Northern Gas Networks Limited

Annual Report and accounts
for the year ended 31 December 2006

Registered number: 5167070

Directors' report

For the year ended 31 December 2006

The directors present their Annual Report on the affairs of the company, together with the accounts and auditors' report, for the year ended 31 December 2006.

Principal activity

The principal activity of the company throughout the year was the distribution of gas through the North of England network.

Business review

The business has made a strong start in achieving both its operational and financial targets during the key early stages of new ownership in the UK. On acquisition of the business, the directors implemented a unique operating model, referred to as strategic asset management, by separating the asset management and ownership responsibilities of the network from the delivery of operational activity. The split of assets and operations means the company retains all of the obligations and responsibilities required by its Gas Distribution Licence and the safety case agreed with the Health and Safety Executive ("HSE"). The company owns the assets and is responsible and accountable for the continued safe and efficient running of the gas distribution network, ensuring the highest possible performance standards from planning through to asset maintenance and replacement. The operation and maintenance of the network, together with the implementation of the asset maintenance and replacement programmes has been contracted out to United Utilities Operations Limited ("UUOL"), a company owned by United Utilities plc, under the terms of an Asset Services Agreement ("ASA"). Following the first full year of operation, this model is delivering the expected operational results.

The company's financial results for the year are in line with expectations but are not comparable with the previous period as it only included eight months of trading and was distorted as the high revenue months of January to March were pre acquisition and not included in the previous period results. The financial performance of the business for the year is heavily weighted towards the winter months as approximately 60% of revenue is earned in the period November to March, due to the seasonality of gas consumption. Total revenue for the year was £273.3m (2005 - £155.8m) which was impacted by reduced throughput volumes as a result of the warmer than seasonal normal weather experienced, with 2006 being the warmest year on record across the UK. Operating profit for the year was £47.9m (2005 - £16.7m).

The company has gross debt (before financing costs) of £958.8m (2005 - £919.8m) at the year end. This includes a drawn term loan of £366.4m (2005 - £366.4m) repayable on 31 March 2010 and short term facilities of £64.0m (2005 - £25.0m), both of which carry interest at 6 month LIBOR plus a margin of 0.26% and an interest bearing loan of £505.0m, with £250.0m repayable in 2027 and £255.0m repayable in 2035. Interest is payable at a rate of 4.875% plus a margin to cover related costs. This debt structure has given rise to interest payable and similar charges of £45.5m (2005 - £31.6m).

The tax charge for the year was £5.7m (2005 - £1.0m) which represents an effective tax rate of 136% (2005 - 8%). The high effective tax rate is as a result of the fair value assessment and the resulting revaluation of the asset base at acquisition.

Capital expenditure for the period was £44.3m (2005 - £24.2m) principally due to investment in network assets and the completion of the development of the new IT systems used to support many of the group's operational business activities.

Key performance indicators

The key financial and non-financial performance indicators used by the Board of Directors in their monitoring of the company, focus on the areas of safety, efficiency and customer service. Key financial and non-financial performance indicators include:

	2006	2005
Post maintenance interest coverage ratio	1.6	1.3
EBITDA interest coverage ratio	2.0	1.5
Senior debt/Regulatory Asset Value	68.6%	69.2%
Number of lost time injuries	9	17*

* includes pre and post acquisition to give a full year comparative

Environment

The company recognises the importance of its environmental responsibilities and undertakes its operations in an environmentally sensitive manner, complying with all relevant legislative requirements and higher standards where possible. The company is committed to the protection of the environment in the region it serves. The company's environmental management systems are certified under ISO14001. This helps the directors deal proactively with future environmental issues and legislation and assist in the development of projects, for example, the land recycling project at Sheepscar in Leeds.

Principal risks and uncertainties

The company's principal risks and uncertainties are set out below:

<u>Regulatory environment, revenue and costs</u>

The gas industry is subject to extensive legal and regulatory obligations and controls which the company must comply with. The application and possible changes of these laws, regulations and regulatory standards could have an adverse affect on the operations and financial position of the company.

<u>Health and safety</u>

There is a risk that an incident within the network leads to injury to an employee, contractor or member of the public. Any such incident could have an adverse affect on the reputation of the company, or lead to potential prosecution and reduced productivity.

Price control

The company could be unsuccessful in negotiating an acceptable five year price control outcome resulting in lower than expected revenue. The final outcome for the 2008-2013 price control is expected to be published in late 2007.

Contract and contractor management

As described above, the operation and maintenance of the network, as well as the responsibility for implementing the Capex and Repex programmes, has been contracted out to UUOL under the terms of the ASA which expires on 31 March 2013. Under the terms of the ASA, UUOL's costs of providing such services are passed through to the company, subject to bonus and penalty payments where the costs are respectively below or above agreed target levels. There is a risk that any delivery delays, excessive costs or inadequate quality by UUOL would damage the company's business reputation or increase costs and liabilities.

Network performance

If the network assets were to fail it could result in a loss in supply of gas to customers and associated adverse publicity.

