(32)	(32)
Expenses not deductible for tax purposes	**3**	**3**	6	6
Non-taxable income	**(3)**	**(4)**	(10)	(10)
Adjustment in respect of foreign tax rates	**-**	**1**	-	-
Impact of employee share schemes	**6**	**6**	(3)	(3)
Other	**2**	**2**	(12)	(12)
Total taxation (continuing operations)	**239**	**232**	152	136
	%	**%**	%	%
At the effective income tax rate	**43.5**	**45.8**	22.4	21.7

Factors that may affect future tax charges

The UK corporation tax rate is expected to decrease from the current rate of 30% to 28% in 2008/09. We are in the process of evaluating the impact this will have on our future tax charges.

10 Discontinued operations

During the year ended 31 March 2006, holdings in four of the eight UK regional gas distribution networks were disposed of.

Results of discontinued operations:

	2007 **£m**	2006 £m
Revenue	**-**	168
Operating costs	**-**	(122)
Operating profit		
Before exceptional items	**-**	61
Exceptional items (i)	**-**	(15)
Total operating profit from discontinued operations	**-**	46
Profit before tax from discontinued operations	**-**	46
Taxation	**-**	(18)
Profit after tax from discontinued operations	**-**	28
Gain on disposal of gas distribution networks	**10**	2,447
Gain on disposal of discontinued operations before tax	**10**	2,447
Taxation	**3**	19
Gain on disposal of discontinued operations	**13**	2,466
Total profit for the year from discontinued operations		
Before exceptional items	**-**	43
Exceptional items	**13**	2,451
	13	2,494

(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 in 1999.

11 Dividends

The following table shows the dividends payable to equity shareholders:

	2007 pence (per ordinary share)	**2007 £m**	2006 pence (per ordinary share)	2006 £m
Ordinary dividends				
Interim dividend for the year ended 31 March 2007	**5.78**	**350**	-	-
Final dividend for the year ended 31 March 2006	**24.79**	**1,500**	-	-
Interim dividend for the year ended 31 March 2006	**-**	**-**	7.86	310
	30.57	**1,850**	7.86	310

12 Intangible assets

	Software £m
Non-current	
Cost at 1 April 2005	69
Additions	11
Disposals	(4)
Cost at 31 March 2006	76
Additions	20
Cost at 31 March 2007	96
Amortisation at 1 April 2005	(27)
Amortisation charge for the year	(19)
Disposals	4
Amortisation at 31 March 2006	(42)
Amortisation charge for the year	(10)
Amortisation at 31 March 2007	(52)
Net book value at 31 March 2007	**44**
Net book value at 31 March 2006	34

Software comprises internally developed assets and related licences.

Current intangible assets consist of emission allowances of £2m (2006: £41m).

13 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 2005	85	17,899	155	655	18,794
Additions	11	610	254	28	903
Disposal of subsidiaries	(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
Additions	8	590	544	38	1,180
Other disposals	(1)	(11)	-	(15)	(27)
Reclassifications	3	36	(59)	20	-
Cost at 31 March 2007	79	12,066	768	590	13,503
Depreciation at 1 April 2005	(27)	(5,481)	-	(476)	(5,984)
Depreciation charge for the year	(4)	(358)	-	(46)	(408)
Disposal of subsidiaries	11	1,873	-	117	2,001
Other disposals	1	67	-	2	70
Depreciation at 31 March 2006	(19)	(3,899)	-	(403)	(4,321)
Depreciation charge for the year	(5)	(337)	-	(49)	(391)
Disposals	-	11	-	15	26
Depreciation at 31 March 2007	(24)	(4,225)	-	(437)	(4,686)
Net book value at 31 March 2007	**55**	**7,841**	**768**	**153**	**8,817**
Net book value at 31 March 2006	50	7,552	283	144	8,029

The net book value of land and buildings comprised:

	2007 £m	2006 £m
Freehold	**44**	46
Long leasehold (over 50 years)	**-**	1
Short leasehold (under 50 years)	**11**	3
	55	50

The cost of property, plant and equipment at 31 March 2007 included £51m (2006: £27m) relating to interest capitalised.

Included within trade and other payables and other non-current liabilities at 31 March 2007 are contributions to the cost of property, plant and equipment amounting to £26m (2006: £27m) and £955m (2006: £907m) respectively.

During the year, the useful lives of certain plant and machinery assets have been reviewed resulting in a £12m increase in the depreciation charge for the year.

14 Deferred tax assets and liabilities

	Accelerated tax depreciation £m	Employee share options £m	Financial instruments £m	Other net temporary differences £m	Total £m
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 to income statement	55	(1)	(3)	(17)	34
Credited to equity	-	(4)	(1)	-	(5)
Disposal of subsidiaries	(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
At 31 March 2006	1,516	(15)	11	31	1,543
Charged/(credited) to income statement	83	7	-	8	98
Charged/(credited) to equity	-	(2)	6	-	4
Disposal of subsidiaries	-	-	-	(19)	(19)
At 31 March 2007	**1,599**	**(10)**	**17**	**20**	**1,626**
Deferred tax assets at 31 March 2007	-	(10)	-	(14)	(24)
Deferred tax liabilities at 31 March 2007	1,599	-	17	34	1,650
At 31 March 2007	1,599	(10)	17	20	1,626

Deferred tax assets are all offset against deferred tax liabilities.

At the balance sheet date there were no material current deferred tax assets or liabilities (2006: £nil).

15 Other non-current receivables

	2007 £m	2006 £m
Loans and receivables		
Amounts owed by parent	**5,611**	5,611
Other receivables	**3**	3
	5,614	5,614

The amount owed by the parent is non-contractual and accordingly its fair value equals its book value. The fair value of other non-current receivables approximates to their book value.

16 Financial investments

	2007 £m	2006 £m
Current		
Available-for-sale investments	**300**	42
Amounts due from fellow subsidiaries	**75**	-
Loans and receivables	**5**	-
	380	42

Financial investments include the following:

	2007 £m	2006 £m
Investments in short term UK money funds	**300**	42
Loans due from fellow subsidiaries	**75**	-
Restricted cash balances	**5**	-
	380	42

Available-for-sale investments are recorded at their fair value. The fair value of loans and receivables approximates to their book value.

The maximum exposure to credit risk at the reporting date is the fair value of the financial instruments - refer to note 18 for further information on our treasury related credit risk. None of the financial instruments are past due or impaired.

Investments in short term UK money funds and restricted cash balances comprise floating rate interest bearing investments. Loans due from fellow subsidiaries are non-interest bearing.

Restricted cash balances represent cash posted by the Company and its subsidiaries under collateral agreements.

