Network Rail Infrastructure Limited

Annual Report and Accounts

Year Ended 31 March 2006

Company registration no. 2904587

Contents

Officers

Directors
John Armitt
David Bailey
Rob den Besten
Ian Buchan
Yvonne Constance
Jim Cornell
Iain Coucher
Michael Firth
Christopher Green
Peter Henderson
Ron Henderson
Charles Hoppe
Ian McAllister

Secretary
Hazel Walker

Overview

28%	reduction in Network Rail train delays since we took over in 2002/03
86.4%	of trains arrive on time, the highest level for six years
6.7%	increase in gross freight tonne miles
£400m	of new money for enhancements
£74m	reduction in operating costs before depreciation
7th	consecutive annual reduction in number of broken rails

Financial highlights for the year ended 31 March 2006

	2006 £m	2005 £m
Revenue	**3,837**	3,800
Operating profit	**468**	465
Loss before taxation	**(232)**	(47)
Loss after taxation	**(253)**	(29)
Net cash from operating activities	**655**	482
Net debt	**(18,201)**	(15,646)
Net assets	**4,363**	3,610
Railway network fixed assets	**25,991**	22,221
Investment property	**892**	872
Capital expenditure	**3,151**	3,590

Chairman's statement

The proportion of trains arriving on time now stands at its highest level for six years and substantial reductions in costs are now being made. This success gives Network Rail a sound platform for the future and the Company is ambitious to grow the railway, meeting the aspirations of our customers.

Network Rail has had a very successful year, building upon the achievements of the previous two years.

When Network Rail was created two major priorities were identified – improving train punctuality and reducing the costs of the railway.

During 2005/06, 86.4% of trains ran on time. This is the highest for six years and compares to 78.6% punctuality in the twelve months before Network Rail was created. This improvement is the result of the efforts of both Network Rail and the train operators, who together have reduced delays significantly. In the last year delays caused by Network Rail stood at 10.5m minutes. This compares to 11.4m delay minutes during the previous year and 14.7m minutes in the year Network Rail was formed.

Alongside the increase in train punctuality, Network Rail has also made very significant progress in reducing the costs of the railway infrastructure. In the last year, operating costs before depreciation have come down by £74m and the Company is on target to meet the 31% efficiency target agreed with the Office of Rail Regulation (ORR).

The success the Company has achieved in the last three years provides a sound platform from which Network Rail can build. We are ambitious for the railway and, with passenger and freight demand increasing year-on-year, we want to grow the railway.

In our 2006 Business Plan, published in April 2006, we were delighted to announce £400m of new money to grow the network with half of that money coming from the Company and half from the Government. Network Rail's £200m contribution has come out of our better than expected financial performance in recent years. Network Rail's not-for-dividend structure means this money can be re-invested in the network rather than returned to shareholders.

The benefits of investment in the railway can now clearly be seen on the West Coast mainline. The line has been upgraded to 125mph running from London to Glasgow and journey times between the two cities are now 41 minutes less than they were two years ago. The modernisation of the line has also had major benefits in terms of punctuality, with a 25% reduction in delays to Virgin West Coast trains over the year despite an increase in train miles of 17%.

All of the improvements the railway has seen in recent years would count for nothing if the industry was not maintaining a good safety record. Pleasingly, the performance of many of the key safety indicators does remain strong, with broken rails and the risk from signals passed at danger both at the lowest level ever recorded, and the number of passenger fatalities caused by train accidents in 2005/06 was zero.

The number of railway workforce fatalities remains an area of serious concern, with four railway infrastructure employees killed in 2005/06. Whilst this level is low in historical terms, any workforce fatalities are unacceptable and Network Rail remains committed to working to eliminate these fatalities.

Following the acquisition of Railtrack, Network Rail inherited the liabilities in relation to the tragic incident at Hatfield in October 2000 which killed four people. Last year, the Hatfield trial concluded with the four Network Rail employees who had been accused of offences found not guilty of all charges laid against them. The Court found Network Rail to be guilty of offences under the Health & Safety at Work Act and the Company was fined £3.5m. Balfour Beatty was also fined £10m in relation to the incident.

The Hatfield incident was a tragedy, the lessons have been learned and the structure that was in place at the time of Hatfield no longer applies. Network Rail has replaced Railtrack, all rail maintenance has been brought in-house and record investment is being made in renewing the rail infrastructure. All these changes have been made to minimise the chances of anything like Hatfield ever happening again.

I was delighted to welcome Ian Buchan to the Board of Network Rail this year. Ian joined as a non-executive director on 5 February 2006 and with his previous experience at National Express Group he is already making a significant contribution to the Company. Tragically, one of our non-executive directors, Ross Sayers, passed away this year. Ross' death was a tremendous shock to his colleagues on the Board and we miss his contribution greatly – both on a personal and professional level.

Finally, no review of 2005/06 would be complete without paying tribute to the Network Rail employees and other railway workers for their work in London on 7 July 2005. Across London, Network Rail's station staff and signallers worked to enable Londoners and commuters to get home on that difficult day. At King's Cross our station staff, together with those from the train operators, were at the front line supporting the emergency services as they sought to deal with the aftermath of the bomb attack on the Piccadilly Line train near that station.

In the year to come, the three-year rotation of Network Rail Members will begin with around 25 new Public Members joining the Membership. I would like to thank those Members whose term is expiring for their contribution to the success of Network Rail over the last three years, and I look forward to welcoming the new Members this Autumn.

These are exciting times at Network Rail. We have made great strides in the last three years, but there is a lot more to do. The railway is now a success story, and

Network Rail needs to respond to that success with an ambitious agenda to meet the aspirations of our customers. Delivering a growing railway, whilst maintaining the focus on day-to-day safety, punctuality and efficiency, will be the major challenge for the years ahead.

Ian McAllister
Chairman
25 May 2006

Delivering a growing railway, whilst maintaining the focus on day-to-day safety, punctuality and efficiency, will be the major challenge for the years ahead.

Chief Executive's review

Across the country, Network Rail employees have worked more closely with their customers to deliver a better railway for passengers and freight. This review of the year details a series of achievements of which they can all be proud.

With the best train punctuality in six years, millions of pounds worth of efficiency savings made, and the continuation of the railway's good safety record, Network Rail has had an extremely good year.

Performance

Quite understandably, the measure of railway performance which receives the most scrutiny and attention is the proportion of trains which arrive on time. During 2005/06, 86.4% of trains ran on time, compared to 83.6% the previous year and 78.6% in the twelve months before Network Rail was created. The punctuality level now exceeds the 86.1% level which preceded the Hatfield crash of October 2000 and stands at its best for six years.

Network Rail's contribution to overall train punctuality is measured by Network Rail delay minutes, and these have fallen by nearly one million minutes in the last year. Annual Network Rail delays now stand at 10.5m minutes, compared to 14.7m minutes in the year Network Rail was formed.

These improvements in performance have been achieved by Network Rail and the train operators working much more closely together, both at a day-to-day level in integrated control centres and on longer-term performance planning with the introduction of joint improvement plans for each part of the network. It is this co-operation which is really bearing fruit for passengers, and which we will continue to work to improve still further in the year to come.

Network Rail has commenced a major public education campaign about the safe use of level crossings.

Our freight customers have also had a good year with a 6.7% increase in gross tonne miles over the year. Forecasts for future freight growth are equally strong, with a 50% increase in gross tonne miles predicted over the next ten years. Network Rail is focussed on meeting this growing freight demand and our strategy for the South West mainline recommended the enhancement of the route from Southampton to the West Coast mainline to carry the larger W10 freight containers preferred by the international freight market. In the coming year, our freight strategy will examine the options all over the country to develop and enhance the network for freight traffic.

Cost control

To have a secure long-term future in which it can grow and prosper, the railway needs to ensure it has its costs under control so that it is affordable for the country. For this reason, delivering an efficient railway infrastructure is an absolutely key priority for Network Rail.

The Group Finance Director outlines in detail the progress Network Rail has made in the last year as we strive to meet the challenging 31% efficiency target agreed with the Office of Rail Regulation (ORR). However there are two areas I would like briefly to mention.

Network Rail has made further significant progress in reducing operating costs in the last year. Operating costs before depreciation, and before allowing for inflation, fell by some £74m last year. This builds on the savings made during the previous year.

The largest single area of Network Rail expenditure is on renewals, with over £2bn projected to be spent each year over the remaining three years of this regulatory Control Period. It is therefore vital that efficiencies are made not just on operational expenditure, but on the renewal of the railway infrastructure. We are pleased, therefore, to have made a 3% saving on the unit costs of track renewals over the last year.

At the beginning of this Control Period, Network Rail agreed to a two year deferral in the increase in our income that the ORR had determined. This deferral ended in March 2006 and from this financial year the Company is now in receipt of the full income levels to which the ORR determined we are entitled. This means that the Company expects to earn profits after tax in 2006/07, as was outlined in our 2006 Business Plan. This move into profit represents a further step in the progression of Network Rail as a mature and successful organisation, and provides a further solid foundation for our ambitions for the railway in the future.

Safety

In common with every other industry or mode of transport, safety is an imperative on the railway.

The trend of recent years of strong safety performance has continued in the last year. The annual number of broken rails declined for the seventh successive year and now stands at 317 compared to a peak of 952 in 1998/99. The current level is the lowest level ever recorded.

The number of signals passed at danger has also declined for the seventh successive year and stood at 328 in 2005/06. With the introduction of the Train Protection & Warning System (TPWS) which stops or slows trains which pass red signals, the risk from signals passed at danger has now fallen dramatically compared to its level five years ago. Again, the number of signals already in place for dozens of stations across the country including Birmingham New Street, Edinburgh Waverley, London Bridge and King's Cross. Smaller stations should also benefit from Network Rail's ambitious agenda for stations. It is our intention to develop a 'stations clusters' initiative which will group smaller stations into packages attractive to developers, and use the funds raised to further improve the stations for passengers.

Outlook

The outlook for Network Rail is good.

Punctuality continues to rise and costs continue to fall. Safety performance, meanwhile, remains strong and levels of investment in the rail infrastructure are high. We have a sound foundation which allows us to be ambitious for growing the railway in the future.

I would like to thank Network Rail's 32,000 employees for their efforts in delivering the substantial improvements we have made so far. It will require equal effort to continue this progress in the months and years to come. We are determined that we will be up to the task.

John Armitt
Chief Executive
25 May 2006

Network Rail is determined to lead a programme of investment and improvement in the nation's railway stations.

passed at danger now stands at its lowest level ever recorded.

With the decline in the risks from broken rails and signals passed at danger, the greatest train accident risk is at level crossings. However 96% of the risk at level crossings comes from abuse or misuse by crossing users, not from the crossings themselves. In order to tackle this risk, Network Rail is pleased that the Government has agreed to the Company's proposal that the Road Safety Bill be used to amend the legislation governing level crossings.

To address the risks associated with level crossings further, Network Rail has also commenced a major public education campaign about the safe use of level crossings, primarily targeted at road users. The campaign commenced in May 2006 with the launch of a television advertisement and the distribution of direct mail to one million households close to problem crossings.

The challenge of improving workforce safety continues and regrettably there were four railway infrastructure workforce fatalities in the last year. Fatalities are not acceptable to the Board and over the coming year we will continue to work with our employees and our industry partners to improve practices, processes and working culture.

Asset condition

Since the creation of Network Rail, very high levels of investment have gone into the railway infrastructure and this has continued during the last year with £2.7bn spent on renewals.

In total 696 miles of rail, 496miles of ballast and 563 switches and crossings units were replaced during 2005/06. This volume of activity maintains the high levels of the last five years and represents a substantial increase in the level of renewals on the railway being carried out in the late 1990s.

This investment is delivering a real improvement in the condition of the railway assets. In fact, the Asset Stewardship Index target set by the ORR for March 2009, has now been met. This is an outstanding performance and has been achieved by the substantial investment in renewals, together with the benefits from bringing maintenance in-house.

Projects

The modernisation of the West Coast mainline has been one of the biggest engineering and construction projects in Europe. In total, more than 1,266 miles of new rail, 700 switches and crossings and over 2,802 miles of new signalling cable have been laid. This huge amount of work is now paying great dividends for passengers with journey times between London and Glasgow now 41 minutes faster than they were two years ago and Virgin Trains is now making substantial inroads into the air market from London to Manchester.

A number of the most significant major railway projects in development are in Scotland. This includes a scheme to increase capacity at Edinburgh Waverley station with the addition of three extra platforms as well as new signalling to facilitate additional train services. Work began on this scheme in January and is due to conclude by early 2008.

Network Rail is also working with Transport Scotland on the reinstatement of an old railway line between Airdrie and Bathgate. The Bill to allow construction of the Airdrie-Bathgate line will be introduced to the Scottish Parliament shortly. Parliamentary proceedings are scheduled to last approximately one year, with construction to begin after that.

The Thameslink Programme is a proposed scheme to increase substantially the capacity of the route which runs north-south through central London, with longer trains and higher train frequencies. The programme has been considered by a Public Inquiry in the last year and the result of this inquiry is expected shortly. Assuming a positive outcome to the Public Inquiry, Network Rail will immediately seek to commence discussions with the Department for Transport over the funding of the programme. In our view, it should be seen as one of the priorities for developing the railway in London.

Growing the railway

The last three years have seen a remarkable improvement in the performance of the national railway system. Train punctuality has increased markedly, costs have come under control and a good safety record has been maintained.

This excellent performance provides the railway with a strong basis for growth. Passenger and freight demand continues to increase and Network Rail is ambitious to grow the railway to meet these needs. Through our programme of Route Utilisation Strategies (RUS), we will assess each and every route across the network and make recommendations for how and where the railway can grow, so that still more passengers, and more freight, can be accommodated in future.

To date one RUS has been published – that covering the lines into London Waterloo. This RUS recommended a programme of investment including the complete redevelopment of Waterloo station and the lengthening of commuter trains serving those routes. The strategy also recommended the enhancement of the route from Southampton to the West Coast mainline to accommodate the larger W10 wagons preferred by our freight operating customers. W10 gauge enhancement is a key issue for the rail freight industry to improve its competitiveness. This issue will be examined by Network Rail in the forthcoming freight RUS.

Network Rail has further demonstrated its commitment to growing the railway this year by providing £200m of new money for enhancement schemes. This money is available as a result of Network Rail's strong financial performance over the last two years. Due to our status as a 'not for dividend' company limited by guarantee, we are able to re-invest this money directly into the railway and add it to the £200m the Government has also provided to Network Rail for rail enhancement schemes.

Stations are the front door to the railway, and Network Rail is determined to lead the railway industry in a programme of investment and improvement in the nation's railway stations.

In the last year we have invited development proposals for Euston and Victoria, and we expect to do so for Waterloo in the year to come. In each case, we are seeking to leverage funding from developers to improve stations for passengers. This is in addition to plans

Investment is delivering a real improvement in the condition of the railway.

Group Finance Director's review

The year ended 31 March 2006 has seen further consolidation and progress.

The results for the year are in line with the projections we published in our Business Plan on 31 March 2005, being an operating profit in line with the previous year and a loss after interest and tax, caused entirely by the further deferral of revenue grants. This deferral agreement ended on 31 March 2006 and going forward for the remainder of the Control Period (to 31 March 2009) profits after tax are expected. In addition we delivered our renewals spending target for the year.

The challenge of meeting our efficiency targets set by the Office of Rail Regulation (ORR) continues to be our key focus. Savings have been delivered by continuing our regime of strong budgetary control, minimising inefficient and discretionary spend and improving the understanding of our cost bases and cost drivers. We are ahead of our targeted efficiencies but further efficiencies will need to be delivered for the remainder of the Control Period in order to meet fully the ORR's challenge of 31% reductions by 31 March 2009. Clearly these efficiencies become harder to deliver as the overall spend reduces. I am, nonetheless, confident that the delivery of these financial targets, as outlined in our recently published Business Plan, will be substantially achieved.

Financial performance

Financial highlights

- Turnover was £3,837m, an increase of £37m against prior year turnover of £3,800m. The modest increase was a result of higher passenger franchise revenue, freight revenue and property rental income partially offset by a decrease in revenue grants.
- Operating costs before depreciation totalled £2,431m, a reduction of £74m compared to the prior year total of £2,505m.
- Profits of £61m were achieved from the sale of properties (2004/05: £54m).
- Net interest charges have increased to £778m from £647m reflecting the increased levels of debt in the group, mainly as a result of the deferral of income outlined above.
- Net debt increased to £18.2bn from £15.7bn in the year.
- Total non-current assets have increased from £23.7bn to £27.5bn. This includes investment properties valued at £892m, an increase of £20m from the previous year's valuation of £872m and financial assets of £571m (2004/05: £498m).
- Net assets at 31 March 2006 totalled £4.36bn (2004/05: £3.61bn).

Performance against the ORR Control Period 3 determination

The table below outlines the out turn on the key areas of expenditure for the business.

Maintenance costs were reduced as a result of the renegotiation of commercial contracts, a reduction on the reliance on sub-contractors, productivity improvements, as well as residual benefits from the elimination of contractors' profit and overheads. We have made continued progress on delivering efficiencies and achieving a meaningful unit costing structure for maintenance work. By year end we had established a reliable unit cost framework for 50% of our maintenance costs. Core maintenance costs continue to reduce with more maintenance work delivered for less money than in prior years.