Employees

The success of the company depends to a significant extent on the contribution of its employees. Fair and effective recruitment, training and employee development are critical to the successful functioning and progression of the business. The ability to adapt in a climate of change is dependent on the appointment of a high calibre, competent, flexible, quality conscious and customer focused workforce all of whom are committed to business success. Appropriate succession planning strategies mean that development of existing staff is crucial. Effective resourcing and selection processes also play a positive role in improving the image of the company in the community it serves.

The company, as an equal opportunities employer, ensures that no job applicant receives less favourable treatment because of his or her age, colour, disability, ethnic or national origin, gender, marital status or sexuality or is disadvantaged by conditions or requirements which are irrelevant to performance and the company's needs.

Future outlook

The directors expect the general level of activity to remain stable however the future outlook has some dependence on the outcome of the current five year price control review.

Financial risk management objectives and policies

The company's financial instruments, other than derivatives, comprise borrowings, cash and various items, such as trade debtors and trade creditors that arise directly from its operations. The main purpose of these financial instruments is to finance the group's operations.

The company also enters into derivative transactions, principally interest rate swaps. The purpose of such transactions is to manage the interest rate risks arising from the group's sources of finance.

The main risks arising from the company's financial instruments are interest rate risk, currency risk and liquidity risk. The Board of Directors reviews and agrees policies for managing each of these risks and they are summarised below.

Interest rate risk

The approach adopted in eliminating interest rate exposures on debt is to synchronise the maturities of fixed rate interest hedges with the timing of the regulator's five yearly price control periods. This ensures that interest rate hedges are reset in the economic environment prevailing at the time the regulator is resetting the industry's weighted average cost of capital.

Currency risk

No exposures are currently identified. Regular monitoring procedures will identify material risks as they arise. Currency risk management is only used to hedge underlying commercial exposures. Therefore trading in currency is prohibited and if an underlying exposure ceases to exist then the corresponding hedge is closed out immediately.

All non-sterling borrowings and associated service costs are hedged into sterling at the time the commitment to draw down is made.

Liquidity risk

The maturities of required committed debt facilities will be managed such that at any one time all have a time to maturity of more than one year and that at least 50% by value have a time to maturity of more than two years except for the working capital facility and finance leases which are less than one year.

Facilities are staggered to mature to avoid excessive concentrations in any twelve month period (though the value of facilities required may be insufficient to allow split maturities) as well as removing refinancing risk if such timeframes coincide with a regulatory reset date. Non-facility debt maturities are also staggered where practicable.

Dividends

The directors do not recommend payment of a final dividend. Interim dividends of £150,000 per share were paid on 27 June 2006 and of £450,000 per share were paid on 27 December 2006 making a total of £600,000 per share for the year (2005 – £340,000).

Directors

The directors, who served throughout the year except as noted, were as follows:

W Shurniak (Chairman)	
B Scarsella	
F R Frame	
D V Latham	
H Lam Kam	
K Sum Tso	
N McGee	(appointed 4 July 2006)
A Hunter	(resigned 4 July 2006, re-appointed 1 December 2006)
E Bing Sing Kwan	(resigned 1 December 2006)
G A I Waters	(deceased 23 December 2006)
C J Brook	(appointed 2 January 2007, resigned 12 April 2007)
C Cornish	(appointed 12 April 2007)

Directors' interests

The directors who held office at 31 December 2006 had no interests in the shares of the company at any time during the year. The directors do not have any other interests required to be disclosed under Schedule 7 of the Companies Act 1985.

Supplier payment policy

The company's policy is to settle terms of payment with suppliers when agreeing the terms of each transaction, ensure that suppliers are made aware of the terms of payment and abide by the terms of payment. Trade creditors of the company at 31 December 2006 were equivalent to 14 (2005 – 22) days' purchases, based on the average daily amount invoiced by suppliers during the year.

Charitable and political contributions

During the year the company made charitable donations of £4,520 (2005 - £500), principally to local charities serving the communities in which the company operates. No political donations were made (2005 - £nil).

Auditors

Each of the directors at the date of approval of this report confirms that:

- so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
- the director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s234ZA of the Companies Act 1985.

The directors will place a resolution before the annual general meeting to reappoint Deloitte & Touche LLP as auditors for the ensuing year.

1100 Century Way
Thorpe Park Business Park
Colton
Leeds
LS15 8TU

By order of the Board,

B Scarsella

23 May 2007

Director

Directors' responsibilities

The directors are responsible for preparing the Annual Report and accounts in accordance with applicable law and regulations.

Company law requires the directors to prepare accounts for each financial year. Under that law the directors have elected to prepare the accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The accounts are required by law to give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these accounts, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- prepare the accounts on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the accounts comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the United Kingdom governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

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Independent auditors' report

To the Members of Northern Gas Networks Limited

We have audited the accounts of Northern Gas Networks Limited for the year ended 31 December 2006 which comprise the Profit and Loss Account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, the Statement of Accounting Policies and the related notes 1 to 22. These accounts have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and accounts 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 accounts in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the accounts give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the accounts.

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 the other information contained in the Annual Report, and consider whether it is consistent with the audited accounts. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the accounts. Our responsibilities do not extend to any further information outside the Annual Report.

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 accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the 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 accounts 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 accounts.

Opinion

In our opinion:

- the accounts 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 December 2006 and of its loss for the year then ended;
- the accounts have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' report is consistent with the accounts.