The carrying amounts of financial investments and restricted cash balances are denominated in sterling.

17 Derivative financial instruments

Derivatives are financial instruments that derive their value from the price of an underlying item such as interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable their users to alter exposure to market or credit risks. We use derivatives to manage both our treasury and operational market risks.

Derivatives are carried at fair value and are shown in the balance sheet as separate totals of assets and liabilities. Asset values represent the cost of replacing all transactions with a fair value in our favour assuming that all relevant counterparties default at the same time, and that the transactions can be replaced immediately in the market. Liability values represent the cost to counterparties of replacing all their transactions with a fair value in their favour in the case of default. Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis.

Treasury financial instruments

Derivatives are used for hedging purposes in the management of exposure to market risks. This enables the optimisation of the overall cost of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from the maturity and other profiles of its assets and liabilities.

Hedging policies using derivative financial instruments are further explained in note 18. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges or cash flow hedges. These are described as follows:

Fair value hedges

Fair value hedges principally consist of interest rate and cross-currency swaps that are used to protect against changes in the fair value of fixed-rate, long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and changes in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

17 Derivative financial instruments (continued)

Cash flow hedges

Exposure arises from the variability in future interest and currency cash flows on assets and liabilities which bear interest at variable rates. Interest rate and cross-currency swaps are maintained to manage this exposure, and designated as cash flow hedges, where they qualify. Fair value changes on designated cash flow hedges are initially recognised directly in the cash flow hedge reserve, as gains or losses recognised in equity. Amounts are transferred from equity and recognised in the income statement as the income or expense is recognised on the hedged asset or liability.

Forward foreign currency contracts are used to hedge anticipated and committed future currency cash flows. Where these contracts qualify for hedge accounting they are designated as cash flow hedges. On recognition of the underlying transaction in the financial statements, the associated hedge gains and losses deferred in equity are transferred and included with the recognition of the underlying transaction.

The gains and losses on ineffective portions of such derivatives are recognised immediately in the income statement.

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 or on the balance sheet. 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

Our 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 more appropriate.

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement within interest expense and other finance costs.

Operational financial instruments

Commodity derivatives are used to manage commodity prices associated with our gas transmission and distribution operations. As these contracts are for normal usage in our operations and are not settled net, they are carried at cost and are recognised within trade receivables or payables as appropriate.

17 Derivative financial instruments (continued)

Our use of derivatives may entail a derivative transaction qualifying for one or more hedge type designations under IAS 39. The fair value and their notional amounts by designated hedge type can be analysed as follows:

	2007				2006			
	Asset		Liability		Asset		Liability	
	Fair value £m	Notional amount £m	Fair value £m	Notional amount £m	Fair value £m	Notional amount £m	Fair value £m	Notional amount £m
Fair value hedges								
Interest rate swaps	**2**	**(116)**	**(12)**	**(550)**	24	(237)	(7)	(817)
Cross-currency interest rate swaps	**46**	**(782)**	**(65)**	**(345)**	84	(763)	(58)	(444)
	48	**(898)**	**(77)**	**(895)**	108	(1,000)	(65)	(1,261)
Cash flow hedges								
Interest rate swaps	**3**	**(281)**	**(3)**	**(192)**	39	(155)	(12)	(343)
Cross-currency interest rate swaps	**26**	**(481)**	**(7)**	**(22)**	55	(411)	(5)	(22)
Foreign exchange forward contracts	**-**	**(3)**	**-**	**(27)**	1	(38)	(3)	(41)
	29	**(765)**	**(10)**	**(241)**	95	(604)	(20)	(406)
Derivatives not in a formal hedge relationship								
Interest rate swaps	**9**	**(856)**	**(11)**	**(468)**	10	(171)	(16)	(360)
Cross-currency interest rate swaps	**-**	**-**	**(3)**	**(7)**	-	(5)	(3)	(7)
Foreign exchange forward contracts	**-**	**-**	**-**	**-**	-	-	-	28
	9	**(856)**	**(14)**	**(475)**	10	(176)	(19)	(339)
Total	**86**	**(2,519)**	**(101)**	**(1,611)**	213	(1,780)	(104)	(2,006)

The maturity of derivative financial instruments is as follows:

	2007		2006	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
In one year or less	**10**	**(14)**	95	(47)
Current	**10**	**(14)**	95	(47)
In more than one year but not more than two years	**23**	**(4)**	3	(1)
In more than two years but not more than three years	**12**	**(7)**	25	(5)
In more than three years but not more than four years	**-**	**-**	17	(4)
In more the four years but not more than five years	**-**	**-**	-	-
In more than five years	**41**	**(76)**	73	(47)
Non-current	**76**	**(87)**	118	(57)
	86	**(101)**	213	(104)

18 Financial risk factors

Our activities expose us to a variety of financial risks: market risk (including currency risk; fair value interest rate risk; cash flow interest rate risk), credit risk and liquidity risk. The overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on financial performance. Derivative financial instruments are used to hedge certain risk exposures.

Risk management is carried out by a central treasury department under policies approved by the Board of Directors of National Grid plc. This department identifies, evaluates and hedges financial risks in close co-operation with the operating units. The National Grid plc Board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments, and investment of excess liquidity as discussed further in our treasury policy, described on pages 29 and 30.

(a) Market risk

Foreign exchange risk

National Grid Gas raises finance in various currencies and is exposed to foreign exchange risk arising from related currency exposures. Foreign exchange risk arises from future commercial transactions and recognised assets and liabilities.

With respect to near term foreign exchange risk, we use foreign exchange forwards to manage foreign exchange transaction exposure. Our policy is to hedge a minimum percentage of known contracted foreign currency flows in the period out to six months and also in the period six to twelve months in order to mitigate foreign currency movements in the intervening period. Where cash forecasts are uncertain, we generally cover a percentage of the foreign currency flows depending on the certainty of the cash flows.

During 2007 and 2006, derivative financial instruments were used to manage foreign currency risk as follows:

	2007				
	Sterling £m	**Euro £m**	**US dollar £m**	**Other £m**	**Total £m**
Cash and cash equivalents	**174**	**-**	**-**	**-**	**174**
Financial investments	**380**	**-**	**-**	**-**	**380**
Bank overdrafts	**(6)**	**-**	**-**	**-**	**(6)**
Borrowings	**(4,647)**	**(249)**	**(486)**	**(335)**	**(5,717)**
Pre-derivative position	**(4,099)**	**(249)**	**(486)**	**(335)**	**(5,169)**
Derivative effect	**(1,090)**	**280**	**460**	**335**	**(15)**
Net debt position	**(5,189)**	**31**	**(26)**	**-**	**(5,184)**

	2006				
	Sterling £m	Euro £m	US dollar £m	Other £m	Total £m
Cash and cash equivalents	223	-	-	-	223
Financial investments	42	-	-	-	42
Bank overdrafts	-	-	-	-	-
Borrowings	(1,966)	(650)	(695)	(401)	(3,712)
Pre-derivative position	(1,701)	(650)	(695)	(401)	(3,447)
Derivative effect	(1,796)	798	706	401	109
Net debt position	(3,497)	148	11	-	(3,338)

Cash flow and fair value interest rate risk

There are no significant interest-bearing assets maintained on an ongoing basis. The income and operating cash flows are substantially independent of changes in market interest rates.

Interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose National Grid to cash flow interest rate risk. Borrowings issued at fixed rates expose National Grid Gas to fair value interest rate risk. Our interest rate risk management policy as further explained on page 29 is to minimise the finance costs (being interest costs and changes in the market value of debt). Some of our borrowings issued are index-linked, that is their cost is linked to changes in the UK retail prices index (RPI). We believe that these borrowings provide a good hedge for revenues and our regulatory asset values that are also RPI-linked.

18 Financial risk factors (continued)

(a) Market risk (continued)

Cash flow and fair value interest rate risk (continued)

The following table sets out the carrying amount, by contractual maturity, of borrowings that are exposed to interest rate risk before taking into account interest rate swaps:

	2007 £m	2006 £m
Fixed interest rate borrowings		
In one year or less	**(304)**	(916)
In more than one year but not more than two years	**(420)**	(243)
In more than two years but not more than three years	**(494)**	(426)
In more than three years but not more than four years	**-**	(507)
In more the four years but not more than five years	**-**	-
In more than five years	**(1,109)**	(1,248)
	(2,327)	(3,340)
Floating interest rate borrowings (including RPI)	**(3,390)**	(372)
Total borrowings	**(5,717)**	(3,712)

During 2007 and 2006, net debt was managed using derivative instruments to hedge interest rate risk as follows:

	2007				
	Fixed rate £m	**Floating rate £m**	**RPI (i) £m**	**Other (ii) £m**	**Total £m**
Cash and cash equivalents	**-**	**174**	**-**	**-**	**174**
Financial investments	**-**	**305**	**-**	**75**	**380**
Bank overdrafts	**-**	**(6)**	**-**	**-**	**(6)**
Borrowings	**(2,327)**	**(1,814)**	**(1,576)**	**-**	**(5,717)**
Pre-derivative position	**(2,327)**	**(1,341)**	**(1,576)**	**75**	**(5,169)**
Derivative effect	**979**	**(994)**	**-**	**-**	**(15)**
Net debt position	**(1,348)**	**(2,335)**	**(1,576)**	**75**	**(5,184)**

	2006				
	Fixed rate £m	Floating rate £m	RPI(i) £m	Other (ii) £m	Total £m
Cash and cash equivalents	-	223	-	-	223
Financial investments	-	42	-	-	42
Bank overdrafts	-	-	-	-	-
Borrowings	(3,340)	(372)	-	-	(3,712)
Pre-derivative position	(3,340)	(107)	-	-	(3,447)
Derivative effect	2,209	(2,100)	-	-	109
Net debt position	(1,131)	(2,207)	-	-	(3,338)

(i) Represents financial instruments which are linked to the UK retail prices index.

(ii) Represents financial instruments which are not directly affected by interest rate risk, including investments in equity or other non-interest bearing instruments.

18 Financial risk factors (continued)

(b) Credit risk

Credit risk is managed on a portfolio basis for the National Grid group as a whole. Credit risk arises from cash and cash equivalents, derivative financial instruments and deposits with banks and financial institutions, as well as credit exposures to wholesale and retail customers, including outstanding receivables and committed transactions.

Treasury related credit risk

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. Our limits are managed by National Grid plc, as explained in our treasury policies on page 29.

As at 31 March 2007 and 2006, we had a number of exposures to individual counterparties. In accordance with our treasury policies and exposure management practices, counterparty credit exposure limits are continually monitored and no individual exposure is considered significant in the ordinary course of treasury management activity. We do not expect any significant losses from non-performance by these counterparties.

The counterparty exposure under derivative financial contracts as shown in note 17 was £86m (2006: £213m); after netting agreements it was £63m (2006: £145m). This exposure is further reduced by collateral received as shown in note 22.

Wholesale and retail credit risk

Our principal commercial exposure in the UK is governed by the credit rules within the Uniform Network Code. These lay down the level of credit relative to the regulatory asset value for each credit rating. Sales to retail customers, such as those requiring connections, are usually settled in cash or using major credit cards. Management does not expect any significant losses of receivables that have not been provided for as shown in note 20.

18 Financial risk factors (continued)

(c) Liquidity analysis

We manage our liquidity requirements by the use of both short- and long-term cash flow forecasts. These forecasts are supplemented by a financial headroom position which is used to demonstrate funding adequacy for at least a 12-month period.

The following is an analysis of the contractual undiscounted cash flows payable under financial liabilities and derivative assets and liabilities as at the balance sheet date:

At 31 March 2007	**Due within 1 year**	**Due between 1 and 2 years**	**Due between 2 and 3 years**	**Due 3 years and beyond**	**Total**
Non-derivative financial liabilities					
Borrowings	**(1,809)**	**(466)**	**(500)**	**(3,321)**	**(6,096)**
Interest payments on borrowings (i)	**(165)**	**(136)**	**(110)**	**(2,119)**	**(2,530)**
Other non interest bearing liabilities	**(736)**	**(8)**	**-**	**-**	**(744)**
Derivative financial liabilities					
Derivatives contracts - receipts	**50**	**34**	**10**	**112**	**206**
Derivatives contracts - payments	**(52)**	**(27)**	**(12)**	**(158)**	**(249)**
Total at 31 March 2007	**(2,712)**	**(603)**	**(612)**	**(5,486)**	**(9,413)**

At 31 March 2006	Due within 1 year	Due between 1 and 2 years	Due between 2 and 3 years	Due 3 years and beyond	Total
Non-derivative financial liabilities					
Borrowings	(917)	(285)	(485)	(2,460)	(4,147)
Interest payments on borrowings (i)	(163)	(140)	(112)	(898)	(1,313)
Other non interest bearing liabilities	(607)	(46)	-	-	(653)
Derivative financial liabilities					
Derivatives contracts - receipts	78	44	37	261	420
Derivatives contracts - payments	(49)	(43)	(10)	(64)	(166)
Total at 31 March 2006	(1,658)	(470)	(570)	(3,161)	(5,859)

(i) The interest on borrowings is calculated based on borrowings held at 31 March without taking into account future issues. Floating rate interest is estimated using a future interest rate curve as at 31 March.