Controllable Opex saw savings as a result of the targeted reduction of agency staff and contractors and consultants.

On the investment front our focus on detailed cost analysis and value for money to maximise the impact of each pound in the ground remains the cornerstone of our approach. We have successfully delivered efficiencies in terms of cost and, through the introduction and increasing use of high-output plant and equipment, we are laying solid foundations to deliver significant volume efficiencies in the medium to long term future. Our Business Plan 2006 underlines our intention to deliver the ORR five-year targets which will continue the unprecedented levels of investment in the railway network.

Efficiencies across the renewals portfolio (excluding West Coast Route Modernisation) totalled 18.7% against a regulatory target of 15.2%. Whilst all asset disciplines are reporting efficiencies, the most significant out performance comes from the signalling and civils portfolios, driven by improved contracting arrangements and sensible bringing in-house of front end works such as signalling design. The development of the Cost Analysis Framework, which provides consistent volume and cost collection rules, processes for estimating and reporting costs, and a central database which holds all emerging actual data and scrutiny through the year end joint audit with Halcrow (the ORR reporters) have enhanced this process further this year.

It is becoming increasingly apparent that it will be difficult to achieve the ORR efficiency levels for track renewals, in part due to the upwards pressure on steel prices, fuel and materials. Achievement of the current year's budget will be challenging but in the longer term new technology will

Progress towards ORR's 31% target

Category	31.03.06 Actual £m	Real savings v 31.03.05	Cumulative progress
Controllable Opex	839	7%	25%
Maintenance	1,195	10%	17%*
Renewals (excluding West Coast)	2,000	6%	18%
Non-controllable Opex	298	3%	(12)%

* After accounting for the impact of traffic growth the real saving increases to 20%.

be available (eg the modular switches and crossings programme) to drive further savings.

Non-controllable Opex costs were 3% less than 2004/2005 but are currently 12% worse than the ORR determination largely as a result of the increasing costs of electricity for traction and the British Transport Police.

The overall challenge set by the ORR required Network Rail to produce efficiencies of 15% of operating costs, maintenance costs and renewals costs in the first two years of the Control Period. The current out turn based on the above results is a saving of some 20% (after taking into account the traffic growth annotated to the table). Clearly further efficiencies will be progressively harder to deliver as the cost bases contract.

The West Coast Route Modernisation project has continued to deliver its outputs on time and its impact on the travelling times on the route and the reliability and punctuality of the service are a sound justification of the significant investment involved. We are now in a position to conclude that the demanding savings in overall cost set by the ORR in the 2003 determination will not be delivered in full, but the anticipated final cost of the project of £8.1bn is a successful out turn to this critical upgrade of the network.

Carrying value of the railway network

The value of railway fixed assets has increased by £3.77bn from £22.22bn to £25.99bn. The significant revaluation in the period mainly represents the further value to the Company of the network grant deferral agreed with DfT and the ORR, which is outlined below.

Under depreciated replacement cost accounting the network is valued in the accounts at the lower of its same state replacement cost (which is estimated at circa £63bn) and its value in use. This value in use is based on a discounted future cash flow that assesses the value to the business of the net income stream produced by the railway network. This is a function of the Regulatory Asset Base (RAB) set by the ORR and, as such, this RAB is used as a proxy for that value together with appropriate adjustment for any forecast cash flow variance from the determination.

As with last year the deferred revenue grant represents a loss of income to the business this year of £2.0bn which will be recovered from 2006/07 onwards. We continue to recognise this value to Network Rail in the financial statements to reflect fairly the value in use of the railway network and also to assert our right to this economic benefit which is clearly outlined in both the ORR Access Charges Review 2003 and also in the 23 December 2003 Review Notice in respect of potential grant dilution. These documents demonstrate the ORR's intention that the deferral will be rolled up in the RAB at 31 March 2009 and, in any case, in the event of default on the repayments then Network Rail has an immediate right to raise track access charges to cover the resulting deficit. On the basis that the future income stream is secure, it remains prudent and proper to reflect the value of this economic benefit in the fixed asset valuation at 31 March 2006.

Pensions

Included within the income statement for the period is a charge of £133m in respect of pension costs of which £112m represents service costs and £21m is net interest on liabilities. The balance sheet liability, which represents the Company's share (60%) of the full deficit of the Network Rail section of the Railway Pension Scheme (RPS), fell from £414m to £359m. This is clearly a positive sign and, whilst the scheme is still in deficit, it is in better shape than many other large defined benefit schemes.

During the year under review the RPS actuary, Watson Wyatt, published its triennial actuarial funding valuation which reported an overall deficit in the scheme of £118m at 31 December 2004, of which the Company's share is some £71m. Most of the large discrepancy between these two valuations is driven by some fundamental differences in the discount rate assumptions used as International Accounting Standard 19, ('Employee Benefits'), dictates avery cautious approach in this area. The impact on contributions is still being assessed with the Scheme trustees and we are seeking to balance the needs of the RPS along with the needs of its members both in terms of contributions and benefits. There is no escaping the fact that pension schemes are becoming more expensive but the Company believes that the benefits offered to pensioners in the RPS are worthwhile. Unlike many other companies our defined benefit scheme has suffered no curtailment of benefits and remains open to new members.

Taxation

The Company recorded a taxation charge for the year of £21m compared to a credit of £18m last year. This was the result of an increase in the deferred tax provision.

Cash flow

- During the year the Company's operating activities generated cash of £655m (2004/05: £482m).
- Spending on fixed assets totalled £3.1bn (2004/05: £3.5bn) while receipts from fixed asset sales contributed £65m (2004/05: £74m).

Funding

Network Rail Infrastructure Finance PLC (NRIF), a special purpose financing company, was incorporated for the sole purpose of acting as the issuer under Network Rail's Debt Issuance Programme (DIP) and is not a member of the Network Rail group. For accounting purposes NRIF is treated as a subsidiary in the consolidated accounts of Network Rail Infrastructure Limited (NRIL).

The year ended 31 March 2006 saw the transfer of Network Rail's debt support obligations from the Strategic Rail Authority to the Secretary of State for Transport on 26 June 2005. The DIP is supported by a financial indemnity from the Secretary of State for Transport which expires in 2052. As at 31 March 2006, all Network Rail's debt (including loans from European Investment Bank and Kreditanstalt für Wiederaufbau) sits under the DIP other than £5.7bn equivalent of medium term notes which sit under Network Rail MTN Finance PLC. Within the DIP is a £20bn note programme which has been highly rated (AAA by Standard and Poors, Aaa by Moody's and AAA by Fitch).

The DIP allows access, through a single platform, to the widest possible sources of funding, at the lowest possible cost, including the long-term capital markets. This gives Network Rail a stable base for funding a continuing programme of long-term investment in the national rail network.

During the year ended 31 March 2006 £4.4bn of bonds have been issued under the DIP in a number of currencies (£ Sterling (including index linked), US Dollars, Australian Dollars, and Canadian Dollars) and in a number of maturities. All non-sterling issuance under the programme was swapped into fixed sterling interest rates as at the balance sheet date to protect against movements in interest and foreign exchange rates.

The Company had £6.75bn of undrawn committed facilities available at 31 March 2006 through the DIP working capital facility which includes the Secretary of State for Transport standby facility A (£4bn). The Secretary of State for Transport standby facility is undrawn but will only be called upon as a last resort.

Accounting policies

The financial statements have been prepared in accordance with International Financial Reporting Standards for the first time. Significant accounting policies are set out in Note 2 to the financial statements.

International financial reporting standards

The Company has a regulatory requirement to report in the manner of a listed PLC and therefore in line with all listed companies in the European Union, has adopted International Financial Reporting Standards (IFRS) with effect from 1 April 2005.

Comparative financial information in these financial statements for the year ended 31 March 2005 have been presented in accordance with IFRS with the exception of International Accounting Standard 32 (IAS 32) 'Financial Instruments: Disclosure and Presentation' and International Accounting Standard 39 (IAS 39) 'Financial Instruments: Recognition and Measurement'. The Company took advantage of the allowed exemption to exclude accounting for derivatives and hedges at fair value in the comparative IFRS year and adopted IAS 32 and IAS 39 in full from 1 April 2005.

The Company completed a project during the year to ensure full compliance with IFRS was achieved. Restated IFRS balance sheets and reconciliations of equity as at 1 April 2004 and 31 March 2005, and a restated income statement for the year ended 31 March 2005 were published on the Company's website in August 2005. The interim financial information for the six months ended 30 September 2005 was the first to be presented under IFRS.

Financial instruments

Adoption of IAS 32 and IAS 39 in full has resulted in recognition of derivative balances on the balance sheet at fair value. Movements in fair value on instruments that qualify for cash flow hedge accounting under IAS 39 are recognised directly in equity to the extent the hedging is effective for accounting purposes. Instruments not qualifying for hedge accounting and ineffective portions of hedge relationships are recorded in the income statement. The Group has successfully implemented hedge accounting for its Medium Term Note and Debt Issuance Programme bonds. The net fair value of derivatives on the Group's balance sheet at 31 March 2006 was an asset of £68m based on a notional value of swaps of £9.8bn. The net impact on the Group's income statement of IAS 32 and IAS 39 in the year ended 31 March 2006 was an expense of £10m.

Treasury operations

The Group's treasury operations are co-ordinated and managed in accordance with policies and procedures approved by the Board. Treasury is subject to regular internal audits and does not engage in trades of a speculative nature.

Group policy is to ensure that there are sufficient committed bank facilities and short-term investments to cover, as a minimum, the next 12 months' funding requirements.

The major financing risks that the Group faces are its interest rate fluctuation risk and liquidity risk. Treasury ensures sufficient liquidity is available to meet the Group's needs, while reducing financial risks and prudently maximising interest receivable on surplus cash.

Counterparty limits are set with reference to published credit ratings. These limits dictate how much and for how long Treasury may deal with each counterparty and are monitored on a regular basis.

The Group's primary liquidity is provided by committed bank facilities. At 31 March 2006, the Group had £2.75bn in undrawn committed Bank facilities.

Summary

This has been another year of considerable progress and achievement where financial stability and efficiency through strong budgetary and investment control and planning has been continued. Now that the deferral of network grant has ceased the Company will receive the full annual payment of grant to which the ORR determined we were entitled and enabling the Company to record both operating and retained profits for the remainder of the Control Period. It is encouraging that last year's solid beginning to the Control Period has been built upon and that further efficiencies are planned. It is this sound progress that we are committed to drive further, to deliver the business plan efficiencies for this Control Period and to secure the long term viability, reliability and demonstrable value for money of our railway.

Ronald Henderson

Ron Henderson
Group Finance Director
25 May 2006

Financial stability and efficiency through strong budgetary and investment control and planning has been continued.

Directors' report

Under its network licence the Company is required to publish such corporate governance information as would be required if it were a listed company and also to comply with the principles of good governance and code of best practice under, or approved for the purposes of, the listing rules of the Financial Services Authority.

Business review and principal activities

Network Rail Infrastructure Limited has responsibility for the management of the national rail infrastructure. Its principal activities are the operation, maintenance, renewal and, in co-operation with train operators and funders, the development or enhancement of the national rail network and in particular:

- Provision to train operators of railway track access.
- Management of train timetabling, train planning and signalling.
- Maintenance, renewal and enhancement of the infrastructure and undertaking major capital programmes.

In June 2005 the relevant provisions of the Railways Act 2005 came into force facilitating a number of significant changes to the structure and organisation of the railway. These included giving Network Rail additional responsibilities for industry performance, planning and projects. The changes are designed to deliver improvements in reliability and the effectiveness of industry planning, building on the already close collaboration between Network Rail and train operators. Further details of the changes are set out in Network Rail's Business Plan 2006 which can be found at www.networkrail.co.uk.

Route Utilisation Strategies (RUSs) take a strategic look at the rail network and its timetable. They form the analytical and consultation process by which options are evaluated to balance capacity, passenger and freight demand, operational performance and cost.

The Cross London RUS consultation document was published in November 2005, followed by the final South West mainline RUS in March 2006. There are a number of other RUSs underway that have yet to reach the consultation stage.

Significant events subsequent to 31 March 2006

On 4 April 2006 Network Rail launched its Business Plan 2006 articulating the priorities for Network Rail over the current regulatory Control Period.

Details of the Company's business activities, key events and changes during the year and likely future developments are contained in the Chairman's statement, the Chief Executive's review and the Group Finance Director's review. This report should also be read in conjunction with the Corporate Governance Report and the Directors' Remuneration Report.

Results

The loss before tax was £232m (2004/05: loss of £47m) and the loss after tax was £253m (2004/05: loss of £29m). Further details of the financial results can be found in the financial statements commencing on page 31.

Share capital

50,084,937 ordinary shares of 0.1p and 160,000,000 redeemable shares of £1 of the Company are held by its immediate parent company Network Rail Holdco Limited.

Key future issues

Network Rail's key priority is to deliver a safe, reliable and efficient railway working with our industry partners to provide acceptable and improving levels of performance. Looking forward it intends to achieve further sustainable improvements for its customers, employees and wider stakeholders as well as seeking ways to meet where possible the increases in demand for both passenger and freight traffic.

With its responsibilities relating to the national rail network (including the additional responsibilities for industry performance, planning and projects placed upon it as a consequence of the 2004 Rail Review) Network Rail has a pivotal role in a complex industry. The way in which it looks after its assets affects a wide range of people and Network Rail works collaboratively with its customers and funders to facilitate the delivery of their plans. It needs also to work with its wider stakeholders to take account, where possible, of the wider social impacts of the operation of the national rail infrastructure.

Of the issues facing Network Rail in the future the following are key to the deliverability of its objectives:

Safety

Steady improvement has been made over the past three years in most of the key safety performance indicators. Two areas where improvement continues to be a key objective are workforce and level crossing safety.

The most significant component of Network Rail's strategy to deliver a step change in safety performance is the 'Safety in the Line' programme designed to embed safety accountability improvements and decision-making more fully into the key delivery functions within the Company. A change programme to support this is being implemented over the next 18 months. Safety awareness campaigns are also focusing on raising the profile of safety within local workforce teams as are other initiatives designed to develop safety cultural and behavioural changes including by railway contractors.

Additional level crossing risk reduction initiatives are currently being developed for implementation in 2006 including the evaluation of new detection technologies, new road safety legislation and public awareness campaigns on the use of level crossings. Work will also continue to seek future improvement of safety in this area.

Following the July 2005 terrorist attacks on the transport system in London, Network Rail continues to work closely with the British Transport Police, Department for Transport, and Transport Scotland as well as with train operators and Transport for London to improve security measures on the mainline railway system.

Service reliability

Network Rail's performance improvement plans focus on greater co-operative rail industry working, the development of robust timetables, improved performance management and better operational support systems and processes. Actions are being taken in many areas aimed at developing these. Relationships between Network Rail and its employees as well as with other rail industry stakeholders remain key to the success of delivery.

There is also expected to be an increase in demand for both passenger and freight traffic. With increased road congestion the role of rail in providing sustainable national and regional transport strategies is becoming increasingly important. In common with other key transport modes, rail already suffers from scarce capacity and a key issue will be Network Rail's ability to accommodate demand. Understanding the future demand for rail is important to the Company's work with government and the rest of the rail industry to develop the railway.

Increase in demand for, and supply of, train services has led to a more intensively used rail network. This increased utilisation will impact on operational performance and on the cost of running, maintaining and renewing the railway infrastructure. Reliability is also brought under greater pressure with increased utilisation. Despite this, reliability as measured in delay minutes has improved since 2000/01. A careful balance has to be struck between making the network available for carrying traffic and needing to maintain and renew the infrastructure in the most efficient and cost effective way.

Asset stewardship

One of the major components of Network Rail's improvement plans is reliability and long term sustainability of the network. This requires successful delivery of Network Rail's asset management responsibilities within the constraints of the available funds as well as being consistent with the reasonable requirements of its stakeholders. Development and implementation of the asset management activities involves comprehensive understanding of the criteria and systematic organisation in their delivery. Key areas being addressed aimed at achieving this are the establishment of route specifications, asset policies that deliver these specifications and the supporting information that underpins this process. These asset policies will provide an important input into Network Rail's submissions for the next regulatory periodic review that determines Network Rail's regulated income set by the Office of Rail Regulation (ORR) which concludes in 2008 ('the 2008 Periodic Review').

Cost efficiency

Good progress has been made in delivering efficiency savings but work continues to identify further opportunities across the business. In 2006/07 it is anticipated that Network Rail will be able to reduce its controllable operating costs by a further £27m. By the end of the current Control Period, it is planned that total costs will be £330m less than the amount allowed by the ORR in its last review. Delivery of these savings requires, however, development of further plans for more radical solutions in the business which remains a major challenge. Maintenance costs have been reduced whilst improving performance levels despite the increase in volume of traffic. Plans are for further reductions, with 2006/07 identified as benefiting from a reduction by another £58m, after including an allowance of £10m for the impact of increased traffic.

Planned expenditure on renewals continues to increase, in particular, in the level of signalling and civils renewal work. Much of the increase will come from a number of major projects which have been in development and are now moving into implementation. However Network Rail continues to focus on getting the correct specification for these and on efficient delivery. As a result it is possible that the planned underlying increase in renewals may not be achieved. Moreover the renewals plans may be subject to revision in light of emerging requirements for delivery of spectator transport for the 2012 Olympic Games and Paralympic Games.