Deloitte & Touche LLP

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Leeds

23 May 2007

Profit and loss account

For the year ended 31 December 2006

	Notes	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Turnover	1	273,326	155,813
Cost of sales		(20,866)	(11,568)
Gross profit		252,460	144,245
Other operating expenses	2	(204,538)	(127,591)
Operating profit		47,922	16,654
Profit on disposal of fixed assets	4	941	-
Finance charges (net)	3	(44,663)	(29,032)
Profit (loss) on ordinary activities before taxation	4	4,200	(12,378)
Tax on profit (loss) on ordinary activities	7	(5,706)	(959)
Loss for the financial year	18	(1,506)	(13,337)

The above results arise from continuing operations.

The accompanying notes are an integral part of this profit and loss account.

Statement of total recognised gains and losses

For the year ended 31 December 2006

	Notes	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Loss for the financial year		(1,506)	(13,337)
Actuarial gain (loss) relating to the pension scheme	21	400	(4,400)
Deferred tax attributable to actuarial gain (loss)		(120)	1,320
Total recognised losses relating to the year		(1,226)	(16,417)

The accompanying notes are an integral part of this statement of total recognised gains and losses.

Balance sheet

31 December 2006

	Notes	2006 £'000	2005 £'000
Fixed assets			
Intangible assets - goodwill	9	157,947	162,073
Tangible assets	10	1,379,782	1,370,768
Investments	11	154	154
		1,537,883	1,532,995
Current assets			
Debtors - due within one year	12	45,096	42,009
Cash at bank and in hand		4,809	201
		49,905	42,210
Creditors: Amounts falling due within one year	13	(150,243)	(88,504)
Net current liabilities		(100,338)	(46,294)
Total assets less current liabilities		1,437,545	1,486,701
Creditors: Amounts falling due after more than one year	14	(909,759)	(902,173)
Provisions for liabilities and charges excluding pension liability	16	(121,570)	(115,880)
Net assets excluding pension liability		406,216	468,648
Pension liability	21	(19,584)	(20,790)
Net assets including pension liability		386,632	447,858
Capital and reserves			
Called-up share capital	17	-	-
Profit and loss account	18	386,632	447,858
Shareholders' funds	19	386,632	447,858

The accompanying notes are an integral part of this balance sheet.

The accounts were approved by the Board of Directors and authorised for issue on 21 May 2007 and signed on its behalf by:

B Scarsella Director

23 May 2007

Statement of accounting policies
31 December 2006

The principal accounting policies are summarised below. They have all been applied consistently throughout the year and the prior period other than for the adoption of Financial Reporting Standard (FRS) 20 “Share based payments”. This new standard is not considered by management to have had a material effect on the accounts in the current year or prior period.

Basis of accounting

The accounts have been prepared under the historical cost convention and in accordance with applicable United Kingdom accounting standards.

The company is exempt from the requirement of FRS1 (revised) “Cash flow statements” to present a cash flow statement as it is a wholly owned subsidiary of Northern Gas Networks Holdings Limited, which prepares consolidated accounts which are publicly available.

The company is not required to prepare group accounts as it is a wholly owned subsidiary of Northern Gas Networks Holdings Limited which prepares consolidated accounts which are publicly available.

Intangible assets – goodwill

Goodwill arising on the acquisition of subsidiary undertakings and businesses, representing any excess of the fair value of the consideration given over the fair value of the identifiable assets and liabilities acquired, is capitalised and written off on a straight line basis over its useful economic life, which is estimated to be 40 years in line with the acquired asset base. Provision is made for any impairment.

Tangible fixed assets

Tangible fixed assets are stated at cost, net of depreciation and any provision for impairment. Cost includes internal labour costs and finance costs incurred which are directly attributable to the construction 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 estimated economic lives of the assets. Depreciation is provided on all tangible fixed assets, other than freehold land and assets in the course of construction, at rates calculated to write off the cost, less estimated residual value, of each asset on a straight-line basis over its expected useful life, as follows:

Mains & Services	55 to 65 years
Storage	40 years
Plant & machinery	10 to 50 years
Freehold buildings	50 years
Leasehold land and buildings	Lesser of lease period and 50 years
Motor vehicles and office equipment	3 to 10 years

Investments
Fixed asset investments are shown at cost less provision for impairment. Current asset investments are stated at the lower of cost and net realisable value.

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

Taxation
Current tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more tax in the future or a right to pay less tax in the future have occurred at the balance sheet date. Timing differences are differences between the group's taxable profits and its results as stated in the accounts that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the accounts.

A net deferred tax asset is regarded as recoverable and therefore recognised only when, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

Deferred tax is not recognised when fixed assets are revalued unless by the balance sheet date there is a binding agreement to sell the revalued assets and the gain or loss expected to arise on sale has been recognised in the accounts. Neither is deferred tax recognised when fixed assets are sold and it is more likely than not that the taxable gain will be rolled over, being charged to tax only if and when the replacement assets are sold.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax is measured on a non-discounted basis.

Decommissioning and environmental costs
Decommissioning and environmental costs, based on discounted future estimated expenditures, are provided for in full and where appropriate a corresponding tangible fixed asset is also recognised. The unwinding of the discount is included within the profit and loss account as a financing charge.

