

Operating and Financial Review *continued*

As explained in 'Exceptional items' below, the total operating profit for 2002/03 of joint ventures (discontinued operations) included an exceptional pre-tax credit amounting to £129 million. The £129 million credit represents the partial release of impairment provisions charged in the year ended 31 March 2002 to match the recognition of retained losses arising from these joint ventures, and is recorded within the net £109 million credit relating to the Group's 'share of joint ventures' and associate's operating profit/(loss) - discontinued operations'.

The retained losses of the joint ventures against which the provisions are being released are reflected in the profit and loss account according to their nature, for example: share of operating loss; share of net interest; and share of tax, the principal element being an exceptional net interest charge of £92 million (before and after tax) relating to the Group's share of exchange losses incurred on foreign exchange borrowings at Intelig.

Operating losses of £672 million recorded in 2001/02 in respect of the discontinued activities of joint ventures and associate reflect the very significant level of impairment charges incurred during that year.

Operating results for all the above associate and joint ventures have been reflected in the accounts within 'share of joint ventures' and associate's operating profit/(loss) - discontinued operations'.

Goodwill amortisation

Goodwill amortisation for 2002/03 rose from £97 million to £102 million. This increase reflects a full year's amortisation of goodwill relating to the prior year's acquisition of Niagara Mohawk, partially offset by the following:

- no recognition of the Group's share of goodwill amortisation in the year in respect of Energis; and
- the reduced sterling cost of US dollar denominated goodwill amortisation as a result of the weakening of the US dollar.

Exceptional items

The results for the year ended 31 March 2003 included total net exceptional pre-tax charges of £477 million (£349 million post-tax). Pre-tax charges are made up of pre-tax net charges of £308 million and £39 million of operating exceptional items relating to continuing and discontinued operations respectively; £99 million of non-operating exceptional items (note 4(b) to the accounts on page 66); and £31 million of financing-related exceptional charges. In addition, the Group reflected

£28 million of exceptional minority interest charge. These net charges, including minority interest effect, comprise:

- costs arising from the Merger of £184 million (£147 million after tax) relating to transaction costs of the Merger, together with related employee share scheme costs amounting to £79 million and other property and employee costs of £105 million;
- restructuring costs principally arising from business related efficiency programmes of £209 million (£165 million after tax). These costs are mainly severance-related;
- an impairment charge relating to the Group's telecoms assets held by 186k of £168 million (£143 million after tax);
- a £135 million credit (£155 million after tax) in respect of Intelig and other telecoms joint ventures of which £129 million has been reflected in 'share of joint ventures' and associate's operating profit/(loss) - discontinued operations' - see above;
- an exceptional net interest loss of £31 million (before and after tax). This relates to the Group's share of exchange losses incurred on foreign exchange borrowings of £98 million (£92 million of which related to Intelig) partially offset by a gain on net monetary liabilities of £67 million as a result of the adoption of hyper-inflationary accounting, under UK GAAP, relating to Citelec, the Group's Argentinian joint venture - see 'Exchange rates and hyper-inflation' below;
- a £28 million minority interest charge being a share of the £61 million net exceptional credit related to the Argentinian joint venture - see 'Exchange rates and hyper-inflation' below;
- a £68 million loss (before and after tax) arising from the sale of the Group's leasing business, The Leasing Group, and loss on termination of 186k's operations; and
- net profit on the disposal of tangible fixed assets of £48 million (£50 million after tax).

Interest

Net interest rose from £799 million in 2001/02 to £970 million in 2002/03. Both years included exceptional financing costs amounting to £142 million and £31 million in 2001/02 and 2002/03 respectively. A separate discussion of exceptional financing costs is contained in 'Exceptional items' when comparing the results for each year.

Net interest, excluding exceptional items, rose from £657 million in 2001/02 to

£939 million for 2002/03, as shown in note 8 to the accounts on page 71. This increase is explained by a full year's interest charge in respect of the acquisition of Niagara Mohawk and foreign exchange movements.