One project, West Coast Route Modernisation, is of particular importance given its size and planned completion in 2008. Substantial ongoing renewals will be required on this route. The resources to deliver all of the works specified – for example contractor capacity, access, haulage and materials – are expected to be available. However the resource requirement plans, national core renewals plans and industry resource availability will be reviewed regularly to gauge the ongoing sustainability of the plan. Considerable progress has been made in achieving the regulatory efficiencies assumed in the Access Charges Review in 2003 (ACR2003) with the result that the original programme is broadly on target for the end of the Control Period but there is no contingency in these plans. The scale of the challenge has been increased further as a result of modifications to the outputs required, engineering scope of works and pressure to reduce disruptive access. The projected costs of the currently proposed works is now £246m (seven per cent) above the amount provided for in the ACR2003. Additional efficiencies will be targeted, but it is not likely that these will address fully certain shortfalls identified.

Non-controllable operating costs will increase. Of these it is anticipated that the cost of purchase of electricity to Network Rail and the train operators will increase significantly over the remainder of the Control Period. In addition, increased costs of economic and safety regulation are anticipated. Other non-controllable costs include Network Rail's contribution to the funding of Railway Safety Standards Board (RSSB) and British Transport Police.

Under the regulatory framework there is a system of penalty payments made between Network Rail and the train operators known as Schedule 4 and Schedule 8 payments. These are payments made by the party causing delays on the network. The Company forecasts that it will be receiving Schedule 8 payments for the remainder of this Control Period (i.e. to 2008/09) and that there will be an increase in Schedule 4 payments made to train operators for possessions due to changes in the Schedule 8 regime.

Funding and financing

Network Rail's income comprises principally fixed track access charges and variable usage charges paid by train operators for their use of the infrastructure, together with network grants. These charges are subject to variation. In 2006/07 Network Rail's income is expected to increase by £1.9bn, mainly reflecting the increase in fixed track access charges and network grants with a further possible increase likely through track access agreement renegotiation with one train operator. The variable usage charges will be higher by £165m than the access charges review for Control Period 3 due to projected traffic increases and changes in the mix of train types. These increases will be partly offset however by additional maintenance and renewals costs resulting from the increased traffic.

Network Rail's net debt was £18.2bn at 31 March 2006 and is forecast to increase to over £19bn by March 2007 and nearly £21bn by March 2009. This is less than forecast at the time of the last access charges review.

It is anticipated that between £3bn and £5bn will need to be raised over the next three years through a combination of public and private bonds to cover the refinancing of existing debt as well as funding working capital. This is currently expected to be the cheapest form of finance available to Network Rail and there is expected to be sufficient market capacity. Hedging arrangements have been put in place to fix the Company's interest costs. Further details of funding arrangements are set out in the financial statements on pages 45 to 47.

In readiness for the 2008 Periodic Review, Network Rail is already working closely with the ORR, Department for Transport and Transport Scotland with the aim of ensuring that there is a common understanding of the processes, activities and timescales that must be met.

Performance indicators

The ORR sets certain regulatory financial and non-financial performance targets for Network Rail. The key performance indicators (KPIs) are summarised in the table below. Further details can be found in the narrative below the tables and also more information is contained in the Business Plan 2006.

Safety

Steady progress has been made in most of the key safety performance indicators as shown below.

Regrettably last year saw a number of work-force and level crossing related fatalities and these are two areas where improvement is a key objective.

Network Rail is working currently with Rail Safety & Standards Board (RSSB) to develop a new safety risk measure.

Train performance

There are two measures relating to train performance – Train Delay Minutes being the number of minutes of train delays attributable to Network Rail and Public Performance Measure (PPM) being the percentage of trains arriving on time at their final destination.

Train punctuality is steadily improving and in collaboration with train operators Network Rail is working hard to continue this trend.

Delay minutes are down more than 8% compared to last year and this is reflected in PPM which has improved by around 2.8% compared with last year. The year end target (March 2006) was achieved in September 2005 and at year end, punctuality was at its highest for six years. In 2003 the ORR set a target for the Company to improve the reliability of the network by more than 30% by 2008/09. Looking forward the Company hasset itself a target to beat that set by the ORR by 600,000 minutes by the end of the Control Period.

Asset stewardship

The Asset Stewardship Incentive Index, which is the measure of the overall condition of the rail network, has improved on last year by 11%. The number of broken rails was at the lowest recorded level and the number of temporary speed restrictions shows a similar margin of improvement compared to last year.

Financial efficiency

The Financial Efficiency Index (FEI) is a measure of how efficiently Network Rail spends on operations, maintenance and track renewals. As efficiency improves the Company should spend less to deliver the same outputs and therefore the FEI should reduce. As Network Rail gains more reliable data the FEI will be reviewed to identify whether it can be extended to cover renewals of other assets.

Business performance

Network Rail believes that business performance improvement is dependent in part on the development of key skills and behaviours of employees. To improve these investment is being made in a range of programmes.

To measure progress in behaviours an employee engagement survey has been developed. This survey is conducted each year, the most recent being in December 2005.

The results of this latest survey showed improvement in employee engagement against the previous results although the improvement between last year's and this year's survey was less than targeted. Further improvement is now being sought with a programme of communication of the results of the survey together with training and action plans to increase employee engagement. The next survey is scheduled to be conducted in December 2006 with further surveys planned for subsequent years.

Health and safety

The health and safety of the Company's employees, whilst working within the business, and the public, whilst travelling on the railway infrastructure, are of great importance to Network Rail. The Company's policies and procedures relating to health and safety at work recognise the

Performance indicators	Notes	2005/06	2004/05	2003/04
Improving safety				
Public Safety Index	1	0.543*	0.503**	0.573
Higher performance				
Train Delay Minutes ('000 mins.)	2	10.50	11.46	13.72
Public Performance Measure	3	86.4%	83.6%	81.2%
Improved asset stewardship				
Asset Stewardship Incentive Index***	4	0.80	0.90	1.09
Improved financial control				
Financial Efficiency Index***	5	1,972	2,144	2,314

1 In 2005/06 RSSB changed the method of calculation of the Public Safety Index. The figures quoted for 2005/06 are based on the new calculation and are therefore not comparable with those shown for 2003/04 and 2004/05.

2 Train Delay Minutes are the number of minutes of train delays attributable to Network Rail (rather than the train operating companies) as defined in the contractual performance regime with operators.

3 Public Performance Measure is the overall rail industry key performance indicator measuring punctuality and reliability of train performance. It shows the percentage of trains that arrive 'on time' at their final destination compared to the number of trains planned to run on a given day. 'On time' means arrival within 10 minutes of the planned destination time for long distance operators and within 5 minutes for London and south east or regional operators.

4 Asset Stewardship Incentive Index is an index proposed by the ORR in its December 2003 access charges review. The components of this index and weightings are: track geometry index (20%), number of broken rails (15%), Level 2 exceedences (15%), total number of signalling failures (15%), wrong side signalling failures – hazard rating 20 or above (15%), structure and earthworks train speed restrictions (10%), and traction power supply failures AC and DC (10%).

5 Financial Efficiency Index is a measure of the efficiency of operations, maintenance, track renewals and other key central expenditure.

* To 31 December 2005.

**To 31 December 2004.

*** A lower figure represents an improvement.

Safety indicators	2005/06	2004/05	2003/04
Workforce fatalities	4	2	8
Severe Category A SPADs*	98	131	148
Broken rails	317	322	334
Collisions at level crossings	15	17	17
Significant train accidents	24	41	35
Passenger accidental fatalities**	3	9	7

* SPAD = signal passed at danger.

**Five of the passenger fatalities in 2004/05 and none in 2005/06 were caused by train accidents.

requirements of current legislation and are kept under constant review with the aim of providing a safe working environment for all employees. Significant resource is committed to safety, health and environmental matters and Network Rail aspires to continuing improvement of its performance in these areas. Further details of safety performance is set out on pages 10 and 12 as well as in the Chief Executive's Review on pages 4 and 5.

Previous incidents

In relation to the Hatfield derailment in October 2000 charges against one former and one then current director, one senior manager and the manslaughter charges against the Company were dismissed in October 2004. The remaining manslaughter charges against four other senior managers were subsequently dismissed in the course of the trial heard in 2005. The jury also acquitted these managers of the outstanding health and safety charges whilst convicting the Company of one health and safety charge. The Company was fined £3.5m (plus £300,000 costs) in October 2005. In December 2005 a health and safety charge was laid against the Company in relation to the Ladbroke Grove collision in October 1999. These proceedings are ongoing. The derailment which took place at Potters Bar in May 2002 is the subject of continuing HMRI investigations; the outcome is unknown at present.

Corporate social responsibility

Network Rail is committed to carrying out its activities in a socially responsible manner in respect of customers, stakeholders, employees and local communities. As part of its objective of operating in a transparent and accountable environment, a report on these aspects within its business was published in June 2005 and a further report will be published in the summer of 2006.

Code of business conduct

The Company has adopted a code of business conduct that is applicable to all employees.

Research and development

During the year the Group charged to the profit and loss account £2m (2004/05: £3m) on research and development. Other costs relating to significant development work have been capitalised in tangible fixed assets.

Directors and their interests

The present Directors and brief biographical details can be found on page 15.
Ian Buchan was appointed to the Board as a Non-Executive Director on 5 February 2006. Under the provisions of the Articles of Association of the Company the Directors are not subject to the requirement of retirement by rotation (as required under the Code) due to it being a wholly-owned subsidiary of Network Rail Limited. Under the provisions of the Articles of Association of Network Rail Limited, however, all Directors, except the Special Director (if appointed – there being no Special Director at the time of publication of this report), must retire by rotation, and may stand (together with any new Director appointed since the last general meeting) for re-election by the Members of that Company at least every three years. In common with the other members of the Board of the Company, Ian Buchan is also a Director of Network Rail Infrastructure Limited. He will be seeking election by the Members of Network Rail Limited at the 2006 AGM.

During the year Ross Sayers was also a non-executive director and the senior independent director until his sad death on 25 November 2005.

There were no other changes to the Board during the year.

Directors' interests

The Directors have no interest in the shares of the Company or any other Group company.

Employees

Details of the number of employees and related costs are set out in Note 8 to the financial statement on page 39.

Network Rail recognises the role of its employees in enabling the Group to achieve its business objectives. This is reflected in the Board's commitment to equal opportunities and effective employee communications.

Network Rail believes that success in achieving its objectives is influenced significantly by the skills, behaviour and attitude of its employees. Substantial investment is being dedicated by the Company to deliver high quality, accredited training and development programmes as a primary means of stimulating cultural change and management competence. Apprenticeship schemes through to leadership development programmes are being implemented.

Effective communication in raising the level of employee engagement is also important. To do this a wide range of communications media is being used, encompassing local information cascades and briefings, videos, the Company newspaper, email news bulletins, electronic data links and road shows by the Directors to reach all our employees. During the Employee Briefings road shows conducted in January 2006 over 11,000 of the workforce were able to attend the geographically spread briefings at which key messages on performance and safety were delivered and employees had the opportunity to question the Executive Directors and Chairman on any aspect of the business that they chose to raise. As reported earlier to monitor our progress we conduct an annual survey of employee engagement with an active follow-up programme to address practical issues.

The Directors of the Company were appointed on the following dates:

Current Directors

Name	Position	Date of first appointment	Next re-election
Ian McAllister	Chairman	22 March 2002	July 2006
John Armitt	Chief Executive	3 October 2002	July 2006
Iain Coucher	Deputy Chief Executive	22 March 2002	July 2006
Peter Henderson	Projects and Engineering Director	1 October 2002	July 2007
Ron Henderson	Group Finance Director	12 August 2002	July 2008
David Bailey	Non-Executive Director	15 August 2002	July 2008
Rob den Besten	Non-Executive Director	24 September 2003	July 2007
Ian Buchan	Non-Executive Director	5 February 2006	July 2006
Yvonne Constance	Non-Executive Director	1 May 2005	July 2008
Jim Cornell	Non-Executive Director	3 October 2002	July 2006
Michael Firth	Non-Executive Director	4 December 2004	July 2008
Christopher Green	Non-Executive Director	26 June 2005	July 2008
Charles Hoppe	Non-Executive Director	1 August 2002	July 2006

There is also a strong belief by the Board of the Company in the importance of consultation on issues affecting the workforce. Frequent consultation and information sharing is conducted therefore at regular intervals through both national and local procedures with representatives from Network Rail and trades unions.

Our equal opportunities policy is communicated to employees. We are committed to offering our employees a fulfilling and challenging career in an environment free from discrimination, harassment, victimisation and bullying. Network Rail continues to work with trades unions in the area of equality of opportunity and development of policy to promote best practice within the business.

Employee review processes are in place to allow every individual manager to discuss key performance issues in a structured, fair and consistent way and to identify training and development needs.

Contributions for political and charitable purposes

During the year the Company donated £480,000 to charitable organisations (2004/05: £448,000). A further £406,000 (2004/05: £639,000) was used to sponsor charitable and community-related activities. No political donations were made in either year.

At the Annual General Meetings of Network Rail Limited (being the ultimate parent of the Company) in 2004 and 2005 Members gave authority for the Group to incur political expenditure and make political donations up to a maximum aggregate sum of £400,000 for each of those years as a precautionary measure in light of the wide definition in The Political Parties, Elections and Referendums Act 2000. These authorities have only been used to support Network Rail's programme of work with all types of community representatives. This includes the significant amount of contact Network Rail has with a wide range of elected representatives (Members of Parliament, Members of the Scottish Parliament, members of the Greater London Authority, members of the Welsh Assembly, regional assemblies, local councils and others) as well as non-governmental organisations, pressure groups and campaigning organisations. This programme includes meetings to discuss issues facing Network Rail and those using the railways, both passengers and freight customers nationally and regionally.

Opportunity is also taken each year to explain to elected representatives our business plans, our performance and significant developments within the business. In addition this covers the cost of full-time trade union representatives.

Creditors payment policy

It is our policy, with respect to payment of our suppliers, to settle the terms of payment when agreeing the terms of each transaction where standard terms are not used, to ensure that suppliers are made aware of the terms of payment and to abide by the terms of payment.

At 31 March 2006 the Group's creditor days compared with the value of suppliers' invoices received in the year was 49 days (2004/05: 59).

Annual General Meeting

Network Rail Limited, as the ultimate parent company of Network Rail Infrastructure Limited, will be holding its Annual General Meeting on 19 July 2006. Notice of that meeting will be sent to Members.

Auditors

At the next Annual General Meeting of Network Rail Limited, which will be held on 19 July 2006, a resolution will be proposed to reappoint Deloitte & Touche LLP as the Group's auditors and to authorise the Directors to fix their remuneration. Details of the fees earned by Deloitte & Touche LLP during the period, for both audit and non-audit work, are set out in Note 7 on page 38.

The Directors confirm that, so far as they are aware, there is no relevant audit information of which the Company's auditors are unaware and that the Directors have taken all responsible steps in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

By order of the Board

H Walker

Hazel Walker
Secretary
25 May 2006

Board of Directors

John Armitt CBE
Chief Executive (3, 5 & 6)*
John Armitt, 60, is the Chief Executive of Network Rail. A civil engineer by training, he was previously Chief Executive of Costain Group PLC, and before that Chief Executive of Union Railways.

David Bailey OBE
Non-Executive Director (1, 2, 4 & 5)*
David Bailey, 66, was the Strategic Rail Authority's Non-Executive Director on the Network Rail Board. He was formerly Commercial Director for London Transport, having previously held various director-level roles within London Underground.

Rob den Besten
Non-Executive Director (1 & 2)*
Rob den Besten, 65, joined the Board on 24 September 2003 having previously been President and Chief Executive Officer of Netherlands Railways, President and CEO of Amsterdam Airport Schiphol, Permanent Secretary of the Ministry of Transport and Public Works and Managing Director of the Rotterdam Municipal Transport Corporation.

Ian Buchan
Non-Executive Director (2)*
Ian Buchan, 59, joined the Board on 5 February 2006 having recently been Chief Executive of National Express's trains division. He was previously Business Development Director at FirstGroup. He is a director of Manchester School of Flying.

Yvonne Constance OBE
Non-Executive Director (1 & 2)*
Yvonne Constance, 63, joined the Board on 1 May 2005 having previously been Chairman of the National Electricity Consumers' Council between 1995 and 1999, a Non-Executive Director of Innogy plc from 2000 to 2002 and a Non-Executive Director of St Mary's Hospital NHS Trust. Since 2000 she has also been a member of the Greater London Magistrates' Courts' Authority, as well as being a Justice of the Peace since 1976 and, in the 1980s, practised as a barrister.

Jim Cornell
Non-Executive Director (2, 4 & 5)*
Jim Cornell, 66, joined British Rail (BR) in 1959 as a student civil engineer before taking up various positions in BR including latterly Group Managing Director of British Rail Infrastructure Services between 1993 and 1996. He is also Executive Director of the Railway Heritage Trust. He was appointed the Senior Independent Non-Executive Director of Network Rail in January 2006.