Turnover
Turnover represents amounts receivable for the distribution of gas and provision of other services in the normal course of business, net of trade discounts, VAT and other sales related taxes. Turnover includes an assessment of transportation services supplied to customers between the date of the last meter reading and the year end.

Pension costs

The company has obligations for a defined benefit scheme which is operated on its behalf by UUOL under the terms of the ASA. The responsibility for making payments of current service costs lies with UUOL, however the responsibility for any scheme deficit or surplus remains with the company. The amounts charged to operating profit are the current service costs and gains and losses on settlements and curtailments. They are included within operating costs, as part of the charge to the company from UUOL, under the terms of the ASA. Past service costs are recognised immediately in the profit and loss account if the benefits have vested. If the benefits have not vested immediately, the costs are recognised over the period until vesting occurs. The interest cost and the expected return on assets are shown as a net amount of other finance costs or credits adjacent to interest. Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses.

Defined benefit schemes are funded with the assets of the scheme held separately from those of the company, in separate trustee administered funds. Pension scheme assets are measured at fair value and liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate equivalent to the current rate of return on a high quality corporate bond of equivalent currency and term to the scheme liabilities. The actuarial valuations are obtained at least triennially and are updated at each balance sheet date. The resulting defined benefit asset or liability, net of the related deferred tax, is presented separately after other net assets on the face of the balance sheet.

For defined contribution schemes the amount charged to the profit and loss account in respect of pension costs and other post-retirement benefits is the contributions payable in the year. Differences between contributions payable in the year and contributions actually paid are shown as either accruals or prepayments in the balance sheet.

Leases

Assets held under finance leases and other similar contracts, which confer rights and obligations similar to those attached to owned assets, are capitalised as tangible fixed assets and are depreciated over the shorter of the lease terms and their useful lives. The capital elements of future lease obligations are recorded as liabilities, while the interest elements are charged to the profit and loss account over the period of the leases to produce a constant rate of charge on the balance of capital repayments outstanding. Hire purchase transactions are dealt with similarly, except that assets are depreciated over their useful lives.

Rentals under operating leases are charged on a straight-line basis over the lease term, even if the payments are not made on such a basis. Benefits received and receivable as an incentive to sign an operating lease are similarly spread on a straight-line basis over the lease term, except where the period to the review date on which the rent is first expected to be adjusted to the prevailing market rate is shorter than the full lease term, in which case the shorter period is used.

Finance costs

Finance costs of debt are recognised in the profit and loss account over the term of the instrument at a constant rate on the carrying amount.

Finance costs (continued)

Finance costs which are directly attributable to the construction of tangible fixed assets are capitalised as part of the cost of those assets. The commencement of capitalisation begins when both finance costs and expenditures for the asset are being incurred and activities that are necessary to get the asset ready for use are in progress. Capitalisation ceases when substantially all the activities that are necessary to get the asset ready for use are complete.

Debt

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. The carrying amount is increased by the finance cost in respect of the accounting period and reduced by payments made in the period.

Derivative financial instruments

The company uses derivative financial instruments to reduce exposure to interest rate movements. The company does not hold or issue derivative financial instruments for speculative purposes. The company does not hedge account.

1 Segment information

The directors consider that the company has only one class of business and one geographical segment by both destination and origin.

2 Other operating expenses

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Distribution costs	196,180	121,442
Administrative expenses	8,358	6,149
	204,538	127,591

3 Finance charges (net)

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Interest payable and similar charges	45,522	31,646
Less: investment income	(981)	(1,514)
Other finance charges (income)	122	(1,100)
	44,663	29,032

Interest payable and similar charges

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Bank loans and overdrafts	20,836	28,572
Intercompany interest payable	25,259	3,299
Finance leases and hire purchase contracts	204	136
	46,299	32,007
Finance costs capitalised	(777)	(361)
	45,522	31,646

Finance costs have been capitalised based on a capitalisation rate of 6.25% (2005 - 6.25%).

3 Finance charges (net) (continued)

Investment income

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Income from fixed asset investments	147	-
Interest receivable and similar income	834	1,514
	981	1,514

Other finance charges (income)

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Unwinding of discount on provisions (see note 16)	22	-
Net return on pension scheme (see note 21)	100	(1,100)
	122	(1,100)

4 Profit (loss) on ordinary activities before taxation

Profit (loss) on ordinary activities before taxation is stated after charging:

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Depreciation and amounts written off tangible fixed assets		
- owned	33,732	20,854
- held under finance leases and hire purchase contracts	1,533	1,150
Amortisation of goodwill	4,126	2,384
Operating lease rentals - other	175	-
Fees payable to the company's auditors for the audit of the company's annual accounts	56	57

Fees payable to Deloitte & Touche LLP and their associates for non-audit services to the company are not required to be disclosed because the consolidated accounts of the parent company are required to disclose such fees on a consolidated basis.

4 Profit (loss) on ordinary activities before taxation (continued)

The profit on disposal of fixed assets relates to the sale of land in the year. The effect of the profit on disposal of fixed assets on the tax on profit on ordinary activities is an increase of £282,000 (2005 - £nil).