18 Financial risk factors (continued)

(d) Sensitivity analysis at 31 March 2007

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

The analysis 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 2007 and 31 March 2006, respectively. As a consequence, this sensitivity analysis relates to the position at these dates and is not representative of the year then ended, as all of these varied.

The following assumptions were made in calculating the sensitivity analysis:

- the balance sheet sensitivity to interest rates relates only to derivative financial instruments and available-for-sale investments, 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;
- 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 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;
- 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 twelve-month period for the accrued interest portion of the sensitivity calculations; and
- sensitivity to the Retail Prices Index does not take into account any changes to revenue or operating costs that are affected by the Retail Prices Index or inflation generally.

Using the above assumptions, the following table shows the illustrative effect on the income statement and items that are recognised directly in equity that would result from reasonably possible movements in changes in the UK Retail Prices Index and UK interest rates, before the effects of tax.

	2007		2006 (i)	
	Income statement -/+ £m	**Equity -/+ £m**	Income statement -/+ £m	Equity -/+ £m
UK Retail Prices Index +/- 0.50%	**8**	**-**	-	-
UK interest rates +/- 0.50%	**11**	**15**	10	20

(i) Comparatives have been restated in respect of a calculation error made when preparing the 2005/06 annual report and accounts.

19 Inventories

	2007 £m	2006 £m
Raw materials and consumables	**28**	22

20 Trade and other receivables

	2007 £m	2006 £m
Trade receivables	**47**	61
Amounts owed by fellow subsidiaries	**91**	286
Other receivables	**33**	78
Prepayments and accrued income	**162**	171
	333	596

Trade receivables are non-interest bearing and generally have a 30 - 90 day term. Due to their short maturities, the fair value of trade and other receivables approximates to their book value.

The carrying amounts of trade and other receivables are denominated in sterling.

Provision for impairment of receivables

	£m
At 1 April 2005	6
Release of provision	(5)
Uncollectable amounts written off net of recoveries	2
At 31 March 2006	3
Release of provision	(1)
Uncollectable amounts written off net of recoveries	1
At 31 March 2007	**3**

As at 31 March 2007, trade receivables of £5m (2006: £3m) were past due but not impaired. The ageing analysis of these trade receivables is as follows:

	2007 £m	2006 £m
Up to 3 months past due	**2**	1
3 to 6 months past due	**2**	1
Over 6 months past due	**1**	1
	5	3

Refer to note 18 for further information about our wholesale and retail credit risk.

21 Cash and cash equivalents

	2007 £m	2006 £m
Cash at bank	**1**	-
Short-term deposits	**173**	223
Cash and cash equivalents	**174**	223
Bank overdrafts	**(6)**	-
Net cash and cash equivalents	**168**	223

The fair values of cash and cash equivalents and bank overdrafts approximate to their book amounts.

Cash at bank earns interest at floating rates based on daily bank deposit rates. Short-term deposits are made for various periods of between one day and three months, depending on immediate cash requirements, and earn interest at the respective short-term deposit rates.

Net cash and cash equivalents are held in sterling.

22 Borrowings

The following table analyses total borrowings excluding bank overdrafts:

	2007 £m	2006 £m
Current		
Bank loans	**25**	81
Other bonds	**342**	916
Other loans	**1**	4
Borrowings from fellow subsidiaries	**1,517**	13
	1,885	1,014
Non-current		
Bank loans	**380**	200
Other bonds	**3,351**	2,495
Other loans	**101**	3
	3,832	2,698
Total borrowings	**5,717**	3,712

Total borrowings are repayable as follows:	**2007 £m**	2006 £m
In one year or less	**1,885**	1,014
In more than one year, but not more than two years	**459**	278
In more than two years, but not more than three years	**494**	464
In more than three years, but not more than four years	**-**	507
In more than four years, but not more than five years	**-**	-
In more than five years other than by instalments	**2,879**	1,449
	5,717	3,712

The carrying amounts of borrowings are denominated in the following currencies

	2007 £m	2006 £m
Sterling	**4,647**	1,966
Euro	**249**	650
Dollar	**486**	695
Other currencies	**335**	401
	5,717	3,712

The fair value of borrowings at 31 March 2007 was £5,674m (2006: £3,716m). 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.

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

The notional amount of outstanding of the debt portfolio as at 31 March 2007 was £6,091m (2006: £4,097m).

Collateral is placed with or received from any counterparty where we have entered into a credit support annex to the ISDA Master Agreement once the current mark-to-market valuation of the trades between the parties exceeds an agreed threshold. Included in current bank loans is £25m (2006: £nil) in respect of cash received under collateral agreements. Cash placed under collateral agreements is shown in note 16: Financial investments.

22 Borrowings (continued)

As at 31 March 2007, the Company had committed credit facilities of £840m (2006: £865m) of which £840m was undrawn (2006: £865m undrawn).

Undrawn committed borrowing facilities

	2007 **£m**	2006 £m
Expiring:		
In one year or less	**-**	25
In more than two years	**840**	840
	840	865

All of the unused facilities at 31 March 2007 and at 31 March 2006 were held as back-up to commercial paper and similar borrowings.

23 Trade and other payables

	2007 **£m**	2006 £m
Trade payables	**425**	408
Amounts owed to fellow subsidiaries	**287**	188
Social security and other taxes	**96**	93
Other payables	**24**	11
Deferred income	**71**	99
	903	799

Due to their short maturities, the fair value of trade and other payables approximates to their book value.

The carrying amounts of trade and other payables are denominated in sterling.

24 Other non-current liabilities

	2007 **£m**	2006 £m
Trade payables	**5**	-
Other payables	**3**	3
Deferred income	**1,004**	950
	1,012	953

The fair value of trade and other payables approximates to their book value.

The carrying amounts of trade and other payables are denominated in sterling.

25 Provisions

	Environmental £m	Emissions £m	Restructuring £m	Other £m	Total provisions £m
At 1 April 2005	89	5	91	-	185
Additions	-	18	60	30	108
Unwinding of discount	1	-	-	-	1
Utilised	(2)	-	(118)	(2)	(122)
Disposal of subsidiaries	(44)	-	-		(44)
At 31 March 2006	44	23	33	28	128
Additions	-	13	14	17	44
Released to income statement	-	(23)	(2)	-	(25)
Unwinding of discount	1	-	-	-	1
Utilised	(1)	(12)	(25)	(4)	(42)
	44	**1**	**20**	**41**	**106**

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

	2007 £m	2006 £m
Current	**31**	66
Non-current	**75**	62
	106	128

Environmental provision

The environmental provision represents the net present value of the estimated statutory decontamination costs of old gas manufacturing sites owned by National Grid Gas (discounted using a nominal rate of 5.55%). The anticipated timing of the cash flows for statutory decontamination cannot be predicted with certainty, but they are expected to be incurred over the financial years 2008 to 2058 with some 33% of the spend projected to be incurred 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. We have made our 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 2007 relating to gas site decontamination was £70m (2005: £72m), being the undiscounted best estimate of the liability having regard to the uncertainties referred to above.