Iain Coucher
Deputy Chief Executive (3)*
Iain Coucher, 44, is Deputy Chief Executive with responsibility for operational matters. Previously, he was Chief Executive of Tube Lines. For 16 years, he worked for EDS and for three years was seconded to TranSys as Chief Executive.

Michael Firth
Non-Executive Director (1, 2 & 6)*
Michael Firth, 63, joined the Board on 4 December 2004 having previously been Head of Corporate Banking at HSBC Bank plc until his retirement in September 2002. He is also a Non-Executive Director of Communisis plc and was previously a Non-Executive Director of Somerfield plc and a director of First Technology PLC.

Christopher Green
Non-Executive Director (2 & 5)*
Christopher Green, 62, joined the Board on 26 June 2005 following his retirement as Chairman of Virgin Rail Group. Having joined British Rail upon leaving university Christopher held various management positions including Managing Director of Intercity. He was Chief Executive of Virgin Trains from 1999 to 2004.

Peter Henderson
Projects and Engineering Director (3)*
Peter Henderson, 52, is Network Rail's Projects and Engineering Director. Peter has over 20 years' rail experience, most recently at Bechtel where he was Projects Director, Rail, which included responsibility for engineering. He spent 16 years with the Hong Kong Mass Transit Railway Corporation, latterly as Head of Major Projects.

Ron Henderson
Group Finance Director (3 & 6)*
Ron Henderson, 60, was formerly Group Finance Director of BICC plc, Finance Director of Balfour Beatty, and most recently Chief Executive of Tuberail.

Charles Hoppe
Non-Executive Director (2 & 5)*
Charles Hoppe, 71, is the former Vice President, Operations and Facilities Planning, United States Railway Association, Senior Vice President of Booz, Allen & Hamilton's worldwide rail consulting practice and President of the Long Island Rail Road.

Ian McAllister CBE
Chairman (2 & 4)*
Ian McAllister, 62, is the Company's Non-Executive Chairman having previously been Chairman and Managing Director of Ford Motor Company Limited. Ian is also Chairman of the Carbon Trust and Senior Independent Non-Executive Director of Scottish & Newcastle plc.

* Numbers against Directors' names indicate the committees of the Board on which each of them serves as follows:

1 Audit Committee
2 Remuneration Committee
3 Executive Committee
4 Nominations Committee
5 Safety, Health and Environment Committee
6 Treasury Committee

Directors' remuneration report

The following report has been prepared in accordance with the Directors' Remuneration Report Regulations 2002 (the Regulations) and the Revised Combined Code issued in July 2003 (as amended with effect on 1 July 2005).

The Remuneration Committee

Given the importance of remuneration and incentivisation to the business the Remuneration Committee comprises all of the Company's Non-Executive Directors including the Chairman of Network Rail. The Committee members are:

Jim Cornell – Chairman of the Committee
David Bailey
Rob den Besten
Ian Buchan*
Yvonne Constance**
Michael Firth
Christopher Green***
Charles Hoppe
Ian McAllister

* Joined the Committee in February 2006.
** Joined the Committee in May 2005.
*** Joined the Committee in June 2005.

Ross Sayers was a member of the Committee until his sad death on 25 November 2005.

The Group Company Secretary is the secretary to the Committee.

The Committee is required under its terms of reference to meet at least once a year and during the year 2005/06 it met six times, primarily due to the need to consider in depth the terms of the incentive arrangements for 2006/07.

The Committee is responsible for determining all matters concerning the remuneration and incentivisation of the Executive Directors of the Company. This includes making decisions in respect of the framework of the Executive Directors' remuneration and its cost as well as determining, on behalf of the Board, specific remuneration packages for each of the Executive Directors. It decides the remuneration package for the Chairman without the Chairman being present. It also decides upon the form and content of the Executive Directors' Management Incentive Plan (MIP) for each financial year (within the terms of the Incentive Policy).

Additionally the Committee determines the framework of certain senior executive employees' remuneration as well as the form and content of their MIP.

The full terms of reference of the Committee are available on request and can be found on the Network Rail website www.networkrail.co.uk.

During the year the Committee's activities included:

- Finalising the MIP 2005/06.
- Preparing the MIP 2006/07.
- Reviewing the benchmarking of basic salaries.
- Reviewing the Company's pensions policy in the light of the new simplified tax regime effective from 6 April 2006.

The Committee commissioned New Bridge Street Consultants LLP to provide independent expert advice on the management incentive schemes and remuneration generally. New Bridge Street do not provide other services to Network Rail.

During 2005/06 Mercers Human Resources Consulting Limited advised the Company in respect of pension related matters included in the remuneration policies. Mercers' mandate to provide the Remuneration Committee and the Company with pensions consulting advice has ceased, with effect from 6 April 2006. Future advice on pension matters will be provided by Watson Wyatt Limited.

The Chief Executive and the Human Resources Director also attend Remuneration Committee meetings by invitation and assist the Committee in its considerations but do not participate in discussions or decisions relating to their own remuneration. The Human Resources Director is responsible for employees within Network Rail and is not a Board Director nor is he appointed by the Committee.

Directors' remuneration policy

The Company has a network licence condition requirement to have a MIP for its Executive Directors and senior executives and for that plan to be cascaded throughout Network Rail.

Under this condition Network Rail is required, when formulating its MIP, to have particular regard to:

- Securing the operation and maintenance, renewal and replacement, improvement, enhancement and development of the network especially operational performance, asset serviceability and condition, efficiency, economy and safety.
- Infringement by Network Rail of any access contracts and safety factors.
- Achievement of the licence requirement of dealing with dependent persons with due efficiency and economy and in a timely manner and compliance with Network Rail's Code of Practice for dealings with dependent persons.
- The extent to which Network Rail is subject to orders and to statements by the Office of Rail Regulation (ORR) on non-compliance with the licence.

The ORR may also specify other objectives in connection with the MIP.

Taking into account these regulatory requirements the Committee has formulated Network Rail's remuneration strategy to attract and retain competent individuals and to create the potential to reward outstanding performance at a competitive market rate based on individual contribution and the overall success of Network Rail in meeting the objectives of the Business Plan.

These principles are reflected in the terms of the Management Incentive Policy which can be modified only with the consent of the ORR. Under this policy the objectives and principles are to:

- Provide strong incentives to deliver the actions and objectives specified in the Business Plan.
- Identify specific accountability for the achievement of the actions and objectives laid out in the Business Plan.
- Enable Network Rail to recruit, retain and motivate individuals with the right skills, knowledge, experience and competencies.
- Draw on best practice for listed companies in the UK where appropriate given the unique mission and structure of Network Rail.
- Recognise that Network Rail Limited is accountable for the public interest as a

monopoly owner and operator of an asset of considerable public importance.
- Recognise that Network Rail Limited is a company limited by guarantee founded on a 'not-for-dividend' principle.
- Reflect the fact that the Company is unable to offer the traditional benefits of UK listed companies including stock options and other profit-share mechanisms.

These are structured within a total remuneration approach, defined as the sum of base salary, incentives and benefits. The use of variable pay through the availability of incentives to form a significant part of total remuneration is intended to ensure that each individual's reward is clearly linked to the successful delivery of Company objectives.

Account is taken of information from internal and independent sources on the remuneration for comparable positions in relevant regulated and unregulated companies. The strategy for Executive Directors' pay is for base salaries broadly to reflect the relevant market median, for benefits such as car allowances and medical insurance to reflect market practice, for pensions to reflect the rail industry practice and for total direct compensation (i.e. base salary and incentives) to be broadly competitive in the appropriate marketplace, provided always that performance justifies the amount. This strategy is consistent with the Company's belief that performance should determine a sizeable proportion of the total remuneration package for Executive Directors.

Through the following means the Company ensured that there was suitable transparency as to the principles upon which remuneration of the Directors of the Company has been set during the year:
- Publication in May 2005 of a statement detailing the contents of the Executive Directors' MIP 2005/06 (pursuant to the terms of the Company's network licence).
- Debate at the Annual General Meeting of Network Rail Limited held in July 2005 over a resolution put by a group of Members relating to the MIP awards made for 2004/05.

Additionally in June 2006 the Company will publish a statement detailing the contents of the Executive Directors' MIP 2006/07 (pursuant to the terms of the Company's network licence).

Executive Directors' reward package

The current package for Executive Directors under their service agreements comprises the following elements:

Base salary

This is a fixed cash sum payable over 13 periods during the financial year. The Committee reviews salaries annually as part of the total reward package recognising market levels and personal contribution. The aim is to ensure that salaries are competitively set at broadly median levels in relation to similar roles in appropriate regulated companies and companies within the FTSE.

Current salaries for the Executive Directors, following the most recent salary review effective from 1 July 2005 are:

Executive Directors	Annual base salary as at 31 March 2006 £
John Armitt	504,000
Iain Coucher	450,000
Peter Henderson	335,750
Ron Henderson	335,750

Incentive arrangements

The purpose of the MIP is to place additional emphasis on the delivery of the objectives of the Business Plan.

MIP 2005/06 – annual incentive

As detailed in last year's Annual Report, the annual bonus for 2005/06 was to be calculated measuring actual Company performance against the three equally-weighted targets set in the MIP 2005/06. These were Train Delay Minutes, Asset Stewardship Incentive Index (ASII) and Financial Efficiency Index (FEI). For each measure a target level and maximum level of achievement was set, with the maximum level representing at least the achievement of the 2006/07 Business Plan a year early.

Achievement between the target level and maximum was calculated on a 'straight line' basis. For the year 2005/06, all three measures achieved at least target level, as outlined below.

Train Delay Minutes are the number of minutes of train delays attributable to Network Rail (rather than the train operating companies) as defined in the contractual performance regime with operators.

The following level of bonuses thus became payable under the terms of the MIP 2005/06:
- In respect of Train Delay Minutes, the target figure was 10,596m minutes with a maximum target of 9.8m minutes. The actual result was 10.496m minutes, producing a payment of 11.26% salary for this element.
- In respect of ASII the target was 0.85 with a maximum target of 0.81. The actual result was 0.803, producing a payment of 20% of salary for this element.
- In respect of FEI the target level of achievement was 2,037 with a maximum target of 1,936. The actual result of 1,972 produced a payment of 16.4% of salary for this element.

The resultant total potential award was 47.40% of basic salary. In accordance with the terms of the MIP, the Committee then considered whether to use its discretion by reducing the overall bonus award for the Executive Directors having regard to the requirements of Network Rail's network licence especially in relation to non-compliance with the network licence. After due consideration the Committee concluded that there were no issues for which the calculated incentive payments should be reduced; it was felt that the incentive payments were appropriate recognition for the excellent year of progress.

Details of the bonus payments awarded to each Director are detailed on page 21.

MIP 2006/07 – annual incentive

Participants under the MIP 2006/07 are eligible to receive bonuses based on demanding business performance measures and targets. The MIP 2006/07 uses key performance indicators (KPIs) based upon those contained in the Business Plan 2006 but in certain respects more stretching as objectives.

The business and individual performance measures relate directly to the objectives set out by the ORR in paragraph 3 of Condition 28 of Network Rail's network licence (including the achievement of the purpose of Condition 7 (stewardship) and Condition 25 (code of practice on dealing with dependent persons)), compliance with other licence conditions and with conditions of access agreements.

Business performance measures

The amount payable to Executive Directors is calculated by reference to performance against similar output measures to those used in the 2005/06 MIP:

Reliability (weight one-third) – this is the key modification to the output measures for 2006/07 being the replacement of Train Delay Minutes by a 'Reliability Index' as the appropriate measure of operational performance. Train Delay Minutes had previously been used as the appropriate measure of operational efficiency for inclusion in the annual incentive. The Public Performance Measure (PPM) was used as one of the two key measures in the long-term incentive.

PPM is the overall rail industry key performance indicator measuring punctuality and reliability of train performance. It shows the percentage of trains that arrive 'on time' at their final destination compared to the number of trains planned to run on a given day. 'On time' means arrival within ten minutes of the planned destination time for long distance operators and within five minutes for London and south east or regional operators.

Following consultation with passenger and freight train operators, it has been decided to change the operational efficiency measure to a 'reliability index'. This differs from the previous operational measure in two key respects:

- It reflects both Train Delay Minutes and PPM (weighted two thirds/one-third).
- For Train Delay Minutes this is expressed as an index per 100 train kilometres, to ensure that the impact of the volume of trains is correctly reflected.

This new reliability index is felt to be a more appropriate measure of continuous improvement in train punctuality.

Financial Efficiency Index (weight one-third) – this is a measure of the efficiency of operations, maintenance, track renewals and other key central expenditure.

Asset Stewardship Incentive Index (weight one-third) – this is an index proposed by the ORR in its December 2003 access charges review. The components of this index and weightings are: track geometry index (20%), number of broken rails (15%), Level 2 exceedences (15%), total number of signalling failures (15%), wrong side signalling failures – hazard rating 20 or above (15%), structure and earthworks train speed restrictions (10%), and traction power supply failures AC and DC (10%).

Each of the above performance measures stands alone and is calculated independently. The total potential incentive award payable is then the sum of the outcomes of each measure.

Payments under each of the three measures can only be made if performance meets or exceeds the targets included in the Business Plan 2006. If target levels are achieved payments are calculated for above-target performance on a 'straight line' basis up to 'maximum' target level; the maximum incentive could be earned by achieving a level of performance at least equal to delivering one year early the 2007/08 performance on each measure as contained in the Business Plan 2006.

The Committee may exercise its discretion and reduce the amounts payable if, over the year, the overall business performance of Network Rail, including the level of safety performance and net debt, is deemed unsatisfactory.

The potential annual incentive entitlement if all three measures achieve target level is 30%. The maximum possible entitlement is 60% of salary, achievable only if all three measures hit maximum performance, by achieving a level of performance equal to or better than the 2007/08 performance described in the Business Plan 2006.

The remuneration potential has been benchmarked against external comparators with the aim of achieving competitive levels set at broadly median levels for comparable organisations.

Personal performance measures

There are no individual performance measures set for the Executive Directors. The Committee continues to believe that collective accountability of the Directors and the need to establish the stability of the organisation necessitates a focus on collective performance incentives without individual performance measures. Other senior executives do have individual performance measures in addition to the business performance measures.

Long-term incentive (L-TIP)

Under the terms of the Management Incentive Policy there is a requirement to have a long-term incentive element within the MIP.

As Network Rail Limited, being the ultimate parent company of Network Rail Infrastructure Limited, is a company limited by guarantee it is not possible to use traditional long-term incentives due to the absence of shares as the reward method.

At the 2004 Annual General Meeting of Network Rail Limited the Members approved the proposal by the Committee for a long-term incentive based on a deferred cash payment in which awards are made after each three-year period triggered by relevant long-term improvement in business performance targets that reflect the Business Plan and the funding determined by the ORR's Access Charges Review. The maximum amounts which could be earned under each three-year long-term incentive cycle are a cash sum equivalent to that earned under the previous year's annual incentive.

The first performance period for the long-term incentive ended on 31 March 2006 and payments under that L-TIP have been calculated, based on the two targets for the scheme.

L-TIP for 3 year period 1 April 2003 to 31 March 2006

Public Performance Measure

Target	Actual
84.9%	86.4%

ORR cost reduction targets

Target	Actual
£10,237m	£9,272m

Consequently payments were made in full to participants in this long-term plan, based on an amount equivalent to the annual incentive earned in 2003/04 (as described in previous years' remuneration reports).

Amounts paid to the four Executive Directors are the same as those published in the 2004/05 Annual Report as the maximum payable.

L-TIP for 3 years to 31 March 2006

Name	Amount Earned
John Armitt	£112,320
Iain Coucher	£99,840
Peter Henderson	£74,880
Ron Henderson	£74,880

The 2005/06 annual incentive awards will set the maximum long-term incentive for the latest three-year scheme, which will run from 2006/07 to 2008/09.

In addition to the L-TIP which has just matured, the maximum potential value of the long-term incentives receivable by each Executive Director at the end of the respective performance periods of the other three-year periods is shown above.

Potential L-TIP awards (audited)

Director	Performance period 1 April 2004 to 31 March 2007 £	1 April 2005 to 31 March 2008 £	1 April 2006 to 31 March 2009 £
John Armitt	112,320	269,757	240,408
Iain Coucher	99,840	240,834	214,650
Peter Henderson	74,880	179,652	160,153
Ron Henderson	74,880	179,652	160,153
Total	361,920	869,895	775,364

These maximum sums will only be paid if the performance measures outlined below are met in full.

Performance measures

The two performance measures are:

Public performance: the Public Performance Measure has to date been used as the most appropriate measure of network performance for inclusion in this long-term incentive, reflecting delays attributable both to Network Rail and the train operating companies. This measure is the percentage of passenger trains arriving on time over each twelve-month period as published in 'National Rail Trends'. 'On time' is defined as running as planned and arriving less than five minutes late at final destination or less than ten minutes late for inter-city operators.

For the three-year period commenced on 1 April 2006, it has been decided, following consultation with the passenger and freight train operators, to introduce a modified target as the base of the measure for public performance. This new measure is the 'Public Performance Target', which also includes delays to freight trains, measured on a similar basis to passenger delays. Passenger and freight delays are therefore both included in this measure, weighted according to the number of train kilometres for each category of traffic. The target level of achievement for full payment to be made under this measure is a Public Performance Target (PPT) at the level included in the relevant Business Plan.