5 Staff costs

The average monthly number of employees (including executive directors) was:

	Year ended 31 December 2006 Number	Nine month period ended 31 December 2005 Number
Operations	-	129
Administration	28	16
	28	145

The calculation of the average monthly number of employees in the prior period includes the 1,027 operations employees for the month of May 2005 only, prior to their transfer to UUOL on 1 June 2005.

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Their aggregate remuneration comprised:		
Wages and salaries	2,044	4,028
Social security costs	250	366
Other pension costs	158	480
	2,452	4,874

6 Directors' remuneration and transactions

Remuneration

The remuneration of the directors was as follows:

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Emoluments	435	275
Amounts receivable (other than shares and share options) under long-term incentive schemes	31	-
Company contributions to money purchase pension schemes	34	17
	500	292

Pensions

The number of directors who were members of pension schemes was as follows:

	Year ended 31 December 2006	Nine month period ended 31 December 2005
Money purchase schemes	1	1

Highest-paid director

The above amounts for remuneration include the following in respect of the highest paid director:

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Emoluments	435	275
Amounts receivable (other than shares and share options) under long-term incentive schemes	31	-
Company contributions to money purchase schemes	34	17
	500	292

Transactions

There have been no transactions with directors in the current year or prior period other than as set out above in respect of remuneration.

7 Tax on profit (loss) on ordinary activities

The tax charge comprises:

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Current tax		
UK corporation tax	-	424
Total current tax	-	424
Deferred tax		
Current year - origination and reversal of timing differences	7,603	535
Adjustments in respect of prior years	(1,897)	-
Total deferred tax	5,706	535
Total tax on profit (loss) on ordinary activities	5,706	959

The differences between the total current tax shown above and the amount calculated by applying the standard rate of UK corporation tax to the profit (loss) before tax is as follows.

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Profit (loss) on ordinary activities before tax	4,200	(12,378)
Tax on profit (loss) on ordinary activities at standard UK corporation tax rate of 30% (2005 – 30%)	1,260	(3,713)
Effects of:		
Expenses not deductible for tax purposes	6,343	4,672
Utilisation of tax losses	(2,760)	-
Creation of tax losses	-	1,465
Capital allowances in excess of depreciation	(4,551)	(1,889)
Other timing differences	(292)	(111)
Current tax charge for the year	-	424

The company earns its profits in the UK. Therefore the tax rate used for tax on profit (loss) on ordinary activities is the standard rate for UK corporation tax, currently 30% (2005 – 30%).

The company's planned level of capital investment is expected to remain at similar levels of current investment. Therefore, it expects to be able to claim capital allowances in excess of depreciation in future years, at a similar level to the current year.

7 Tax on profit (loss) on ordinary activities (continued)

The announcement of the 2007 Budget introduced several potential corporation tax changes which if enacted may impact the deferred tax liability in respect of accelerated capital allowances in future periods. The changes are not believed to significantly impact the company.

8 Dividends paid on equity shares

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Dividends paid on equity shares		
Equity shares		
- interim dividend paid of £90,000 per ordinary share*	-	9,000
- interim dividend paid of £150,000 per ordinary share	15,000	-
- interim dividend paid of £450,000 (2005 - £250,000) per ordinary share	45,000	25,000
	60,000	34,000

* Paid to National Grid Gas plc (all other dividends have been paid to Northern Gas Networks Holdings Limited)

9 Intangible fixed assets – goodwill

	£'000
Cost	
At 1 January 2006 and 31 December 2006	164,457
Amortisation	
At 1 January 2006	2,384
Charge for the year	4,126
At 31 December 2006	6,510
Net book value	
At 31 December 2006	157,947
At 31 December 2005	162,073

10 Tangible fixed assets

	Land and buildings £'000	Gas distribution assets £'000	Motor vehicles £'000	Other equipment £'000	Assets in the course of construction £'000	Total £'000
Cost						
At 1 January 2006	2,589	1,370,717	4,152	9,719	5,595	1,392,772
Additions	400	26,228	283	1,326	16,044	44,281
Disposals	(2)	-	-	-	-	(2)
Transfers	-	-	-	21,562	(21,562)	-
At 31 December 2006	2,987	1,396,945	4,435	32,607	77	1,437,051
Depreciation						
At 1 January 2006	160	19,320	1,154	1,370	-	22,004
Charge for the year	306	31,055	1,594	2,310	-	35,265
At 31 December 2006	466	50,375	2,748	3,680	-	57,269
Net book value						
At 31 December 2006	2,521	1,346,570	1,687	28,927	77	1,379,782
At 31 December 2005	2,429	1,351,397	2,998	8,349	5,595	1,370,768
Leased assets included above:						
Net book value						
At 31 December 2006	406	-	1,207	-	-	1,613
At 31 December 2005	41	-	2,739	-	-	2,780

Short leasehold included within land and buildings above has a cost of £442,000 (2005 - £42,000), depreciation charge in the year of £35,000 (2005 - £1,000), accumulated depreciation of £36,000 (2005 - £1,000) and a net book value of £406,000 (2005 - £41,000).

Cumulative finance costs capitalised included in the cost of tangible fixed assets amount to £1,138,000 (2005 - £361,000).