Emissions provision

The provision for emission costs is expected to be settled using emission allowances granted which are reported as an intangible asset.

Restructuring provision

At 31 March 2007, £7m of the total restructuring provision (2006: £10m) 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 2007 include £24m (2006: £28m) in respect property transfer costs related to the sales of four UK gas distribution networks and £17m (2006: £nil) in respect of employer liability claims. The payment dates for the property transfer costs are uncertain but should largely be over the next four years. The employer liability claims are based on prior claims experience and, therefore, there is no identifiable payment date associated with these items.

26 Share capital

	Allotted, called up and fully paid	
	millions	£m
At 31 March 2006 and 2007	3,944	45

At 31 March 2006 and 31 March 2007 the authorised share capital of the Company was £69m (6,052m ordinary shares of $1^{2}/_{15}$ pence each).

27 Reconciliation 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 shareholders' equity £m	Minority interest £m	Total equity £m
At 31 March 2005	45	204	-	1,332	3,323	4,904	-	4,904
First time adoption of IAS 39	-	-	(44)	-	(15)	(59)	-	(59)
At 1 April 2005	45	204	(44)	1,332	3,308	4,845	-	4,845
Net expense recognised directly in equity	-	-	(16)	-	-	(16)	-	(16)
Profit for the year	-	-	-	-	2,984	2,984	-	2,984
Equity dividends	-	-	-	-	(310)	(310)	-	(310)
Share-based payments	-	-	-	-	(1)	(1)	-	(1)
Tax on share-based payments	-	-	-	-	4	4	-	4
At 31 March 2006	45	204	(60)	1,332	5,985	7,506	-	7,506
Net income recognised directly in equity	-	-	11	-		11	-	11
Profit for the year	-	-	-	-	287	287	1	288
Equity dividends	-	-	-	-	(1,850)	(1,850)	-	(1,850)
Other movements in minority interests	-	-	-	-	-	-	(1)	(1)
Share-based payments	-	-	-	-	10	10	-	10
Tax on share-based payments	-	-	-	-	3	3	-	3
At 31 March 2007	**45**	**204**	**(49)**	**1,332**	**4,435**	**5,967**	**-**	**5,967**

Other reserves represent the difference between the carrying value of the company and of its equity 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.

Gains and losses recognised in the cash flow hedge reserve on interest rate swap contracts as of 31 March 2007 will be continuously transferred to the income statement until the borrowings are repaid (note 22).

The amount of the cash flow hedge reserve due to be released from reserves to the income statement within the next year is £5m, with the remaining amount due to be released with the same maturity profile as borrowings in note 22.

28 Consolidated cash flow statement

a) Cash flow from operating activities – discontinued operations

	2007	2006
	£m	£m
Operating profit	**-**	46
Adjustments for:		
Exceptional items	**-**	15
Depreciation and amortisation	**-**	13
Changes in working capital and provisions	**-**	(73)
Cash flow relating to exceptional items	**-**	(23)
Cash flow relating to discontinued operations	**-**	(22)

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

	2007	2006
	£m	£m
Movement in cash and cash equivalents	**(55)**	219
Increase in financial investments	**328**	30
(Increase)/decrease in borrowings and derivatives	**(2,188)**	1,937
Net interest paid	**337**	204
Change in net debt resulting from cash flows	**(1,578)**	2,390
Changes in fair value of financial assets and liabilities	**21**	(31)
Net interest charge	**(289)**	(177)
Other non-cash movements	**-**	9
Movement in net debt (net of related derivative financial instruments) in the year	**(1,846)**	2,191
Net debt at start of year	**(3,338)**	(5,260)
Impact of adoption of IAS 32 and IAS 39	**-**	(269)
Net debt (net of related derivative financial instruments) at end of year	**(5,184)**	(3,338)

c) Analysis of changes in net debt

	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)

	At 1 April 2006 £m	Cash flow £m	Fair value gains and losses £m	Interest charges £m	Other non-cash movements £m	**At 31 March 2007 £m**
Cash and cash equivalents	223	(49)	-	-	-	**174**
Bank overdrafts	-	(6)	-	-	-	**(6)**
	223	(55)	-	-	-	**168**
Financial investments (ii)	42	328	-	10	-	**380**
Borrowings (ii)	(3,712)	(1,710)	4	(299)	-	**(5,717)**
Derivatives (ii)	109	(141)	17	-	-	**(15)**
	(3,338)	(1,578)	21	(289)	-	**(5,184)**

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

(ii) Includes interest.

29 Related party transactions

The following information is provided in accordance with IAS 24, Related party disclosures, as being material transactions with related parties during the year. Transactions with related parties were in the normal course of business and are summarised below.

	Parent		Other related parties		Total	
	2007	2006	**2007**	2006	**2007**	2006
	£m	£m	**£m**	£m	**£m**	£m
Sales:						
Goods and services supplied	**-**	-	**51**	19	**51**	19
Expenditure:						
Services received	**-**	-	**100**	150	**100**	150
Corporate services received	**-**	-	**18**	14	**18**	14
Charges in respect of pensions costs	**-**	-	**12**	17	**12**	17
Charges in respect of share-based payments	**-**	-	**1**	2	**1**	2
Interest paid on borrowings from fellow subsidiaries	**60**	8	**10**	17	**70**	25
	60	8	**141**	200	**201**	208
Outstanding balances at 31 March in respect of sales, expenditure and settlement of corporation tax:						
Amounts receivable	**74**	-	**17**	286	**91**	286
Amounts payable	**-**	-	**287**	188	**287**	188
Amount payable by parent and due after more than one year:						
At 1 April	**5,611**	2,644	**-**	-	**5,611**	2,644
Advances	**-**	2,967	**-**	-		2,967
At 31 March	**5,611**	5,611	**-**	-	**5,611**	5,611
Borrowings from fellow subsidiaries (amounts due within one year):						
At 1 April	**2**	242	**11**	161	**13**	403
Advances	**3,725**	-	**192**	-	**3,917**	-
Repayments	**(2,413)**	(240)	**-**	(150)	**(2,413)**	(390)
At 31 March	**1,314**	2	**203**	11	**1,517**	13

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 and due after more than one year is not subject to any specific settlement terms and does not bear interest. Borrowings from fellow subsidiaries are repayable on demand and bear interest at commercial rates.