For the period from 1 April 2006 to 31 March 2009, the PPT target is 87.6% (reflecting the target at 31 March 2009 as described in our 2006 Business Plan). No award under this measure will be made if PPT is below 86.1 – 1%.

Cost reduction: this measure reflects the cumulative cost reductions made in the three-year period. For full payment under the long-term incentive the target is achievement of a level related to the levels contained in the Business Plan 2006. No award under the long-term incentive will be payable unless at least 80% of the cumulative savings set by the ORR are achieved.

If these targets are achieved in full, significant improvement to the rail network will have been delivered. The two measures are free standing and equally weighted. The Committee continues to believe that these two measures provide an appropriately challenging framework for the long-term incentive.

Regulatory MIP statement

As required under the network licence, a statement will be published in June 2006 detailing the contents of the Executive Directors' MIP 2006/07.

Pensions

Executive Directors are entitled to pensions based on salary and length of service with a maximum pension of two-thirds of final base salary. Details are set out on page 22.

Directors' service terms

The Executive Directors of the Company are also the Executive Directors of Network Rail Limited but their contractual service agreements are with this Company. No other contractual provisions or remuneration arrangements exist in relation to their directorships of the Company or any other company within the Network Rail Group.
At the time of drawing up the service agreements the Committee took into consideration the UK Listing Authority's corporate governance code and the recommendations contained within the joint statement of the Association of British Insurers and the National Association of Pension Funds published in December 2002 on best practice on executive contracts and severance. These were applied as far as practicable and appropriate having regard to the nature of the business and the corporate structure of the Company and then current practice.

All the Executive Directors' service agreements provide for notice periods of no greater than one year, to reflect current corporate governance best practice. Executive Directors are required to give not less than six months' notice if they wish to leave.

Taking the principles contained within current corporate governance best practice relating to compensation in the event of early termination of a director's service agreement, each such agreement contains an express provision requiring the departing director to exercise their duty to mitigate their loss. Network Rail will have regard to that duty and contractual requirement on a case by case basis when assessing the appropriate level of compensation which may be payable, including using phased payments.

Executive Directors	Effective date of contract
John Armitt	3 October 2002*
Iain Coucher	3 October 2002
Peter Henderson	3 October 2002
Ron Henderson	3 October 2002

* John Armitt had previously a contract of appointment dated 14 December 2001.

Non-Executive Directors are appointed by the Board on the recommendation of the Nominations Committee. Their appointment is for an initial term of three years, subject to election by the Members of Network Rail Limited at the first AGM following their appointment. They do not have service agreements. Instead the terms of their engagement are set out in a letter of appointment and, in accordance with the Company's Articles of Association, their appointments may be terminated at any time on six months' notice without compensation.

The Chief Executive's service agreement and the letter of appointment of the Chairman also contain provisions for termination of their appointments without compensation upon the occurrence of certain significant financial failures of the Group unless a majority of the Board of the Company and the DfT (in its role as provider of credit facilities) decide that these appointments should not be terminated.

Non-Executive Directors	Effective date of original contract
Ian McAllister	3 October 2002
David Bailey*	15 August 2002
Rob den Besten	24 September 2003
Ian Buchan	5 February 2006
Yvonne Constance	1 May 2005
Jim Cornell	3 October 2002
Michael Firth	4 December 2004
Christopher Green	26 June 2005
Charles Hoppe	3 October 2002
Ross Sayers**	3 October 2002

* David Bailey's appointment in 2002 was as Special Director; upon conversion of his appointment a new letter of appointment was issued in 2005.

** Ross Sayers passed away on 25 November 2005.

External appointments

It is recognised that Executive Directors may be invited to become Non-Executive Directors of other companies and that such appointments can broaden their knowledge and experience to the benefit of the Company. An individual Executive Director will normally be required to account to the Group for all fees received in respect of such directorships unless otherwise approved by the Committee.

None of the Executive Directors currently holds a Non-Executive Director position with a listed company. With the approval of the Committee, Ron Henderson previously held two non-executive directorships which he no longer holds.

Current annual fees for the Non-Executive Directors are:

Non-Executive Director	Fee £
David Bailey	37,000
Rob den Besten	37,000
Yvonne Constance	37,000
Jim Cornell*	54,000
Michael Firth**	45,000
Christopher Green	37,000
Charles Hoppe	37,000
Ian McAllister	210,000
Ross Sayers***	50,000
Ian Buchan	37,000

* Includes additional fees paid for his chairmanship of Board committees and membership of Membership Selection Panel.

** Includes additional fees paid for his chairmanship of a Board committee.

*** Includes additional fees paid for his chairmanship of a Board committee until his death on 25 November 2005.

Non-Executive Directors' remuneration

The Non-Executive Directors of the Company are also the Non-Executive Directors of Network Rail Limited but their letters of appointment are with this Company covering both positions. No other contractual provisions or remuneration arrangements exist in relation to their directorships (if any) of any other company within the Network Rail Group. For the purpose of this Directors' Remuneration Report and the Directors' Remuneration Report for Network Rail Limited, therefore, the following provisions of this report also appear in the Annual Report of that company. The letters of appointment are available for inspection at the Company's registered office.

Non-Executive Directors do not receive any benefits from the Company other than a fee together with their reasonable expenses for attending meetings of the Board and other meetings and events.

With effect from January 2005, in view of the additional responsibilities and time commitment placed upon the chairmen of Board committees, and in line with the recommendations of the Higgs Report and good corporate governance practice, it was decided that additional fees would be paid to a Non-Executive Director who chairs the Audit Committee, Remuneration Committee or Safety Health & Environment Committee.

Directors' emoluments (audited)

Disclosure of Directors' remuneration for 2005/06

Name	Notes	Salaries and fees £000	Bonuses Annual £000	L-TIP £000	FURBS* and AVC payments by the Company £000	Benefits £000	2005/06 Total £000
John Armitt		499	240	112	149	27	1,027
David Bailey		39					39
Rob den Besten		37					37
Ian Buchan	1	4					4
Yvonne Constance	2	33					33
Jim Cornell	3	54					54
Iain Coucher		445	215	100	128	36	924
Michael Firth	4	38					38
Christopher Green	5	29					29
Peter Henderson		332	160	75	95	16	678
Ron Henderson		332	160	75	95	21	683
Charles Hoppe		37					37
Ian McAllister		210					210
Ross Sayers	6	35					35

Notes
1 Covers the period from 5 February 2006 (being the date of appointment as Director) to 31 March 2006.
2 Covers the period from 1 May 2005 (being the date of appointment as Director) to 31 March 2006.
3 Includes additional fees paid for his chairmanship of Board committees and membership of Membership Selection Panel.
4 Includes additional fees paid for his chairmanship of a Board committee.
5 Covers the period from 26 June 2005 (being the date of appointment as Director) to 31 March 2006.
6 Covers the period from 1 April 2005 to 25 November 2005 (following his death).
* Funded unapproved retirement benefit scheme.

Directors' remuneration comparison: 2005/06 against 2004/05

	Notes	2005/06 Total £000	2004/05 Total £000
Current Directors			
John Armitt		1,027	919
David Bailey		39	35
Rob den Besten		37	35
Ian Buchan	1	4	n/a
Yvonne Constance	2	33	n/a
Jim Cornell		54	37
Iain Coucher		924	829
Michael Firth		38	11
Christopher Green	3	29	n/a
Peter Henderson		678	607
Ron Henderson		683	611
Charles Hoppe		37	35
Ian McAllister		210	210
Past Directors			
Christopher Leah	4	–	312
Adrian Montague	5	–	48
Ross Sayers	6	35	38
Total		3,828	3,727

Notes
1 Joined the Board on 5 February 2006.
2 Joined the Board on 1 May 2005.
3 Joined the Board on 26 June 2005.
4 Left Board on 3 December 2004 (being date of retirement).
5 Left Board on 4 December 2004 (being the date of resignation as Director).
6 Left Board upon his death on 25 November 2005.

Core pension benefits

	Gross increase in accrued RPS pension £ (A)	Increase in accrued RPS pension net of inflation £ (B)	Total accrued RPS pension at 31 Mar 2006 £ (C)	Transfer value of accrued RPS pension at 31 Mar 2005 £ (D)	Transfer value of accrued RPS pension at 31 Mar 2006 £ (E)	Total change in transfer value during period £ (F)	Value of net increase in accrual over period £ (G)
John Armitt	1,957	1,806	7,546	156,083	222,855	57,771	44,343
Iain Coucher	1,909	1,795	6,129	42,526	68,505	16,977	11,062
Peter Henderson	1,909	1,795	6,129	60,049	97,581	28,530	19,578
Ron Henderson	1,919	1,797	6,432	88,146	136,697	39,550	29,196

Notes
1 Pension accruals shown are the amounts which would be paid annually on retirement (or earlier leaving) based on service to the end of the year.
2 Transfer values as at 31 March 2005 (D) and 31 March 2006 (E) have been calculated in accordance with version 8.1 of guidance note GN11 issued by the actuarial profession.
3 The change in the transfer value (F) includes the effects of fluctuations in the transfer value due to factors beyond the control of the Company and Directors, such as stock market movements. It is calculated after deducting the Director's contribution.
4 The value of net increase (G) represents the incremental value to the Director of their service during the year, calculated on the assumption that service terminated at the year end. It is based on the accrued pension increase (B) after deducting the Director's contribution.

With the exception of the fee for the Chairman (which is determined by the Remuneration Committee), the fees of the Non-Executive Directors are agreed by the Executive Directors of the Board. These fees are designed to recognise the significant responsibilities of Non-Executive Directors and to attract individuals with the necessary high quality experience and ability to make an important contribution to the Company's business. The fees, which are neither performance related nor pensionable, are benchmarked and periodically reviewed against, and are in line with, those paid by other comparable private sector companies taking into account time commitment and competition for similar positions in other companies.

The total amount of Directors' emoluments for services provided solely to the Company during the year was £3,828,000 (2004/05: £3,727,000).

Directors' pensions (audited)

The tables on this page show the pension entitlement from the Network Rail section of the Railways Pension Scheme (RPS), and unapproved arrangements of each Executive Director of the Company during the year ended 31 March 2006, together with the increases in those benefits during the year, calculated using the accrued benefit basis.

The increases in RPS benefits during the year represent the amount of the extra annual pension entitlement earned resulting from additional length of service or changes in salary.

The increase in accrued approved benefit during the year is shown in the table above. Values are shown before (column A) and after (column B) the exclusion of the effect of inflation. All benefit values shown exclude the effect of any additional voluntary contributions made by the director.

Directors participate in the RPS and benefit accrues at a rate of one-sixtieth for each year of membership. They contribute to the RPS at the same rate as other members of the Network Rail section. In addition, some directors are entitled to additional pension benefits that are provided through a Funded Unapproved Retirement Benefits Scheme.

The following sections describe the pension benefits received by Executive Directors in 2005/06:

In normal circumstances the earliest age at which the Executive Directors are entitled to receive their defined benefit pension without actuarial reduction is age 60. However, the Directors can retire early on the same terms and conditions that apply to other members of the Network Rail section of the RPS from the age of 50. The actuarial reduction factors that apply under the RPS are a 2% per annum reduction between the ages of 60 and 55 and a 3% per annum reduction for ages below 55. In keeping with other members of the scheme, the right to take early retirement benefits is at the option of the individual, subject only to having left the Company's employment.

In addition to members' benefits, dependants' pensions are payable after the death of the member, in line with those payable to all members of the RPS. These are at the rate of half the pension the member would have received at age 60 on death in service or half the member's basic pension on death in retirement or after leaving service. Basic pension is pension before commutation for cash and excluding any benefits arising from Additional Voluntary Contributions. In addition, the RPS pays pensions to surviving children. Where two children survive, a pension additional to the dependant's pension is paid at three-eighths of the pension the member would have received at age 60, or three-eighths of the member's basic pension after leaving service or in retirement. Children's pensions are paid to the age of 18 or a later age, at the

	Company contributions to additional pension provision whilst a Director during the year £ (H)	Company payments to additional pension provision in respect of prior year £ (I)	Matching Company additional voluntary contributions whilst a Director during the year £ (J)
Current Directors			
John Armitt	144,526	–	4,658
Iain Coucher	128,473	–	–
Peter Henderson	94,510	–	–
Ron Henderson	94,510	–	–

Notes
1 The current Directors were Directors for the whole year.
2 The contributions in respect of previous years are not included in column (H).
3 None of the Non-Executive Directors is a member of the Network Rail section of the RPS and Non-Executive Directors have no other pension entitlements.

discretion of the Network Rail Section Pensions Committee, if the child is in full time education or disabled. The RPS provides guaranteed increases to all pensions in payment and deferment in line with the retail prices index.

Additional pension benefits

As described above, some Directors are entitled to additional pension benefits in which case the Director could choose the extent to which the gross payment was made to the pension arrangement, or taken as cash. Future contributions are at a pre-determined level, and the amount has been notified to each Director. The contributions made during the year together, where appropriate, with contributions in respect of benefits accrued prior to the year under review are shown on page 22.

The RPS also operates a matching additional voluntary contribution facility, whereby voluntary contributions paid by members are matched by equivalent payments from the Company, up to certain limits. These matching arrangements were 'frozen' for all members of the Network Rail section of the RPS at the levels applicable on 6 November 2003, and this limit was applied to Directors as to other members. Matching payments made in 2005/06 are also shown in the table.

During 2005, the Company reviewed all its current pension arrangements as a consequence of the Government's Tax Simplification changes ('A Day') taking effect from 6 April 2006.

As indicated in last year's report the Company's policy on this issue was that the changes should have no incremental cost impact to the Company. A number of changes have been made to our company pension arrangements, which apply to all employees, including Executive Directors. The key changes are as follows:

- Although the Government Earnings Cap no longer exists, the Network Rail Section of the RPS will continue to limit pensionable salaries to the level of the previous Earnings Cap (increased according to the same annual increase formula as was previously applied).
- Members are from 6 April permitted to pay more than 15% into pensions, though the excess above the previous limit to member's contributions of 15% of salary can only be contributed into the Network Rail Defined Contribution Scheme or to a personal pension (not into the RPS BRASS arrangements).
- A minimum early retirement age of 55 from 6 April 2010 will be introduced for new RPS members after 5 April 2006.
- Members over age 55 will be able to draw their pension whilst remaining in employment with company consent – though such early retirement would be on cost neutral early retirement factors rather than the beneficial ones applying under the RPS.
- Members will be able to take up to 25% of their pension as a cash sum.

Also in relation to the Executive Directors no further contributions will be made by the Company into Funded Unapproved Retirement Benefits Schemes. Instead an equivalent amount will be paid on the Director's behalf into the Network Rail Defined Contribution Scheme; alternatively they may elect to receive a cash payment at no greater cost to the Company. Life Assurance for directors whose pensionable salary is restricted by the notional Earnings Cap mentioned above will be provided through the NRDC.

Performance graph

As the Company has no listed shares total shareholder return cannot be illustrated.

Directors' interests

As the Company has no listed shares Directors have no interests in shares of the Company.

On behalf of the Remuneration Committee

Jim Cornell
Chairman, Remuneration Committee
25 May 2006

Corporate governance report

Corporate governance principles

The Board considers that good corporate governance is central to achieving the Company's objectives and to the principle of safeguarding stakeholders' interests in the rail infrastructure. The Company is committed to high standards of business behaviour and has an established governance framework which comprises an organisational structure, internal control systems and business conduct policies.

It is also a condition of the Company's network licence that, from 3 October 2002, it complies with the governance principles contained in the code annexed to the UK Listing Authority's listing rules (as amended with effect on 1 July 2005) ('the Code'). The Code includes a requirement for companies to make statements on corporate governance in their annual reports.

Having reviewed the requirements of the Code, the Directors consider that Network Rail has complied throughout the financial year ended 31 March 2006 with the provisions set out in Section 1 of the new Code. This Corporate Governance Report, coupled with the Directors' Remuneration Report, explains how the Company has applied the governance principles set out in the Code. Details of the Company's internal controls are set out on pages 27 to 28.

Board of Directors

The Board is responsible for governing the strategic direction of the business, supervising its operational management and providing leadership within a governance framework which it oversees. This responsibility extends to taking overall responsibility for financial performance, internal controls and risk management of the Company.

Directors

The information on page 15 shows that the Company is led and controlled by a board currently comprising four Executive and nine Non-Executive Directors with wide experience both within the rail industry and generally. Collectively, the Board believes it possesses the necessary range of qualities, skills and experience to lead the Company effectively.

Directors are appointed by the Board. The Directors of the Company are also the Directors of Network Rail Limited. Under the Articles of Association of the Company the Directors are not subject to retirement by rotation (as required by the Code), due to it being a wholly-owned subsidiary of Network Rail Limited. Under the provisions of the Articles of Association of Network Rail Limited, however, all Directors (other than the Special Director – see below) must retire by rotation, and may stand (together with any new Director appointed since the last general meeting) for re-election by the Members of that Company at least once every three years.

The names of the Directors standing for election and re-election at the 2006 AGM are set out on page 13 and further information will be given in the documents accompanying the Notice of the AGM to be sent to Members.