11 Investments

	2006 £'000	2005 £'000
Subsidiary undertakings	50	50
Other investments	104	104
	154	154

The company has an investment in the following subsidiary undertaking:

Subsidiary undertaking	Country of incorporation	Principal activity	Holding	%
Northern Gas Networks Finance Plc	England & Wales	Financing	49,999 ordinary shares of £1	100

The other investment represents a 10.38% holding in xoserve Limited, which provides information, data processing, invoicing and supply point administration services to the company. xoserve Limited is registered in England & Wales.

Subsidiary undertakings

	£'000
Cost and net book value	
At 1 January 2006 and 31 December 2006	50

Other investment

	£'000
Cost and net book value	
At 1 January 2006 and 31 December 2006	104

12 Debtors – due within one year

	2006	2005
	£'000	£'000
Trade debtors	7,268	6,101
Amounts owed by group undertakings	-	45
Prepayments and accrued income	36,133	35,863
UK Corporation tax	1,695	-
	45,096	42,009

13 Creditors: Amounts falling due within one year

	2006	2005
	£'000	£'000
Bank loans	64,000	25,000
Obligations under finance leases and hire purchase contracts	425	705
Payments received on account	8,396	12,517
Trade creditors	9,291	3,344
Amounts owed to group undertakings	4,437	2,089
Other taxation and social security	1,805	880
Other creditors	-	180
Accruals and deferred income	61,869	43,767
Defined contribution pension scheme accrual	20	22
	150,243	88,504

Bank loans are a working capital facility of £25.0m repayable on 31 January 2007 and a revolving credit facility of £39.0m repayable on 28 February 2007. Both carry interest at 6 month LIBOR plus a margin of 0.26%.

14 Creditors: Amounts falling due after more than one year

	2006 £'000	2005 £'000
Term loan	365,024	364,811
Amounts owed to group undertakings	529,328	529,328
Obligations under finance leases and hire purchase contracts	12	1,039
Deferred income	15,395	6,995
	909,759	902,173

The term loan is repayable on 31 March 2010 and carries interest at 6 month LIBOR plus a margin of 0.26%.

The amounts owed to group undertakings is an interest free loan of £24.3m, which is only repayable after the term loan has been fully repaid and an interest bearing loan of £505.0m, with £250.0m repayable in 2027 and £255.0m repayable in 2035. Interest is payable at a rate of 4.875% plus a margin to cover related costs.

15 Derivatives and other financial instruments

Pages 3 and 4 of the Directors' report provide an explanation of the role that financial instruments have had during the year in creating or changing the risks the company faces in its activities. The explanation summarises the objectives and policies for holding or issuing financial instruments and similar contracts, and the strategies for achieving those objectives that have been followed during the year.

The numerical disclosures in this note deal with financial assets and financial liabilities as defined in Financial Reporting Standard 13 "Derivatives and other financial instruments: Disclosures" ("FRS 13"). Certain financial assets such as investments in subsidiary companies are excluded from the scope of these disclosures.

As permitted by FRS 13, short term debtors and creditors have been excluded from the disclosures, other than the currency disclosures. The directors believe that the fair values are not materially different from the balance sheet values.

Interest rate profile

The company has no financial assets other than sterling cash deposits of £4,809,000 (2005 - £201,000) which are part of the financing arrangements of the company. The sterling cash deposits comprise monies held in bank accounts.

After taking into account interest rate swap contracts entered into by the company, the interest rate profile of the company's financial liabilities at 31 December 2006 was as follows:

15 Derivatives and other financial instruments (continued)

	Floating rate 31 December 2006 £'000	Fixed rate 31 December 2006 £'000	Interest free 31 December 2006 £'000	Total 31 December 2006 £'000
Borrowings	365,024	569,000	24,328	958,352
Finance leases	-	437	-	437
Total	365,024	569,437	24,328	958,789

The profile at 31 December 2005 for comparison purposes was as follows:

	Floating rate 31 December 2005 £'000	Fixed rate 31 December 2005 £'000	Interest free 31 December 2005 £'000	Total 31 December 2005 £'000
Borrowings	364,811	530,000	24,328	919,139
Finance leases	-	1,744	-	1,744
Total	364,811	531,744	24,328	920,883

Further analysis of the interest rate profile at 31 December 2006 and 31 December 2005 is as follows:

	2006			
	Floating rate	Fixed rate		Interest free
	Weighted average interest rate %	Weighted average interest rate %	Weighted average period for which rate is fixed Years	Weighted average period to maturity Years
Borrowings - Bank Loans	4.5	5.1	0.13	-
Borrowings - Intercompany Loan	-	4.875	25	n/a
Finance leases	-	15	4	-

	2005			
	Floating rate	Fixed rate		Interest free
	Weighted average interest rate %	Weighted average interest rate %	Weighted average period for which rate is fixed Years	Weighted average period to maturity Years
Borrowings - Bank Loans	4.5	4.6	0.25	-
Borrowings - Intercompany Loan	-	4.875	26	n/a
Finance leases	-	15	5	-

15 Derivatives and other financial instruments (continued)

Further details of interest rates on long term borrowings are given in note 14.