No amounts have been provided at 31 March 2007 (2006: £nil) and no expense recognised during the year (2006: £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 5(c).

30 Commitments and contingencies

a) Future capital expenditure

	2007 **£m**	2006 £m
Contracted for but not provided	**753**	767

b) Lease commitments

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

	2007 **£m**	2006 £m
Amounts due:		
In one year or less	**8**	14
In more than one year, but not more than two years	**6**	12
In more than two years, but not more than three years	**5**	9
In more than three years, but not more than four years	**3**	8
In more than four years, but not more than five years	**3**	7
In more than five years	**23**	45
	48	95

c) Other commitments, contingencies and guarantees

The value of other commitments, contingencies and guarantees at 31 March 2007 amounted to £213m (2006: £154m), including performance guarantees amounting to £6m (2006: £4m), relating to certain property obligations of a National Grid group undertaking, and BG Group related commitments and contingencies amounting to £7m (2006: £7m).

d) Parent company loan guarantees on behalf of subsidiaries

The Company has guaranteed the repayment of principal sums, any associated premium and interest on specific loans due from its financial subsidiaries to third parties. At 31 March 2007, the sterling equivalent amounted to £1,108m (2006: £1,430m).

e) Litigation and claims

National Grid, together with the Environment Agency, sought judicial review to clarify the legal position with regard to the remediation of a site in Bawtry, Yorkshire, a former gas site which was not part of the assets that formed part of the gas privatisation in 1986 and therefore had never been owned by National Grid. On 17 May 2006, the High Court found in favour of the Environment Agency. However, the judgment concluded that the matters raised in the proceedings were of considerable general importance and permission to apply for leave to appeal directly to the House of Lords was granted.

A hearing before the House of Lords was held on 21 May 2007 and a judgment is expected in the summer of 2007.

We remain convinced of our case that National Grid has no legal liability with respect to the site in Bawtry, nor for other former UK gas sites which did not form part of the assets we acquired at the time of privatisation, and believe that our position will be upheld by the House of Lords.

At this stage we are unable to reliably estimate the impact of an adverse decision.

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 Subsidiaries and joint ventures

The principal subsidiaries included in the consolidated accounts at 31 March 2007 are listed below. These subsidiaries are incorporated in Great Britain unless otherwise indicated.

	Principal activity	Holding
National Grid Metering Limited	Gas metering services	100%
British Transco International Finance BV (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%
British Transco Finance (No. 1) Limited	Financing	100%
British Transco Finance (No. 2) Limited	Financing	100%
British Transco Finance (No. 3) Limited	Financing	100%
British Transco Finance (No. 5) Limited	Financing	100%
Xoserve Limited	Gas transportation billing services	56.57%

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

Company Accounting Policies

for the year ended 31 March 2007

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

The individual financial statements of the Company have been prepared on a historical cost basis, except for the revaluation of financial instruments.

These financial statements are presented in pounds sterling because that is the currency of the primary economic environment in which the Company operates.

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 the exemption from preparing a cash flow statement under the terms of FRS 1 (revised 1996) 'Cash Flow Statements'.

In accordance with exemptions under FRS 29 'Financial Instruments: Disclosures', the Company has not presented the financial instruments disclosures required by the standard, as disclosures which comply with the standard are included in the consolidated financial 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.

(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:

Depreciation periods	Years
Freehold and leasehold properties	up to 50
Plant and machinery:	
Mains, services and regulating equipment	30 to 100
Meters and metering equipment	5 to 18
Motor vehicles and office equipment	3 to 10

(c) 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.

(d) 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.

(e) 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.

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

(g) 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.

(h) 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, is stated net of value added tax and excludes intra-group transactions.

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, a liability for the over-recovery is not recognised. Similarly, an asset is not recognised where a regulatory agreement permits adjustments to be made to future prices in respect of an under-recovery.

(i) 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.

(j) Pensions
The substantial majority of the Company'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 Company. Accordingly, the Scheme is recognised in these individual financial statements as if it were a defined contribution scheme. The pension charge for the year represents the contributions payable to the Scheme for the period.

A share of the assets and liabilities or the actuarial gains and losses of the Scheme are not recognised in these individual financial statements.

(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 Company 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.

Loans receivable are carried at amortised cost using the effective interest rate method less any allowance for estimated impairments. A provision is established for impairments when there is objective evidence that the Company will not be able to collect all amounts due under the original terms of the loan. Interest income, together with losses when the loans are impaired, is recognised in the profit and loss account.

Current asset investments are initially measured at cost including transaction costs. 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 this time the cumulative gain or loss previously recognised in equity is included in net profit or loss for the period. Investment income on investments classified as available-for-sale is recognised in the profit and loss account 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.

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
Derivative financial instruments ('derivatives') are entered into in order to manage 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 underlying business activities and the financing of those activities.

Derivatives are carried in the balance sheet at their fair value.

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.

(n) Share-based payments

National Grid issues equity-settled share-based payments to certain employees of the Company. 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, based on an estimate of shares that will eventually vest, is recognised by the Company on a straight-line basis over the vesting period, as an operating cost and an increase in equity and. Payments made by the Company to National Grid in respect of share-based payments are recognised as a reduction in equity.

(o) 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.

(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.

(q) Dividends

Dividends are recognised in the financial year in which they are approved.

Company balance sheet
at 31 March

	Notes	2007 £m	2006 £m
Fixed assets			
Tangible assets	6	**5,866**	5,332
Investments	7	**17**	17
		5,883	5,349
Current assets			
Stocks	8	**28**	22
Debtors (amounts falling due within one year)	9	**362**	628
Debtors (amounts falling due after more than one year)	9	**5,613**	5,622
Derivative financial instruments (amounts falling due within one year)		**9**	87
Derivative financial instruments (amounts falling due after more than one year)		**65**	101
Current asset investments		**477**	255
		6,554	6,715
Creditors (amounts falling due within one year)			
Derivative financial instruments		**(11)**	(28)
Borrowings		**(2,288)**	(1,050)
Other creditors		**(910)**	(856)
	10	**(3,209)**	(1,934)
Net current assets		**3,345**	4,781
Total assets less current liabilities		**9,228**	10,130
Creditors (amounts falling due after more than one year)			
Derivative financial instruments		**(83)**	(54)
Borrowings		**(3,435)**	(2,678)
Other creditors		**(672)**	(623)
	11	**(4,190)**	(3,355)
Provisions for liabilities and charges	13	**(912)**	(914)
Net assets employed		**4,126**	5,861
Capital and reserves			
Called up share capital	14	**45**	45
Share premium account	15	**204**	204
Cash flow hedge reserve	15	**(49)**	(59)
Other reserves	15	**1,332**	1,332
Profit and loss account	15	**2,594**	4,339
Equity shareholders' funds		**4,126**	5,861

Commitments and contingencies are shown in note 16.