If the Department for Transport (DfT) exercises its rights under the Articles of Association of Network Rail Limited to appoint to the Board of Network Rail a director ('Special Director'), such Special Director is not subject to election or re-election by Members of Network Rail Limited.

The responsibilities of the Chairman include leading the Board and ensuring its effectiveness. He sets the agenda for the meetings of the Board and, with the assistance of the Group Company Secretary, arranges for the Directors to receive timely, accurate and clear information before Board meetings and updates on issues arising between meetings.

The roles of the Chairman and the Chief Executive are distinct and separate and their responsibilities are clearly established being set out in writing and having been agreed by the Board. The Chairman is responsible for the workings and leadership of the Board. The Chief Executive is responsible for leading and managing the business within the authorities delegated by the Board.

The Non-Executive Directors challenge and contribute constructively to the development of the strategy of the Group as well as scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

The current Senior Independent Director is Jim Cornell who took up the position in January 2006 following the sad death of Ross Sayers who previously held the position. He is available to Members as an additional point of contact to the Chairman and the Chief Executive.

Non-Executive Directors' independence

The Board considers that each of the Non-Executive Directors is independent of the Company. With regards to the guidelines on the meaning of 'independence' as set out in the Code, however, it is appropriate to disclose that:

1 Jim Cornell was, until 1996, a (non-Board) director of British Rail. He currently receives a pension from the Network Rail section of the Railways Pension Scheme. He is also Executive Director of the Railway Heritage Trust. The Board considers, however, that as a Non-Executive Director of Network Rail, Jim Cornell is independent as he was not an employee or Executive Director of Railtrack PLC. Furthermore the corporate structures of Network Rail Limited, being a not-for-dividend company, and the Company eliminate any potential or perceived conflicts between his being a Non-Executive Director of the Company and receiving a pension from the Network Rail section of the Railway Pension Scheme.

   Jim Cornell, having held various senior roles within British Rail before retiring on the creation of Railtrack PLC, is a highly experienced and respected railwayman who contributes considerable knowledge to the Group. This enables him to challenge constructively and effectively operational matters within the Group as well as participating in the full range of responsibilities of a Non-Executive Director.

2 David Bailey was previously the Special Director appointed to the Board of Network Rail by the SRA pursuant to its rights under the Articles of Association. Following the changes under the Railways Act 2005 with the responsibilities of the SRA passing principally to the Department for Transport (DfT), the DfT has not exercised its right to appoint a Special Director.

The Board considers that David Bailey makes a valuable contribution to the Company in his non-executive director role. His wide ranging commercial experience has enabled him to provide additional perspective on issues and the Company wished to retain him as it moves into its new roles. At the AGM in 2005 his appointment as a non-executive director was approved.

None of the Non-Executive Directors are members of more than three committees of the Board except David Bailey, who is a member of the Nominations, Remuneration, Audit, and Safety, Health and Environment Committees. Upon the conversion of his appointment in June 2005 to Non-Executive Director, he has continued to be a member of these committees due to the valuable contribution he is able to make.

Board meetings

The Board is scheduled to meet ten times a year and a format is prepared and agreed which enables the Directors to review corporate strategy regularly together with the operations and results of the business units within the Group and to discharge their other duties. A table detailing the individual Directors' attendance at each of the Board and committee meetings is set out on page 27.

In addition to these meetings, the Board also holds separate meetings to focus on the long term strategy of the business.

Certain matters are formally reserved for decision by the Board including approval of the interim and year-end financial statements of the Company, the Business Plan, material changes to the network licence and pension matters. Matters delegated to Executive Committee or below are also subject to financial limits above which Board approval is required.

In addition, annually the Chairman holds a meeting with the Non-Executive Directors without the Executive Directors present to discuss the performance of the Company under the executive leadership. Further, one meeting of the Non-Executive Directors chaired by the Senior Independent Director is held without the Chairman present.

Organisational structure

The Board has established an organisational structure which is designed to allow for effective and efficient decision-making across the business. The Board has delegated authority to the committees described below on specific matters, which are set out in their terms of reference. These authorities are reviewed regularly. The terms of reference of the Safety, Health and Environment, Audit and Remuneration Committees are published on the Company's website and copies are available on request. Minutes of all committee meetings are made available to Directors.

There are six standing committees with defined terms of reference as follows:

The **Safety, Health and Environment Committee** comprises four Non-Executive Directors and the Chief Executive, chaired by Jim Cornell. The Committee's role is to monitor the safety, health and environmental responsibilities of the Company. In addition to this Committee, and reflecting the recommendations in the Cullen Report, two executive committees have been set up, dealing with strategic and tactical safety matters. Moreover, the Board receives a report on safety, health and environment matters at each of its scheduled meetings.

The **Audit Committee** is comprised exclusively of four independent Non-Executive Directors. Following the death of Ross Sayers who previously chaired the Committee, the Chairman is Michael Firth who has a financial background and experience at chairing a listed company's audit committee. The external auditors, the Chief Executive, the Group Finance Director, the Group Financial Controller and the Head of Internal Audit normally attend meetings of the Committee. The Committee also periodically meets with the external auditors without management present.

The Board is satisfied that the composition of the Committee fulfils the Code's requirement that at least one member of the Committee has recent and relevant financial experience. The Company has also complied with the Smith Guidance on Audit Committees in all material respects.

The main responsibilities of this Committee are to monitor the integrity of the financial reporting and the audit process and to monitor that an effective management and internal control system is maintained. The Committee has a structured programme of activities including receipt of regular detailed reports on relevant aspects of management, focused to coincide with key events of the annual financial reporting cycle. Its work in fulfilling its responsibilities includes:

1. Reviewing the internal control framework and the register of financial and non-financial risks (so far as these are not reviewed by other Board committees such as the Safety, Health and Environment Committee).
2. Monitoring financial reporting practices including considering accounting policies and practices and compliance with accounting standards.
3. Reviewing significant accounting estimates and judgements.
4. Reviewing interim and annual financial statements before publication.
5. Considering and making recommendations to the Board in relation to the appointment, re-appointment and removal of the external auditors following its assessment of their independence and objectivity (including the safeguards that are in place to maintain such independence) and their terms of engagement and remuneration.
6. Setting a policy whereby employment of the external auditors for work for Network Rail other than audit services or tax consulting services is prohibited, as is submission of tenders to the Network Rail Group in response to EU notices for other services, without approval by the Audit Committee.
7. Reviewing the internal and external audit process including the scope of its planned audit and subsequently its audit findings.
8. Reviewing the policy and procedure whereby employees can raise, in confidence, concerns about possible improprieties.

During the year ended 31 March 2006, the principal activities of the Audit Committee included consideration of the following:

- Interim and full year financial results.
- The 2005/06 internal audit plan.
- Quarterly internal control reports from the internal audit function.
- The effectiveness of the internal audit function.
- The effectiveness of the external audit process.
- The independence and objectivity of the external auditors.
- The 2005 external audit plan and associated audit fees.
- The Company's internal control framework including the risk management process and progress on the management of the key risks identified by the Company.

- The introduction of International Financial Reporting Standards.
- The Annual Report disclosure items relevant to the Audit Committee.

Following its recent review of the external auditors the Audit Committee has recommended to the Board that at the AGM in July 2006 it proposes the re-appointment of Deloitte & Touche LLP as auditors until the conclusion of the AGM in 2007.

The **Remuneration Committee** comprises all nine Non-Executive Directors, is chaired by Jim Cornell, and determines appropriate levels of Directors' and senior executives' remuneration including their incentive scheme. The Committee's report is contained in pages 16 to 23.

The **Nominations Committee** is chaired by Ian McAllister as the Chairman of the Board and comprises two further Non-Executive Directors. The role of the Committee includes:

- Reviewing regularly the size, structure and composition of the Board (including use of suitable periodic performance evaluation processes).
- Making recommendations to the Board on any adjustments that may be deemed necessary and feasible (including on matters such as succession planning).
- Evaluating the balance of skills, knowledge and experience of the Board.
- Identifying and nominating candidates for appointment as director for approval by the Board.
- Satisfying itself that appropriate succession plans and processes are in place for the appointments to the Board and to senior management positions.

During the financial year 2005/06 the Nominations Committee has met to consider performance evaluation of the Board, its committees and Directors, succession planning and candidates for appointment as Non-Executive Directors of the Company.

In relation to considering the status of succession plans for the Executive and Non-Executive Directors as well as senior executives within business functions, work was undertaken to identify candidates for appointment of a further Non-Executive Director to the Board. This process included consideration of the experience and skills sought for the role and commissioning Egon Zehnder International to conduct various searches for suitable candidates and interviewing candidates. Through this process Ian Buchan was selected and nominated by the Committee for approval by the Board. The nomination was approved and Ian Buchan joined the Board with effect from 5 February 2006.

The **Treasury Committee** comprises three directors, with Michael Firth, a Non-Executive Director, as chairman. The Committee's role is to review and satisfy itself as to the appropriateness of proposed treasury transactions including banking, cash management, debt raising and management and investment management.

During the year ended 31 March 2006, the principal activities of the Treasury Committee included consideration of the following in relation to the various funding arrangements for the Group:

- Regular review of the Debt Issuance Programme.
- Migration of the Commercial Paper Programme to Network Rail Infrastructure Finance PLC.
- Renegotiation of inter-company loan facilities.
- Review of the renegotiation of legacy debt arrangements (including finance leases and KfW and EIB loans).
- Review of the debt issuance hedging controls.
- Review of treasury policy and activities.
- Review of debt maturity profile.

The **Executive Committee** is chaired by the Chief Executive, John Armitt, and comprises all the Executive Directors and a number of senior executives. This Committee manages the functions of the business and implements the operational and financial objectives within limits set by the Board.

During the year a review was conducted on the role of the **Property Advisory Board** which comprised Non-Executive Director, Ross Sayers, as Chairman, the Executive Directors and, selected for their expertise in relevant property matters, three external non-executives and a special adviser. It was concluded that in view of changes made to the organisational structure of the Company's property function the role of this body had been absorbed into other parts of the corporate governance structure of the Company. With effect from February 2006, therefore, this board was abolished.

The table on page 27 identifies the number of meetings of the Board and the main six Committees held between 1 April 2005 and 31 March 2006 and the attendance record of individual Directors.

Company Secretary

The Group Company Secretary is the secretary to the Board, the above Committees and, until its abolition, the Property Advisory Board. All Directors have access to the Group Company Secretary for advice on corporate governance, Board procedure and compliance matters. The Group Company Secretary is also responsible for facilitating the induction and professional development of Board members and ensuring that good information flows within the Board, its Committees and between the Non-Executive Directors and senior management.

There is a procedure whereby Directors, wishing to do so in furtherance of their duties, may take independent professional advice at Network Rail's expense.

Information about the Directors' remuneration is given in the Directors' Remuneration Report on page 16 of this Report and details of how the Board reviews financial and operational controls and risk management generally are shown on pages 27 to 28.

Board effectiveness

There is a comprehensive programme of induction for new Directors aimed at ensuring that they are fully conversant with their responsibilities as a Director and with the business of Network Rail.

Ongoing professional development is provided to Directors. During the year the Directors were briefed on relevant issues including new legislative and developments relating to corporate governance reporting requirements and best practice. Additional personal development is also available to all Directors.

Board evaluation

The Nominations Committee is charged by the Board to review the performance of the Board annually.

Each of its committees and Directors has been reviewed during the year to assess whether each of these has been contributing effectively and demonstrating commitment to their role. The policy adopted by the Nominations Committee was for external assistance to be provided in conducting the review on a bi-annual basis. In the interim year the review would be conducted internally managed by the

	Board	Safety, Health and Environment Committee	Nominations Committee	Remuneration Committee	Audit Committee	Executive Committee	Treasury and Environment
Number of meetings held	10	7	2	6	4	11	5
Directors							
John Armitt	10	5	–	6*	4*	11	5
David Bailey	9	6	2	5	4	–	–
Ian Buchan	2	–	–	1	–	–	–
Yvonne Constance[2]	9	–	–	5	3	–	–
Jim Cornell	10	7	2	6	–	–	–
Iain Coucher	10	3*	–	–	–	10	–
Rob den Besten	9	–	–	5	3	–	–
Michael Firth	10	–	–	6	4	–	5
Christopher Green[3]	7	4	–	5	–	–	–
Peter Henderson	10	–	–	–	–	11	–
Ron Henderson	10	–	–	–	4*	10	5
Charles Hoppe	7	4	–	4	–	–	–
Ian McAllister	10	–	2	6	–	–	–
Ross Sayers[4]	7	1	–	4	3	–	–

Notes

1 Between 5 February 2006 and 31 March 2006 (being the date Ian Buchan joined the Board of Directors).
2 Between 1 May 2005 and 31 March 2006 (being the date Yvonne Constance joined Board of Directors).
3 Between 26 June 2005 and 31 March 2006 (being the date Christopher Green joined Board of Directors).
4 Between 1 April 2005 and 25 November 2005 (being the date Ross Sayers sadly died).
* As attendee.

Company Secretary. In line with this policy, consultants, Egon Zehnder International, were engaged in 2003/04. The 2004/05 review was conducted internally. For the 2005/06 review Egon Zehnder were engaged again. The review focused on matters such as company strategy, performance, delegation and accountability, corporate responsibility, succession, relationships with stakeholders, Board and committee composition, Board communication and the contribution and effectiveness of individual Directors.

The findings of the review of the Board were considered and discussed by the Board in February 2006. The review of individual Directors was reviewed by the Chairman of the Board and each Director received personal feedback from Egon Zehnder.

The Board has concluded that it and its committees continue to operate effectively and considers that each Director is contributing to the overall effectiveness and success of the Company. Actions were then agreed for incorporating suggestions for development of this effectiveness of the Board and its members.

Relations with Members and stakeholders

The Board is committed to, and recognises the importance of, maintaining an ongoing relationship based on regular communication with its stakeholders.

The Annual General Meeting (AGM) for Members of Network Rail Limited was held in July 2005, at which the Members were advised of developments within the Company. Presentations were also provided on certain aspects of the business to assist Members in their understanding.

Members were also given the opportunity to ask questions at the AGM including by submission of written questions in advance. Members are also encouraged to request areas of the business on which they would like presentations.

In connection with the AGM, the Company disclosed the level of proxy votes (including the details of the votes for, against and the abstentions for each resolution) and the chairmen of the Board committees are available at the AGM to answer questions in relation to their committee's area of responsibility. In addition, the Notice of the AGM and any related papers were sent out to Members to arrive at least 20 business days before the date of the meeting to ensure that Members have sufficient time in which to consider the items of business.

The next AGM will be held on 19 July 2006.

In June 2005, in advance of the AGM, Members were also invited to a meeting at which the chairman of the Office of Rail Regulation (ORR), the rail industry's regulating body, presented the ORR's views on the performance of Network Rail against its regulatory obligations. With members of the Network Rail Board in attendance, Members were then able to question the chairman of the ORR and the Company.

In addition, other meetings, informal briefings and visits for the Members of Network Rail were held, to give them opportunities to discuss all aspects of the business. They also receive periodic newsletters and press releases and are regularly provided with other information relating to the Group.

The Company's website is updated frequently with announcements, the annual Business Plan, the Annual Report and Accounts, the Management Incentive Plan statement and other documents and information. Members also have their own internet site.

The Chief Executive, the Deputy Chief Executive and the other Executive Directors have regular meetings with representatives of the ORR, passenger and freight train operators and other rail stakeholders.

Internal control

The Board is responsible for the Group's system of internal control and for reviewing its effectiveness. Such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives. It can only provide reasonable, (rather than absolute), assurance against material misstatement or loss.

The Board considers the management of risk and internal control to be fundamental to achievement of the Company's objectives and has formally established a policy, strategy and process for identification, evaluation and on-going review of the significant risks faced by the Group which accords with the Turnbull Guidance. During the year the Executive Directors have formally reviewed the key risks faced by the Group. The Directors keep the effectiveness of the system of internal control under review and have done so throughout the year.

Further good progress has been made in developing the Company wide integrated risk management system including:
- Ongoing improvement in the integration of a systematic bottom up process to identify key risks and mitigation and to link with the already established top-down strategic risk management process.
- Company wide introduction of the Active Risk Manager software to record and monitor risks, risk scoring and risk mitigation and management plan commitments.
- Introduction of causal maps to provide an overview of strategic risk interaction across functions and to map high risks with action plan status.
- Continued interface of risk management actions and mitigation with the Business Planning process.
- Refinement of high level risk reporting at monthly business review level and quarterly review by risk register owners of existing and new risks.

There are established internal control procedures for managing the risks faced by the group of which the key elements are:
- Regular structured reviews of all business units and major projects by the Executive Directors assessing progress against objectives with action being taken as required.
- A framework of delegated authority and accountability based on a fully templated organisation structure.
- Board approval of business strategies and objectives, together with plans, annual budgets and targets.
- The monthly reporting of financial results, safety and other operational KPIs.
- Procedures for planning, approving and managing all investment expenditure including the use of the Guide to Railway Investment Projects (GRIP) specifying the requirement and timings for approvals sought by the Investment Board.
- Centralised treasury operations operating within defined limits and overseen by the Treasury Committee.
- Monthly accounting reviews to scrutinise financial data and increase confidence in the integrity of the accounts.
- Continuous monitoring by the Legal Services function within the Company, of claims and litigation issues affecting the Group.
- Management of all business change initiatives through an organisational change board.
- Commitment to continuous improvement in levels of competence via leadership, competency and training programmes.