Maturity of financial liabilities

The maturity profile of the company's financial liabilities at 31 December was as follows:

	2006 £'000	2005 £'000
In one year or less	64,425	25,705
In more than one year but not more than two years	12	807
In more than two years but not more than five years	389,352	389,371
In more than five years	505,000	505,000
	958,789	920,883

Borrowing facilities

The company had undrawn committed borrowing facilities at 31 December, in respect of which all conditions precedent had been met, as follows:

	2006 £'000	2005 £'000
Expiring in more than two years	89,564	128,564

Fair values

Set out below is a comparison by category of book values and fair values of the company's financial assets and liabilities at 31 December.

	2006		2005	
Liabilities (assets)	Book value £'000	Fair value £'000	Book value £'000	Fair value £'000
Primary financial instruments held or issued to finance the company's operations				
Working capital and revolving credit facilities	64,000	64,000	25,000	24,363
Long term borrowings	365,024	358,362	364,811	371,166
Intercompany loans	529,328	527,123	529,328	549,316
Derivative financial instruments held to manage the interest rate and currency profile				
Interest rate swaps	-	1,477	-	(15,198)

15 Derivatives and other financial instruments (continued)

The fair values of the interest rate swaps have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

Gains and losses on hedges

The company enters into interest rate swaps to manage its interest rate profile. Changes in the fair value of instruments used as hedges are not recognised in the accounts until the hedged position matures. An analysis of these unrecognised gains and losses is as follows:

	2006			2005		
	Gains £'000	Losses £'000	Net £'000	Gains £'000	Losses £'000	Net £'000
Unrecognised gains and losses on hedges at 1 January	17,436	(2,238)	15,198	-	-	-
Gains and losses arising in previous years that were recognised in the year	-	-	-	-	-	-
Gains and losses arising before 1 January that were not recognised in the year	17,436	(2,238)	15,198	-	-	-
Gains and losses arising in the year that were not recognised in the year	6,763	(23,438)	(16,675)	17,436	(2,238)	15,198
Unrecognised gains and losses on hedges at 31 December	24,199	(25,676)	(1,477)	17,436	(2,238)	15,198
Of which: Gains and losses expected to be recognised in 2007	-	-	-	-	-	-
Gains and losses expected to be recognised in 2008 or later	24,199	(25,676)	(1,477)	17,436	(2,238)	15,198

16 Provisions for liabilities and charges excluding pension liability

	Environmental restoration £'000	Deferred taxation £'000	Other £'000	Total £'000
At 1 January 2006	7,260	99,750	8,870	115,880
Charged to profit and loss account	-	5,567	352	5,919
Utilised in the year	-	-	(251)	(251)
Adjustment arising from discounting	19	-	3	22
At 31 December 2006	7,279	105,317	8,974	121,570

Environmental restoration

Estimated environmental restoration costs are provided where the company has a legal obligation to restore sites at the balance sheet date. The provision represents the estimated net present value for statutory decontamination of old gas manufacturing sites. It also reflects the obligations associated with other environmental damage.

Other

Other provisions relate to the estimated net present value of future claims in relation to past public and employer's liability events.

The timing of the utilisation of the environmental and other provisions is inherently uncertain although the directors expect that such utilisation will occur mainly beyond one year from the balance sheet date.

Deferred tax

Deferred tax is provided as follows:

	2006 £'000	2005 £'000
Accelerated capital allowances	105,259	99,218
Other timing differences	58	949
Tax losses available	-	(417)
Provision for deferred tax	105,317	99,750

Deferred tax in respect of the defined benefit pension scheme is disclosed in note 21.

17 Called-up share capital

	2006 £	2005 £
Authorised		
100 ordinary shares of £1 each	100	100
	100	100

	2006 £	2005 £
Allotted, called-up and fully-paid		
100 ordinary shares of £1 each	100	100
	100	100

18 Reserves

	Profit and loss account £'000
At 1 January 2006	447,858
Loss for the financial year	(1,506)
Actuarial gain relating to the pension scheme	400
UK deferred tax attributable to actuarial gain	(120)
Dividends paid on equity shares	(60,000)
At 31 December 2006	386,632

19 Reconciliation of movements in shareholders' funds

	2006 £'000	2005 £'000
Loss for the financial year	(1,506)	(13,337)
Dividends paid on equity shares	(60,000)	(34,000)
Other recognised gains and losses relating to the year (net)	280	(3,080)
Net reduction in shareholders' funds	(61,226)	(50,417)
Opening shareholders' funds	447,858	498,275
Closing shareholders' funds	386,632	447,858

20 Financial commitments

Capital commitments are as follows:

	2006 £'000	2005 £'000
Contracted for but not provided for	-	1,415
	-	1,415

Annual commitments under non-cancellable operating leases are as follows:

	Land and buildings	
	2006 £'000	2005 £'000
Expiry date		
- within one year	47	-
- between two and five years	-	234
- after five years	683	683
	730	917

The company has entered in to a Guarantee and Reimbursement Agreement with FGIC UK Limited ("FGIC") in conjunction with its subsidiary Northern Gas Networks Finance Plc ("the Issuer") in relation to the bonds issued by that company in November 2005 of £505.0m. The company guarantees the punctual payment of any and all sums and fees due to FGIC and undertakes to pay any amount due from the Issuer but not paid by it. The company also indemnifies FGIC against any loss or liability suffered, if any obligation guaranteed by FGIC is, or becomes, unenforceable, invalid or illegal. The amount of the loss or liability under the indemnity is equal to the amount FGIC would otherwise have been entitled to recover.