The notes on pages 87 to 93 form part of the individual financial statements of the company, which were approved by the Board of Directors on 29 May Month 2007 and were signed on its behalf by:

Nick Winser Director

Adam Wiltshire Finance Director

Notes to the company accounts

1 Adoption of new Accounting Standards

New financial reporting standards (FRS) and abstracts adopted in 2006/07

During the year the Company has adopted the following FRSs and abstracts:

Amendment to FRS 17 'Retirement benefits' replaces the disclosures required by FRS 17 with those of IAS 19, 'Employee benefits', its international equivalent, and amends paragraph 16 of FRS 17, so that for quoted securities, the current bid price (rather than the mid-market value) is taken as fair value. Implementation of this standard has not had a material impact on the Company's results or assets and liabilities.

Amendment to FRS 23 'The Effects of changes in foreign exchange rates' clarifies the requirements of FRS 23 regarding an entity's investment in foreign operations and, in particular, the treatment of monetary items entered into as net investment hedges. Implementation of this amendment had no impact on the Company's results or assets and liabilities.

Abstract 41, 'Scope of FRS 20 (IFRS 2)' addresses the issue of whether FRS 20 '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 abstract has not had a material impact on the Company's results or assets and liabilities.

UITF Abstract 45 'Liabilities arising from participating in a specific market – waste electrical and electronic equipment' relates to the European Union's Directive on waste electrical and electronic equipment and deals with the responsibility of producers for the backlog of waste for goods sold to private households. Implementation of this abstract has not had a material impact on the Company's results or assets and liabilities.

New financial reporting standards (FRS) and abstracts not yet adopted

The following standards and abstracts will be adopted in future periods:

Amendment to FRS 26: Recognition and derecognition 'Financial instruments: measurement – recognition and derecognition' implements the recognition and derecognition material in IAS 39. The requirements of FRS 5, 'Reporting the substance of transactions', are superseded for transactions that fall within FRS 26's scope, but FRS 5 continues to apply to transactions in non-financial assets and liabilities. Implementation of this standard is not expected to have a material impact on the Company's results or assets and liabilities.

Abstract 42, '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 abstract is not expected to have a material impact on the Company's results or assets and liabilities.

Abstract 44, 'FRS 20 (IFRS 2) – Group and treasury share transactions' provides guidance on whether share-based transactions involving treasury shares or involving group entities (for instance, options over a parent's shares) should be accounted for as equity-settled or cash-settled. Implementation of this abstract is not expected to have a material impact on the Company's results or assets and liabilities.

2 Auditors' remuneration

Auditors' remuneration in respect of Company is set out below:

	2007 £m	2006 £m
Auditors' remuneration		
Audit services		
Audit fee of company	**0.4**	0.5
Other services		
Other services supplied pursuant to legislation	**0.4**	0.2
Services relating to tax advisory	**-**	0.2

3 Employees

a) Number of employees

	2007 Average number	2006 Average number
United Kingdom		
Continuing operations	**5,877**	6,058
Discontinued operations	**-**	343
	5,877	6,401

	31 March 2007 number
United Kingdom	**5,690**

b) Share-based payments

The disclosures required by FRS 20 are provided in note 5(d) to the consolidated financial statements.

4 Directors' emoluments

Details of Directors' emoluments are provided in note 6 to the consolidated financial statements.

5 Pensions

Substantially all the Company'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 Company. Accordingly, the Company accounts for the scheme as if it were a defined contribution scheme.

The disclosures required by FRS 17 are provided in note 7 to the consolidated accounts.

6 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 2006	69	7,803	287	608	8,767
Additions	8	256	545	56	865
Disposals	(1)	(12)	-	(15)	(28)
Reclassifications	3	38	(64)	23	-
Cost at 31 March 2007	79	8,085	768	672	9,604
Depreciation at 1 April 2006	(19)	(2,977)	-	(439)	(3,435)
Depreciation charge for the year	(5)	(264)	-	(58)	(327)
Disposals	-	9	-	15	24
Reclassifications	-	-	-	-	-
Depreciation at 31 March 2007	(24)	(3,232)	-	(482)	(3,738)
Net book value at 31 March 2007	**55**	**4,853**	**768**	**190**	**5,866**
Net book value at 31 March 2006	50	4,826	287	169	5,332

6 Tangible fixed assets (continued)

The net book value of land and buildings comprised:

	2007 £m	2006 £m
Freehold	**44**	46
Long leasehold (over 50 years)	**-**	1
Short leasehold (under 50 years)	**11**	3
	55	50

The cost of tangible fixed assets at 31 March 2007 included £51m (2006: £27m) relating to interest capitalised.

Included within 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 £18m (2006: £19m) and £614m (2006: £577m) respectively.

7 Fixed asset investments

	Shares in subsidiary undertakings £m
Cost at 1 April 2006 and 31 March 2007	17

The names of the principal subsidiary undertakings are included in note 32 to the consolidated financial statements.

8 Stocks

	2007 £m	2006 £m
Raw materials and consumables	**28**	22

9 Debtors

At 31 March	2007 £m	2006 £m
Amounts falling due within one year		
Trade debtors	**47**	61
Amounts owed by fellow subsidiary undertakings	**121**	279
Other debtors	**35**	118
Prepayments and accrued income	**159**	170
	362	628
Amounts falling due after more than one year		
Other debtors	**2**	3
Amounts owed by Group undertakings	**-**	8
Amounts owed by immediate parent undertaking	**5,611**	5,611
	5,613	5,622
Total debtors	**5,975**	6,250

10 Creditors (amounts falling due within one year)

At 31 March	**2007 £m**	2006 £m
Derivative financial instruments (note 11)	**11**	28
Borrowings (note 12)	**2,288**	1,050
Trade creditors and accruals	**397**	395
Amounts owed to Group undertakings	**11**	16
Amounts owed to fellow subsidiary undertakings	**287**	182
Corporation tax	**34**	70
Social security and other taxes	**96**	93
Other creditors	**23**	10
Deferred income	**62**	90
	3,209	1,934

11 Creditors (amounts falling due after more than one year)

At 31 March	**2007 £m**	2006 £m
Derivative financial instruments	**83**	54
Borrowings (note 12)	**3,435**	2,678
Trade creditors	**6**	-
Other creditors	**3**	-
Deferred income	**663**	623
	4,190	3,355

Deferred income mainly comprises contributions to capital projects.