The Company has an independent Internal Audit team that is affiliated to the Institute of Internal Auditors. Its primary role is to provide objective and independent assurance regarding the adequacy of the Group's internal control framework, compliance with policies, laws and regulations. Internal Audit is also responsible for reviewing the company wide risk management system as well as improving processes, providing advice and proliferating best practice.

The Audit Committee approves the internal audit plan, which is closely aligned to the risk management system, and receives regular reports from the Head of Internal Audit, who has direct access to the Chairman of the Audit Committee. Recommendations to improve the internal control framework are reported to the Audit Committee through this process.

Internal Audit work closely with the external auditors and other assurance providers to ensure co-ordination of audit plans and optimisation of audit resources. The Head of Internal Audit and the External Audit Partner meet on a regular basis.

The Company also has an established process by which staff may, in confidence, raise concerns about possible improprieties. Matters arising from the investigation of fraud are reported to the Audit Committee by the Head of Internal Audit.

During the course of its review of the system of internal control, the Board has not identified nor been advised of any failings or weaknesses which it has determined to be significant.

Notwithstanding the above, the Board recognises that there is still an ongoing need to build on the above framework and, in particular, has instigated a number of initiatives to further improve compliance with the control framework.

Going concern

The Directors are satisfied that the Company and the Group have adequate resources to continue to operate for the foreseeable future and are financially sound. For this reason they continue to adopt the going concern basis in preparing the accounts.

Statement of Directors' responsibilities

The Directors are responsible for preparing the Annual Report and the financial statements. The Directors are required to prepare financial statements for the Group in accordance with International Financial Reporting Standards (IFRS) and have also elected to prepare financial statements for the Company in accordance with IFRS. Company law requires the Directors to prepare such financial statements in accordance with International Financial Reporting Standards, the Companies Act 1985 and Article 4 of the IAS Regulation.

International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all International Financial Reporting Standards. Directors are also required to:

- Select applicable accounting policies and apply them properly.
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.
- Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.
- Prepare the accounts on a going concern basis unless, having assessed the ability of the Company to continue as a going concern, management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and Group, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a Directors' Report and the Directors' Remuneration Report which comply with the requirements of the Companies Act 1985.

The Directors are responsible for the maintenance and integrity of the Company website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

Independent auditors' report to the Members of Network Rail Infrastructure Limited

We have audited the group and individual company financial statements (the 'financial statements') of Network Rail Infrastructure Limited for the year ended 31 March 2006. which comprise the consolidated income statement, the consolidated and individual company balance sheets, the consolidated and individual company cash flow statements, the consolidated and individual company statements of recognised income and expenses, the statement of accounting policies and the related notes 1 to 33. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

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, the Directors' Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted for use in the European Union are set out in the statement of Directors' responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report described as having been audited in accordance with relevant United Kingdom legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether the financial statements and the part of the Directors' Remuneration Report described as having been audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

The Directors have asked us to report to you if, in our opinion, the Company has not complied with any of the four Directors' remuneration disclosure requirements specified for our review as if the Listing Rules of the Financial Services Authority applied. These comprise the amount of each element in the remuneration package and information on share options, details of long term incentive schemes, and money purchase and defined benefit schemes. We give a statement, to the extent possible, of details of any non-compliance.

The Directors have asked us to review whether the corporate governance statement on page 24 reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review as if the Listing Rules of the Financial Services Authority applied, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the Directors' Report and the other information contained in the annual report including the unaudited part of the Directors' Remuneration Report and we consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

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 and the part of the Directors' Remuneration Report described as having been audited. 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 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 and the part of the Directors' Remuneration Report described as having been audited 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 and the part of the Directors' Remuneration Report described as having been audited.

Opinion

In our opinion:

- The group financial statements give a true and fair view, in accordance with IFRSs as adopted for use in the European Union, of the state of the Group's affairs as at 31 March 2006 and of its loss for the year then ended.
- The individual company financial statements give a true and fair view, in accordance with IFRSs as adopted for use in the European Union as applied in accordance with the requirements of the Companies Act 1985, of the state of the individual company's affairs as at 31 March 2006.
- The financial statements and the part of the Directors' Remuneration Report described as having been audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.
- The information given in the Directors' Report is consistent with the financial statements.

Deloitte & Touche LLP

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
London
25 May 2006

Income statement for the year ended 31 March 2006

	Notes	2006 Group £m	2005 Group(1) £m
Revenue	3	**3,837**	3,800
Operating costs	5	**(3,369)**	(3,282)
Transitional reorganisation costs	6	**-**	(53)
		(3,369)	(3,335)
Operating profit		**468**	465
Revaluation gains and profits on disposal of properties		**78**	135
Total profit from operations	7	**546**	600
Investment revenues	9	**97**	23
Finance costs	10	**(875)**	(670)
Loss before tax		**(232)**	(47)
Tax	11	**(21)**	18
Loss for the year attributable to equity shareholders		**(253)**	(29)

(1) Excludes the impact of IAS 32 and IAS 39 as explained in Note 2.

All amounts in the current and prior years relate to continuing operations.

Under Section 230 of the Companies Act 1985 the Group has elected to take the exemption with regard to disclosing the Company Income Statement. The Company's net loss for the year was £322m (2005: loss of £37m).

Statements of recognised income and expense

for the year ended 31 March 2006

	2006 Group £m	2005 Group(1) £m	2006 Company £m	2005 Company(1) £m
Recognised income and expense in the year				
Gains on revaluation of the railway network	**1,583**	1,663	**1,583**	1,663
Gains on cash flow hedges	**1**	–	**(88)**	–
Actuarial gains/(losses) on defined benefit pension schemes	**102**	(230)	**102**	(230)
Exchange differences on retranslation of foreign currency debt taken to hedging reserve	**(178)**	–	**–**	–
Tax on items taken directly to equity	**(457)**	(384)	**(482)**	(383)
Net income recognised directly in equity	**1,051**	1,049	**1,115**	1,050
Transfers				
Transferred to profit and loss on cash flow hedges	**27**	–	**27**	–
Tax on items transferred from equity	**(8)**	–	**(8)**	–
	19	–	**19**	–
Loss for the year	**(253)**	(29)	**(322)**	(37)
Total recognised income and expense	**817**	1,020	**812**	1,013
Opening adjustments made on 1 April 2005 on transition to IAS 32 and IAS 39				
Opening value of derivatives on transition to IAS 32 and IAS 39	**(100)**	–	**(100)**	–
Opening exchange differences on translation of foreign currency debt on transition to IAS 32 and IAS 39	**2**	–	**2**	–
Deferred taxation on opening adjustments on transition toIAS 32 and IAS 39	**34**	–	**34**	–
	(64)	–	**(64)**	–
Total recognised income and expense for the year attributable to equity shareholders	**753**	1,020	**748**	1,013

(1) Excludes the impact of IAS 32 and IAS 39 as explained in Note 2.

Balance sheets at 31 March 2006

	Notes	2006 Group £m	2005 Group(1) £m	2006 Company £m	2005 Company(1) £m
Assets					
Non-current assets					
Intangible assets	12	**77**	79	**–**	–
Property, plant and equipment – the railway network	13	**25,991**	22,221	**25,991**	22,221
Investment property	14	**892**	872	**892**	872
Investment in subsidiaries	15	**–**	–	**49**	49
Investments	16	**161**	166	**-**	-
Loan to immediate parent company		**326**	307	**326**	307
Derivative financial instruments	21	**65**	-	**-**	-
Finance lease receivables	18	**19**	25	**19**	25
Total financial assets		**571**	498	**345**	332
		27,531	23,670	**27,277**	23,474
Current assets					
Inventories	17	**44**	35	**44**	35
Finance lease receivables	18	**3**	3	**3**	3
Trade and other receivables	19	**439**	591	**609**	734
Derivative financial instruments	21	**50**	–	**–**	–
Cash and cash equivalents	19	**31**	28	**31**	26
		567	657	**687**	798
Total assets		**28,098**	24,327	**27,964**	24,272
Current liabilities					
Trade and other payables	24	**(2,083)**	(2,098)	**(2,068)**	(2,052)
Bank loans and overdrafts	20	**(4,186)**	(5,122)	**(4,185)**	(5,122)
Derivative financial instruments	21	**(2)**	–	**(130)**	–
Short-term provisions	25	**(17)**	(53)	**(17)**	(53)
		(6,288)	(7,273)	**(6,400)**	(7,227)
Net current liabilities		**(5,721)**	(6,616)	**(5,713)**	(6,429)
Non-current liabilities					
Bank loans	20	**(14,197)**	(10,708)	**(14,009)**	(10,708)
Derivative financial instruments	21	**(45)**	–	**–**	–
Other payables	24	**(919)**	(860)	**(919)**	(859)
Retirement benefit obligation	31	**(359)**	(414)	**(359)**	(414)
Deferred tax liabilities	22	**(1,895)**	(1,444)	**(1,895)**	(1,444)
Long-term provisions	25	**(22)**	(8)	**(22)**	(8)
Obligations under finance leases	23	**(10)**	(10)	**(10)**	(10)
		(17,447)	(13,444)	**(17,214)**	(13,443)
Total liabilities		**(23,735)**	(20,717)	**(23,614)**	(20,670)
Net assets		**4,363**	3,610	**4,350**	3,602
Equity					
Share capital	26	**160**	160	**160**	160
Share premium account	27	**85**	85	**85**	85
Revaluation reserve	27	**4,337**	3,357	**4,337**	3,357
Other reserve	27	**1,451**	1,451	**1,451**	1,451
Hedging reserve	27	**(178)**	–	**(61)**	–
Retained earnings	27	**(1,492)**	(1,443)	**(1,622)**	(1,451)
Total shareholders' funds and equity attributable to equity holders of the parent company		**4,363**	3,610	**4,350**	3,602

(1) Excludes the impact of IAS 32 and IAS 39 as explained in Note 2.

The financial statements were approved by the Board of Directors and authorised for issue on 25 May 2006. They were signed on its behalf by

John Armitt, Director   Ron Henderson, Director

Cash flow statements for the year ended 31 March 2006

	Notes	2006 Group £m	2005 Group(1) £m	2006 Company £m	2005 Company(1) £m
Net cash generated from operating activities	28	**655**	482	**662**	485
Investing activities					
Interest received		**35**	23	**35**	15
Purchases of property, plant and equipment– the railway network		**(3,088)**	(3,528)	**(3,088)**	(3,528)
Proceeds on disposal of property, plant and equipment– the railway network		**65**	74	**65**	54
Capital grants received		**95**	93	**95**	93
Capital element of finance leases' receipts		**6**	3	**6**	3
Purchases of available for sale investments		**5**	(25)	**–**	–
Net cash used in investing activities		**(2,882)**	(3,360)	**(2,887)**	(3,363)
Financing activities					
Repayments of borrowings		**(6,852)**	(1,132)	**(6,852)**	(1,132)
Repayments of obligations under finance leases		**(8)**	(31)	**(8)**	(31)
New loans raised		**9,090**	4,055	**9,090**	4,055
Net cash generated from financing activities		**2,230**	2,892	**2,230**	2,892
Net increase in cash and cash equivalents		**3**	14	**5**	14
Cash and cash equivalents at beginning of the year		**28**	14	**26**	12
Cash and cash equivalents at end of the year		**31**	28	**31**	26

(1) Excludes the impact of IAS 32 and IAS 39 as explained in Note 2.

Notes to the financial statements for the year ended 31 March 2006

1 General information

Network Rail Infrastructure Limited is a company incorporated in Great Britain and registered in England and Wales under the Companies Act 1985.

The Company's registered office is situated at 40 Melton Street, London NW1 2EE.

The Company's principal activities are detailed in the Directors' Report on pages 10 to 14.

Details of the Group's business activities, key events and changes during the year and likely future developments are contained in the Chairman's statement, the Chief Executive's review and the Group Finance Director's review. These financial statements should also be read in conjunction with the Corporate Governance Report and the Directors' Remuneration Report.

The Company's parent is Network Rail Holdco Limited, a company incorporated in Great Britain and registered in England and Wales. The Company's ultimate parent company is Network Rail Limited, a Company limited by guarantee incorporated in Great Britain and registered in England and Wales.

2 Significant accounting policies

Basis of accounting

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) for the first time. The disclosures required by IFRS1 concerning the transition from UK GAAP to IFRS are given in Note 33. The financial statements have also been prepared in accordance with IFRS adopted for use in the European Union and therefore comply with Article 4 of the EU IAS regulation.

The financial statements have been prepared on the historical cost basis, except for the revaluation of the railway network to the lower of its depreciated replacement cost (DRC) and value in use, the revaluation of investment properties, investments, and derivative financial instruments to fair value.

The Group adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' from 1 April 2005, therefore the financial information for the year ended 31 March 2006 is fully compliant with these standards. IFRS 1 'First-Time Adoption of International Financial Reporting Standards' permits those companies adopting IFRS for the first time to take some exemptions from the full requirements of IFRS in the transition period. The Group took advantage of the exemption granted in respect of IAS 32 and IAS 39, therefore the comparative financial information for the year ended 31 March 2005 excludes the impact of these standards.

The principal accounting policies adopted by the Directors are set out below.

Early adoption of standards

The Group, as a first-time reporter, has adopted early with effect from 1 April 2004, the reporting date of the Group's first IFRS financial statements:

- IAS19 Employee benefits amended
- IAS40 Investment Property (revised).
- IAS17 Leases (revised).

We note that IFRS 7 'Financial Instruments: Disclosures' supersedes the disclosure requirements of IAS32. This standard is effective for accounting periods beginning after 1 January 2007. The Group will adopt this standard once it becomes effective.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Revenue recognition

Revenue is measured at the fair value of the consideration received or receivable. Revenue represents amounts derived from the management and provision of assets for the use in the operation of the railway, property rental income, and the sale of commercial and development properties net of value added tax, and takes account of any performance penalties or bonuses in respect of the year.

Supplements to the access charges and bonuses receivable from, less penalties payable to, customers are included in revenue. Additional contract amounts and bonuses payable to, less penalties receivable from, suppliers and the Office of Rail Regulation are included in operating expenditure.

Revenue from construction contracts is recognised in accordance with the Group's accounting policy on construction contracts (see page 35).

2 Significant accounting policies continued

Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

Grants

Grants and other contributions received towards the cost of property, plant and equipment are included in trade and other payables as deferred income and released to the income statement over the estimated useful economic life of the railway network. Revenue grants earned for the management and provision of railway network assets are credited to the income statement in the period to which they relate.

Construction contracts

Construction contracts are stated at cost plus estimated profits attributable to the state of completion (where the outcome can be assessed with reasonable certainty), less provision for any known or anticipated losses and progress payments receivable on account. Contract provisions in excess of amounts recoverable are included in provisions. Advance and progress payments are included under trade and other payables to the extent that they exceed the related cost. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately.

Leasing

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

The Group as lessor

Amounts due from lessees under finance leases are recorded as receivables at the amount of the Group's net investment in the leases. Finance lease income is allocated to accounting periods so as to reflect a constant periodic rate of return on the Group's net investment outstanding in respect of the leases.

Rental income from operating leases, and initial direct costs are recognised on a straight line basis over the term of the relevant lease.

The Group as lessee

Assets held under finance leases are recognised as assets of the Group at their fair value or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged to the income statement, unless they are directly attributable to qualifying assets, in which case they are capitalised in accordance with the Group's general policy on borrowing costs (see below).

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

Foreign currencies

Monetary assets and liabilities expressed in foreign currencies are translated into sterling at rates of exchange prevailing at the balance sheet date. Individual transactions denominated in foreign currencies are translated into sterling at the exchange rates prevailing on the dates payment takes place. Gains and losses arising on retranslation are, with the exception of items that form part of a designated cash flow hedge relationship, included in the income statement for the period and are classified as either operating or financing depending on the nature of the monetary item giving rise to them.

Up to 31 March 2005, before adoption of IAS 32 and IAS 39, where related or matching forward exchange contracts had been entered into, the rates specified in the relevant matching forward contract are used. From 1 April 2005, monetary assets and liabilities are accounted for as set out in the accounting policy for financial instruments below.

Borrowing costs

Borrowing costs directly attributable to the construction of qualifying assets which are assets that necessarily take a substantial period of time to get ready for their intended use are added to the cost of those assets, until such time as 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.

Operating profit

Operating profit is stated before investment income and finance costs.

Retirement benefit costs

Payments to the defined contribution retirement benefit scheme are charged as an expense as they fall due.

For the defined benefit scheme, the cost of providing benefits is determined using the Projected Unit Credit Method, with full actuarial valuations being carried out at least every three years and updates to these valuations carried out in intervening years.

2 Significant accounting policies continued

The Group's share of the actuarial gains and losses are recognised in full in the period in which they occur. They are recognised outside the income statement and presented in the statement of recognised income and expense (see Note 31).

Past service cost is recognised immediately to the extent that the benefits are already vested, and otherwise is amortised on a straight line basis over the average period until the benefits become vested.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation, as adjusted for unrecognised past service cost, and as reduced by the fair value of scheme assets. Any asset resulting from this calculation is limited to past service cost, plus the present value of available refunds and reductions in future contributions to the plan.