20 Financial commitments (continued)

Under the terms of the ASA which expires on 31 March 2013, the operation and maintenance of the network, together with the implementation of the asset and replacement programmes has been contracted out to UUOL. The total value of the contract, to its expiry date, is estimated to be £0.9bn (2005 - 1.1bn).

21 Pension arrangements

The company has obligations for a defined benefit pension scheme which is operated on its behalf by UUOL who are responsible for making payments of current service costs, which are then charged to the company under the terms of the ASA. The scheme was set up following the hive down of the business and the first full actuarial valuation will be carried out in 2008. The position at hive down, at 31 December 2005 and 31 December 2006 was calculated by a qualified actuary. The major assumptions used for the actuarial valuation were:

	31 December 2006	31 December 2005	1 May 2005
Rate of increase in salaries	3.50%	3.30%	3.30%
Rate of increase in pensions in payment	3.00%	2.80%	2.80%
Discount rate	4.90%	4.70%	5.30%
Inflation assumption	3.00%	2.80%	2.80%

The fair value of the assets in the scheme, the present value of the liabilities in the scheme and the expected rate of return at each balance sheet date and at hive down were:

	31 December 2006 %	31 December 2006 £'000	31 December 2005 %	31 December 2005 £'000	1 May 2005 %	1 May 2005 £'000
Equities	7.30	86,100	7.00	82,500	7.50	137,900
Gilts & Bonds	4.40	90,300	4.20	81,800	-	-
Cash	4.75	9,800	4.50	3,300	-	-
Total fair value of assets		186,200		167,600		137,900
Present value of scheme liabilities		(214,177)		(197,300)		(163,900)
Deficit in the scheme		(27,977)		(29,700)		(26,000)
Related deferred tax asset		8,393		8,910		7,800
Net pension liability		(19,584)		(20,790)		(18,200)

The contribution rate for 2006 was 31.1% of pensionable earnings and the agreed contribution rate for the foreseeable future is 31.1% of pensionable earnings.

21 Pension arrangements (continued)

The scheme is a closed scheme and therefore under the projected unit method the current service cost would be expected to increase as the members of the scheme approach retirement.

Analysis of the amount charged to operating profit

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Current service cost	7,400	3,700

Analysis of the amount (charged) credited to net finance charges

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Expected return on pension scheme assets	9,500	7,000
Interest on pension scheme liabilities	(9,600)	(5,900)
	(100)	1,100

Analysis of the actuarial gain (loss) in the statement of total recognised gains and losses

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
Actual return less expected return on pension scheme assets	1,000	21,500
Experience gains and losses arising on the scheme liabilities	-	400
Changes in assumptions underlying the present value of the scheme liabilities	(600)	(26,300)
	400	(4,400)

21 Pension arrangements (continued)

Movement in scheme deficit during the year before deferred tax:

	Year ended 31 December 2006 £'000	Nine month period ended 31 December 2005 £'000
At 1 January	(29,700)	(26,000)
Current service cost	(7,400)	(3,700)
Contributions	8,823	3,300
Net finance (charge) income	(100)	1,100
Actuarial gain (loss)	400	(4,400)
At 31 December	(27,977)	(29,700)

History of experience gains and losses

	31 December 2006	31 December 2005	1 May 2005
Difference between the expected and actual return on scheme assets:			
Amount (£'000)	1,000	21,500	-
Percentage of scheme assets	1%	13%	-
Experience gains and losses on scheme liabilities:			
Amount (£'000)	-	400	-
Percentage of the present value of scheme liabilities	-	0%	-
Total actuarial gain (loss) in the statement of total recognised gains and losses:			
Amount (£'000)	400	(4,400)	-
Percentage of the present value of scheme liabilities	0%	(2%)	-

The company also operates defined contribution schemes for which the pension cost charge for the year amounted to £158,000 (2005 - £58,000).

22 Ultimate controlling party

The directors regard Northern Gas Networks Holdings Limited, a company incorporated in England and Wales as the ultimate parent company and the ultimate controlling party.

Northern Gas Networks Holdings Limited is the parent company of the largest and smallest group of which the company is a member and for which group accounts are drawn up. Copies of the accounts are available from 1100 Century Way, Thorpe Park Business Park, Colton, Leeds, LS15 8TU.

The Shareholders of Northern Gas Networks Holdings Limited are a consortium consisting of:

Able Venture Profits Limited (40%)
Alpha Central Profits Limited (19.9%)
Goldia Resources Limited (15.2%)
United Utilities Contracts Solutions Limited (15%)
Challenger Northern Gas Limited (5.8%)
SAS Trustee Corporation (4.1%)

As a subsidiary undertaking of Northern Gas Networks Holdings Limited, the company has taken advantage of the exemption in FRS 8 “Related party disclosures” from disclosing transactions with other members of the group headed by Northern Gas Networks Holdings Limited.