The derivative financial instruments of National Grid Gas plc and its subsidiary undertakings substantially comprise derivative financial instruments held by the Company. Accordingly, the details provided in note 17 to the consolidated financial statements are considered to meet the disclosure requirements of Schedule 45A of the Companies Act 1985.

12 Borrowings

The following table analyses the company's total borrowings:

At 31 March	**2007 £m**	2006 £m
Amounts falling due within one year		
Bank loans and overdrafts	**31**	81
Bonds	**319**	700
Borrowings from Group undertakings	**1,516**	252
Borrowings from fellow subsidiary undertakings	**419**	13
Other loans	**3**	4
	2,288	1,050
Amounts falling due after more than one year		
Bank loans	**380**	200
Bonds	**2,727**	1,830
Borrowings from Group undertakings	**228**	644
Other loans	**100**	4
	3,435	2,678
Total borrowings	**5,723**	3,728

Total borrowings are repayable as follows:		
In one year or less	**2,288**	1,050
More than one year, but not more than two years	**459**	274
More than two years, but not more than three years	**487**	464
More than three years, but not more than four years	**-**	308
More than four years, but not more than five years	**-**	-
More than five years, other than by instalments	**2,489**	1,632
	5,723	3,728

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

13 Provisions for liabilities and charges

	Environmental £m	Emissions £m	Restructuring £m	Deferred Taxation £m	Other £m	Total £m
At 31 March 2006	44	23	33	786	28	914
Charged/(credited) to profit and loss account	-	(10)	12	14	17	33
Transferred to reserves	-	-	-	6	-	6
Utilised	(1)	(12)	(25)	-	(4)	(42)
Unwinding of discount	1	-	-	-	-	1
At 31 March 2007	**44**	**1**	**20**	**806**	**41**	**912**

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 2007, 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 they are expected to be incurred over the financial years 2008 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.

The undiscounted amount of the provision at 31 March 2007 relating to gas site decontamination was £70m (2005: £72m), being the undiscounted best estimate of the liability having regard to the uncertainties referred to above (excluding the impact of changes in discount rate).

The provision for emission costs is expected to be settled using emission allowances granted which are reported as an intangible asset.

At 31 March 2007, £7m of the total restructuring provision (2006: £10m) 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 at 31 March 2007 include £24m (2006: £28m) in respect property transfer costs related to the sales of four UK gas distribution networks and £17m (2006: £nil) in respect of employer liability claims. The payment dates for the property transfer costs are uncertain but should largely be over the next four years. The employer liability claims are based on prior claims experience and, therefore, there is no identifiable payment date associated with these items.

Deferred taxation comprises:

	Provided	
At 31 March	**2007 £m**	2006 £m
Accelerated capital allowances	**803**	797
Other timing differences	**3**	(11)
	806	786

14 Share capital

	Number of shares 2007 millions	Number of shares 2006 millions	2007 £m	2006 £m
Authorised				
Ordinary shares of $1^2/_{15}$p each	**6,052**	6,052	**69**	69
Allotted and fully paid				
Ordinary shares of $1^2/_{15}$p each	**3,944**	3,944	**45**	45

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

15 Reserves

	Cash flow hedge reserve £m	Share premium account £m	Capital redemption reserve £m	Profit and loss account reserve £m
At 31 March 2006	(59)	204	1,332	4,339
Retained loss for the year	-	-	-	(1,756)
Net expense recognised directly in reserves	10	-	-	-
Share-based payments	-	-	-	10
Tax on share-based payments	-	-	-	1
At 31 March 2007	**(49)**	**204**	**1,332**	**2,594**

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 £94m (2006: £4,342m).

16 Commitments and contingencies

a) Future capital expenditure

As at 31 March 2007, the Company had placed contracts for capital expenditure (tangible fixed assets) amounting to £753m (2006: £763m).

b) Lease commitments

At 31 March 2007, the Company's total operating lease commitments for the financial year ending 31 March 2008 amounted to £8m (2006 commitments for 2007: £14m) and are analysed by lease expiry date as follows:

	Land and buildings		Other		Total	
At 31 March	**2007 £m**	2006 £m	**2007 £m**	2006 £m	**2007 £m**	2006 £m
Expiring:						
In one year or less	**-**	-	**2**	1	**2**	1
In more than one year, but not more than five years	**2**	2	**1**	4	**3**	6
In more than five years	**3**	7	**-**	-	**3**	7
	5	9	**3**	5	**8**	14

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

At 31 March	**2007 £m**	2006 £m
Amounts:		
In one year or less	**8**	14
In more than one year, but not more than two years	**6**	12
In more than two years, but not more than three years	**5**	9
In more than three years, but not more than four years	**3**	8
In more than four years, but not more than five years	**3**	7
In more than five years	**23**	45
	48	95

c) Other commitments and contingencies

The value of other commitments and contingencies at 31 March 2007 amounted to £213m (2006: £154m), including a performance guarantee of £6m (2006: £4m) relating to certain property obligations of a National Grid group undertaking, and BG Group related commitments and contingencies amounting to £7m (2006: £7m).

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 2007, the sterling equivalent amounted to £1,108m (2006: £1,430m).

e) Litigation and claims

National Grid, together with the Environment Agency, sought judicial review to clarify the legal position with regard to the remediation of a site in Bawtry, Yorkshire, a former gas site which was not part of the assets that formed part of the gas privatisation in 1986 and therefore had never been owned by National Grid. On 17 May 2006, the High Court found in favour of the Environment Agency. However, the judgment concluded that the matters raised in the proceedings were of considerable general importance and permission to apply for leave to appeal directly to the House of Lords was granted.

A hearing before the House of Lords was held on 21 May 2007 and a judgment is expected in the summer of 2007.

We remain convinced of our case that National Grid has no legal liability with respect to the site in Bawtry, nor for other former UK gas sites which did not form part of the assets we acquired at the time of privatisation, and believe that our position will be upheld by the House of Lords.

At this stage we are unable to reliably estimate the impact of an adverse decision.

17 Related party transactions

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

There were no material transactions with any other related parties during the year to 31 March 2007.

During the year to 31 March 2006, 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 other material transactions with related parties during that year.

Definitions

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

bcm
Billion cubic metres

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

Lost time injury
A work-related injury which 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, the ultimate parent company of National Grid Gas plc and its controlling party

National Grid Gas
National Grid Gas plc and/or its subsidiaries or any of them as the context requires

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

Way Ahead
The restructuring programme implemented in the Gas Distribution business which commenced in 2004/05 following the announcement of the planned sales of four gas distribution networks

National Grid Gas plc
1-3 Strand, London WC2N 5EH, United Kingdom
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