Taxation

The net tax charge for 2002/03 of £245 million included an exceptional tax credit on pre-tax exceptional items of £128 million. Excluding the exceptional tax items from the tax charge, the effective tax rate for 2002/03 based on adjusted profit before taxation was 29.9% compared with the standard corporation tax rate in the UK of 30%. The effective tax rate for 2002/03 based on profit before taxation before exceptional items was 32.6%. Note 9 to the accounts on page 72 shows a reconciliation of the main components giving rise to the difference between the relevant effective tax rate and the UK standard corporation tax rate.

Exchange rates and hyper-inflation

Exchange rate movements have had an adverse effect on the translation of US dollar adjusted operating profit for 2002/03 compared with 2001/02. US dollar adjusted operating profit was translated at a weighted average rate of £1.00 = \$1.59 during 2002/03 as compared with £1.00 = \$1.44 for 2001/02. If the rate that applied during 2001/02 had been used, sterling operating profit and adjusted operating profit for 2002/03 would have been higher by around £57 million and £74 million respectively.

The above analysis does not take into account the fact that Niagara Mohawk only impacted on Group results for two months in 2001/02. On page 18, taking into account this factor, it is estimated that adjusted operating profit would have been higher by around £34 million.

The reduced adjusted operating profit and operating profit is largely offset by the reduced sterling cost of US dollar debt taken out to finance US dollar denominated investments and the reduced sterling cost of US taxes. As a result, the impact of the higher US dollar rate on National Grid USA's results has not had a significant effect on adjusted earnings per share or earnings per share.

Exchange rates have marginally affected the Group's recognition of operating losses arising in respect of Intelig, the Group's Brazilian telecoms joint venture. This reflected sterling's continued strengthening against the Brazilian currency in the period that the Group equity accounted for Intelig - see 'Associate and joint ventures' above. The Group estimates that, as compared with the average exchange rate for 2001/02, this effect has reduced our share of operating losses by around £2 million.

The Group's joint venture in Argentina, Citelec, is currently considered to be operating within a hyper-inflationary economy. In accordance with UK GAAP, the accounts of the joint venture, which includes Transener, a transmission company, have been prepared using hyper-inflationary accounting principles. This has resulted in all entries in the joint venture's accounts being measured at current purchasing price.

The fall in the Argentinian exchange rate has given rise to the recognition of the Group's share of exchange losses arising on the joint venture's US dollar denominated debt, amounting to £6 million. This loss is more than offset by the Group's share of a gain on net monetary liabilities of £67 million, arising as a result of inflating these liabilities as part of the hyper-inflationary adjustments referred to above. Together with the minority interest's share of these items, all of these effects have been reflected as exceptional in the profit and loss account.

Retirement arrangements

Following the Merger, the Group now operates two major UK occupational pension schemes – the National Grid Company Group of the Electricity Supply Pension Scheme (the National Grid Scheme) and the Lattice Group Pension Scheme (the Lattice Scheme).

The National Grid Scheme is a defined benefit pension scheme. The Lattice Scheme has a defined benefit section which is effectively closed to new entrants and a defined contribution section. There are no current plans to merge the two schemes.

In addition to the UK schemes, employees of National Grid USA are eligible to receive retirement income benefits through defined benefit arrangements. Post-retirement healthcare and life insurance benefit are also provided to qualifying retirees.

The next actuarial valuation of the Lattice Scheme is being carried out as at 31 March 2003, while the National Grid Scheme actuarial valuation will be carried out as at 31 March 2004.

In respect of the US-based pension schemes, the latest full actuarial valuations were carried out as at 31 March 2002. These valuations were updated using assumptions and market values at 31 March 2003.

In respect of the healthcare and life insurance schemes, the latest actuarial valuations were carried out at 31 March 2002 in respect of the New England and New York schemes. Updated valuations of these schemes were carried out at 31 March 2003.

Note 7 to the accounts on pages 68 to 70 provides more information on the Group's retirement arrangements.

Pension accounting

The Group continues to account for pensions under UK GAAP in accordance with Statement of Standard Accounting Practice 24 (SSAP 24) and, consistent with that statement, the Group had been spreading pension surpluses and deficits over the remaining service lives of employees based on the information contained in the last formal actuarial valuations.

The Board is of the view that, in light of the performance of the world's stock markets over the past year, if a formal actuarial valuation of both the UK pension funds were conducted, this would in all likelihood reveal a deficit in both schemes. The continuing recognition of a surplus is incompatible with this position, and until the next formal actuarial valuations are undertaken, the decision to suspend the recognition of any further pension surplus has been taken in respect of both schemes. Consequently, with effect from 1 October 2002, the spreading of pension surpluses in respect of the UK defined benefit schemes, based on their last formal actuarial valuations at 31 March 2001, was suspended.

Adjusted operating profit and net interest included £21 million and £12 million respectively in respect of the recognition of the UK pension schemes' surplus up to 30 September 2002, totalling £33 million (£23 million net of tax). As a result of the suspension of the recognition of any further pension surplus since that date, adjusted operating profit and net interest have been reduced and increased by £21 million and £10 million respectively compared with the ongoing recognition of a surplus. Accordingly, adjusted profit before tax has been reduced by around £31 million (£22 million net of tax).

The Group does not account for pension costs under Financial Reporting Standard 17 'Retirement benefits' (FRS 17), but has provided the required transitional pension scheme disclosures as shown in note 7 to the accounts on pages 68 to 70.

Application of UK GAAP accounting policies

As explained above, the application of UK GAAP to the business combination of Lattice and National Grid has resulted in the transaction being treated as a merger. As a result, the financial information presented for all years has been prepared on the basis of common accounting policies as if the Group had always applied those accounting policies.

There have been no new UK GAAP accounting pronouncements issued during the year that have had any significant impact on the Group.

Accounting policies adopted by Lattice that were changed to accord with the accounting policies adopted by the Group were deferred taxation and the classification of the amortisation of a pension surplus in the profit and loss account. Full details of these changes are given in note 29 to the accounts on page 90.

In addition, National Grid adopted, as a merger adjustment, the accounting treatment relating to capital contributions to the cost of tangible fixed assets ('capital contributions') as previously applied by Lattice. As a result, the net book value of capital contributions included in National Grid's accounts at 31 March 2002 of £90 million has been transferred from tangible fixed assets to creditors as part of the Merger adjustments to arrive at the opening balances for creditors and tangible fixed assets at 31 March 2002 – see note 29 to the accounts on page 90.

Earnings per share

Adjusted basic earnings per share for 2002/03 were 28.3 pence compared with 30.8 pence for 2001/02. Basic earnings per share for 2002/03 rose from a loss per share of 11.3 pence in 2001/02 to earnings of 12.7 pence per share, reflecting a reduction in net exceptional charges between the two years.

A reconciliation of the movement from basic earnings per share to adjusted basic earnings per share is shown in note 11 to the accounts on page 73.

Ordinary dividends

The total ordinary dividend for 2002/03 (£530 million) amounted to 17.20 pence per ordinary share. This represents an increase of 7.2% (5% in real terms) over the previous year's National Grid ordinary dividend per share, as this is the most appropriate dividend comparison for the reason explained in 'Dividend policy' below. The total ordinary dividend per share is covered 1.6 times by adjusted earnings per ordinary share and 0.7 times by basic earnings per ordinary share.

Dividends

The table on the following page ('dividend table') shows the ordinary dividends paid or payable by National Grid Transco or National Grid, as appropriate (see 'Dividend policy' below), for the last five most recent financial years. These dividends do not include any associated UK tax credit in respect of such dividends.