Tax

The tax expense represents the sum of the current tax payable and deferred tax.

Current taxes are based on the taxable results of the Group and calculated in accordance with tax rules in the United Kingdom. The Group's current tax liability is calculated using the tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on the temporary differences that arise when tax authorities recognise and measure assets and liabilities with rules that differ from those of the consolidated accounts. Deferred taxes are calculated under the balance sheet liability method at the rate of tax expected to prevail when the temporary differences reverse.

Deferred tax liabilities are recognised for all taxable temporary differences; and deferred tax assets are recognised on all deductible temporary differences to the extent that it is probable that there will be taxable profits available against which the temporary timing differences can be utilised.

Deferred tax assets/liabilities are not recognised if the temporary differences arise from the initial recognition of goodwill, non deductible goodwill or from initial recognition (other than business combination) of other assets and liabilities in a transaction that affects neither the taxable profit or loss nor the accounting profit or loss.

Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Property, plant and equipment – the railway network

The railway network is valued at depreciated replacement cost. This is calculated at the lower of its same state replacement cost and its value in use. The value in use is based on a discounted future cash flow that assesses the value to the business of the net income stream generated from the railway network. The remaining weighted average useful economic lives are estimated annually, with external verification of the valuation and asset lives carried out, where required, at least every five years.

The railway network is depreciated on a straight-line basis over its estimated remaining weighted average useful economic life. The estimated remaining weighted average useful economic life of the network is currently 25 years.

Investment property

Investment property, which is property held to earn rentals and/or for capital appreciation, is stated at its fair value at the balance sheet date. Gains and losses from changes in the fair value of investment property are included in the income statement for the period in which they arise.

Research and development

Research and general development expenditure is charged to the income statement as incurred. Expenditure on the development of specific projects is recognised only if all of the following conditions are met:

- An asset is created that can be identified.
- It is probable that the asset created will generate future economic benefits.
- The development cost of the asset can be measured reliably.

Intangible fixed assets

An intangible asset is only recognised if, it is probable that future economic benefits will flow to the Group and its costs can be measured reliably. Intangible fixed assets are measured initially at purchase cost and are amortised on a straight-line basis. Concessions are amortised over the length of their contractual agreement. Intangible fixed assets are tested for impairment at each balance sheet date by comparing their carrying value and the expected discounted cash flows expected to arise from them over their contractual agreements. If the carrying value exceeds the discounted cash flows expected to arise from the assets, the carrying value would be impaired accordingly.

Inventories

Inventories are stated at the lower of cost and net realisable value. Cost comprises direct materials, direct labour costs and those overheads that have been incurred in bringing the inventories to their present location and condition. Cost is calculated using the weighted average method.

2 Significant accounting policies continued

Financial instruments

Financial assets and financial liabilities are recognised on the Group's balance sheet when the Group becomes party to the contractual provisions of the instrument.

Trade receivables

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts, recognised in profit and loss.

Investments

Investments are recognised and derecognised on a trade date where a purchase or sale of an investment is under contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at cost, including transaction costs.

Investments are classified as either held for trading or available-for-sale, and are measured at subsequent reporting dates at fair value. Where securities are held for trading purposes, gains and losses arising from changes in fair value are included in the income statement for the period. For available-for-sale investments, gains and losses from changes in fair value are recognised directly in equity, until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the income statement for the period. Non-current asset investments in subsidiaries are stated at cost less provision for impairment.

Financial liabilities and equity instruments

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities.

Debt

Debt instruments are recorded at the proceeds received, net of discount and direct issue costs. Finance charges, including premiums payable on settlement or redemption and direct issue costs are accounted for on an accrual basis to the income statement using the effective interest rate method and are added to the carrying value of the debt instrument to the extent that they are not settled in the period in which they arise.

Trade payables

Trade payables are not interest bearing and are stated at cost.

Derivative financial instruments and hedge accounting (applied from 1 April 2005)

The Group's activities expose it primarily to the financial risks of changes in interest rates and foreign currency exchange rates. The Group uses interest rate swaps and foreign exchange forward contracts to hedge these exposures.

The use of financial derivatives is governed by the Group's policies approved by the Board of Directors, which provide written principles on the use of financial derivatives.

Changes in the fair value of derivative financial instruments that are designated and effective as hedges of future cash flows are recognised directly in equity and the ineffective portion is recognised immediately in the income statement. If the cash flow hedge of a firm commitment or forecasted transaction results in the recognition of an asset or a liability, then, at the time the asset or liability is recognised, the associated gains or losses on the derivative that had been previously recognised in equity are included in the initial measurement of the asset or liability. For hedges that do not result in the recognition of an asset or a liability, amounts deferred in equity are recognised in the income statement in the same period in which the hedged items affect net profit and loss.

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

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement in the year.

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

Provisions

Provisions are recognised when the Group has a present obligation as a result of a past event, and it is probable that the Group will be required to settle that obligation. Provisions are measured at the Directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

3 Revenue

	2006 Group £m	2005 Group £m
Passenger franchise revenue	**1,515**	1,435
Revenue grants	**1,983**	2,058
Freight revenue	**97**	73
Property rental income	**183**	172
Other income	**59**	62
	3,837	3,800

The net effect of the performance regimes on the results of the Group and Company was net income of £110m (year to 31 March 2005: net income of £102m).

4 Segmental analysis

No segmental analysis is provided because the Group operates one class of business, that of managing the national rail infrastructure, and undertakes that class of business in one geographical segment, Great Britain.

5 Operating costs

	2006 Group £m	2005 Group £m
Employee costs (excludes transitional reorganisation costs referred to in note 6)	**1,292**	1,101
Own costs capitalised	**(409)**	(334)
Other external charges (including infrastructure maintenance costs)	**1,674**	1,869
Other operating income	**(126)**	(131)
Operating costs before depreciation	**2,431**	2,505
Depreciation and other amounts written off non-current assets	**964**	805
Capital grants amortised	**(26)**	(28)
Operating costs	**3,369**	3,282

6 Transitional reorganisation costs

	2006 Group £m	2005 Group £m
Employee costs	**–**	3
Other external charges	**–**	50
	–	53

7 Profit from operations

Profit from operations is stated after charging/(crediting):

	2006 Group £m	2005 Group £m
Research and development costs	**2**	3
Depreciation and other amounts written off property, plant and equipment	**964**	805
Amortisation of intangible fixed assets	**2**	2
Profit on sale of properties	**(61)**	(54)
Increase in the fair value of investment properties	**(17)**	(81)
Cost of inventories recognised as an expense	**166**	127
Employee costs (see note 8)	**1,292**	1,104
Auditors remuneration for statutory audit services	**0.4**	0.4
Amounts payable to auditors in respect of regulatory accounts audit and interim review	**0.1**	0.1
Amounts payable to auditors in respect of non-audit services	**0.1**	0.1

8 Employee costs

The average number of employees (including Executive Directors) was:

	2006 Group Number	2005 Group Number
Management and operation of the railway	**31,584**	26,433

	2006 Group £m	2005 Group £m
Their aggregate remuneration comprised:		
Wages and salaries	**1,084**	933
Social security costs	**93**	82
Defined contribution pension costs	**3**	3
Defined benefit pension costs – current service costs	**112**	86
	1,292	1,104

9 Investment revenue

	2006 Group £m	2005 Group(1) £m
Interest receivable from immediate parent company	**19**	8
Interest receivable on investments and deposits	**13**	12
Interest receivable on finance leases	**2**	3
Increase in fair value of fair value hedges	**7**	–
Inefffective portion of cash flow hedges	**22**	–
Increase in fair value of derivatives not hedge accounted	**34**	–
	97	23

(1) Excludes the impact of IAS 32 and IAS 39 as explained in Note 2.

10 Finance costs

Finance costs and foreign exchange gains/(losses) are presented net of effective cash flow hedges for respective interest bearing and foreign currency borrowings. Fair value gains/(losses) on derivatives, presented below, include the mark-to-market change of interest rate and currency derivatives designated as fair value hedges, net of fair value changes in the associated hedged risk.

	2006 Group £m	2005 Group £m
Interest on bank loans and overdrafts	**18**	57
Interest on debt issued under the Debt Issuance Programme	**356**	68
Interest on debt issued under the Medium Term Note Programme	**353**	349
Interest on loan from immediate parent company	**–**	53
Interest on loans from other group companies	**103**	180
Interest on obligations under finance leases	**16**	9
Expected return on assets less interest on liabilities in respect of defined benefit pension scheme	**21**	7
Other interest	**5**	17
Total borrowing costs	**872**	740
Less: amounts included in the cost of qualifying assets	**(70)**	(70)
Total finance costs before remeasurements	**802**	670
Decrease in fair value of fair value hedges	**7**	–
Fair value losses on interest rate swaps transferred from equity	**27**	–
Exchange differences on retranslation of foreign currency debt taken directly to income statement	**39**	–
Total finance costs	**875**	670

Borrowing costs are included in the costs of qualifying assets to the extent that the asset is financed by the Company. The average rate used during the year was 5.01% (2005: 4.95%).

11 Tax

	2006 Group £m	2005 Group £m
Current tax:		
UK Corporation tax at 30%:	–	–
Total current tax	–	–
Deferred tax:		
Deferred tax at 30%:		
Current year credit/(charge)	**34**	(27)
Prior year (charge)/credit	**(55)**	45
Total deferred tax	**(21)**	18
Total tax	**(21)**	18

The tax charge/credit for the year can be reconciled to the loss per the income statement as follows:

	2006 Group £m	2005 Group £m
Loss before tax	**(232)**	(47)
Tax at the UK corporation tax rate of 30%	**(70)**	(14)
Adjustments in respect of prior years	**55**	(45)
Permanent differences	**36**	41
Tax charge/(credit) for the year	**21**	(18)

In addition to the amounts charged to the income statement, deferred tax relating to the revaluation of the railway network amounting to £476m (2005: £453m) has been charged directly to equity. Amounts relating to movements on the hedging reserve amounting to a credit of £76m (2005: £nil)(including £34m on transition to IAS32 and IAS39) and a charge relating to retirement benefit obligations of £31m (2005: £69m credit) have been reflected in equity.

UK corporation tax and deferred tax is calculated at a rate of 30% (2005: 30%).

12 Intangible assets

Group	Concessions £m
Cost	
At 1 April 2004, 1 April 2005 and 31 March 2006	**83**
Amortisation	
At 1 April 2004	(2)
Charge for the year	(2)
At 1 April 2005	**(4)**
Charge for the year	(2)
At 31 March 2006	**(6)**
Carrying amount	
At 31 March 2006	**77**
At 31 March 2005	79

The concessions above are held by the Company's wholly owned subsidiary Network Rail (CTRL) Limited.

Concessions are amortised in equal annual amounts over the length of their contractual agreement. The Railway Services agreement is being amortised over 4 years, to 2007. The concession to run the operations, maintenance and renewal business of the Channel Tunnel Rail Link is being amortised over 84 years, to 2086.

13 Property, plant and equipment – the railway network

	Group and Company £m
Valuation	
At 1 April 2004	17,773
Additions	3,590
Depreciation charge for the year	(805)
Revaluation in the year	1,663
At 1 April 2005	**22,221**
Additions	3,151
Depreciation charge for the year	(964)
Revaluation in the year	1,583
At 31 March 2006	**25,991**

In the year ended 31 March 2003 Ove Arup and Partners reviewed Network Rail Infrastructure Limited's engineering assessment of the replacement cost, depreciated replacement cost and useful economic lives of all the assets that comprise the railway network and confirmed in writing to the Directors that the basis upon which the assessment had been prepared was appropriate and that the resultant valuations and estimates were reasonable.

In accordance with accounting standards Ove Arup and Partners carried out an interim review in the year ended 31 March 2005 of the Company's engineering assessment of the replacement cost, depreciated replacement cost and useful economic lives of the railway network assets. This interim review updated the full review carried out in the year ended 31 March 2003. Ove Arup and partners confirmed in writing that the basis upon which the assessment was prepared continued to be appropriate and that there had been no material changes to the valuations and estimates derived in the year ended 31 March 2003.

The Directors have reviewed the assessments in the current year and are satisfied that they remain valid and appropriate at 31 March 2006. A full review of the valuation and asset lives is prepared and externally verified at least every five years.

The unimpaired depreciated replacement cost of the network (after excluding the replacement cost of embankments, cuttings and tunnels) is estimated at £63bn.

As the depreciated replacement cost of the railway network significantly exceeds its value in use, it is revalued to its value in use at each reporting date. Given the interdependency of the assets comprising the railway network, the Group has concluded that the railway network is a single cash generating unit and that its value in use is the estimated future cash flows that will be generated in perpetuity, discounted at the Group's pre-tax cost of capital, as set by the Office of Rail Regulation (ORR) in its Access Charges Review. The estimate of the value in use is based on the Regulatory Asset Base (RAB), which is in effect a discounted future cash flow calculation, adjusted for the net present value of any variances from the ORR's Determination included in the Group's Business Plans.

The depreciation charge for any year is calculated using the average carrying value for the year and the estimated weighted average remaining useful economic life of the railway network. The estimated remaining weighted average useful economic life of the network is currently 25 years.

As at 31 March 2006 the comparable valuation of the railway network according to the historic cost convention is £20,363m.

As at 31 March 2006 and 31 March 2005 it is not possible to identify the undepreciated capitalised interest or the undepreciated finance leased assets, within the net book value of fixed assets. The undepreciated interest capitalised since the date of adoption of the network value as deemed cost on 1 April 2002 (see Note 33) was £116m (2005: £99m). No finance leased assets have been acquired since 1 April 2002.

At 31 March 2006, the Group had entered into contractual commitments in respect of capital expenditure amounting to £1,091m (2005: £883m).

14 Investment property

	Group and Company £m
Fair value	
At 1 April 2004	803
Additions	8
Disposals	(20)
Increase in fair value in the year	81
At 1 April 2005	**872**
Additions	7
Disposals	(4)
Increase in fair value in the year	17
At 31 March 2006	**892**

The fair value of the Group's investment properties at 31 March 2006 has been arrived at on the basis of a valuation carried out at that date by Jones Lang LaSalle, independent valuers not connected with the Group, and by the Head of Commercial Property (Network Rail), a Chartered Surveyor. The valuation, which conforms to International Valuation Standards, was arrived at by, firstly, the external valuation of the 16 largest properties amounting to 12% of the total valuation.

Secondly, the balance of the estate, amounting to 6,914 properties, was valued using the Beacon method. The portfolio was analysed into 69 homogenous classes of property and areas. Jones Lang LaSalle independently assessed the appropriate yield to be adopted within each of the portfolio classes/areas in order to enable the directors to estimate market values by applying the adopted yields to the net rental income in accordance with a traditional UK investment property valuation.

The property rental income earned by the Group from its investment property, all of which is leased out under operating leases, amounted to £72m (2005: £69m). Direct operating expenses arising on the investment properties in the year amounted to £4.7m (2005: £4.8m).

The Group's investment properties are let on a tenant repairing basis. The Group's maintenance obligations are limited to common areas and vacant property units.

15 Investment in subsidiaries: Company

	At cost £m
Investment in subsidiaries at 1 April 2004, 1 April 2005 and 31 March 2006	**49**

The Company's subsidiaries are set out below:

Directly owned	Country of incorporation	Proportion of all classes of issued share capital owned by the Company	Principal activity
Network Rail Insurance Limited	Guernsey	100%	Insurance
Network Rail (CTRL) Limited	Great Britain	100%	Holds St Pancras concession and CTRL Railway Services Agreement
Network Rail (Spacia) Limited	Great Britain	100%	Property letting
Network Rail (Stations) Limited	Great Britain	100%	Dormant
Network Rail (Projects) Limited	Great Britain	100%	Dormant
Network Rail (Property) Limited	Great Britain	100%	Dormant
Spacia (2002) Limited	Great Britain	100%	Dormant
Network Rail Defined Contribution Pension Scheme Trustee Limited	Great Britain	Company limited by guarantee	Administration of defined contribution pension scheme
Shares held by a trustee			
Network Rail MTN Finance PLC	Great Britain	Shares held by HSBC Trustee (C.I.) Limited	Administration of Medium Term Note Programme
Network Rail Infrastructure Finance PLC	Great Britain	Shares held by HSBC Trustee (C.I.)Limited	Administration of Debt Issuance Programme

The shares in Network Rail MTN Finance Limited and Network Rail Infrastructure Limited are held by HSBC Trustee (C.I.) Limited for charitable purposes. The sole activity of these companies is to act as a special purpose funding vehicle, including issuing debt under the Medium Term Note Programme and Debt Issuance Programme respectively. The companies are treated as quasi-subsidiaries for accounting purposes as proceeds from the Medium Term Note Programme and Debt Issuance Programme are on-lent to Network Rail Infrastructure Limited and are used to finance the activities of the Company and to refinance the existing debt of the Group.

16 Investments

	Group £m	Company £m
At 1 April 2004	145	–
Additions	21	–
At 1 April 2005	**166**	**–**
Disposals	(5)	–
At 31 March 2006	**161**	**–**

The investments included above represent amounts held by the Group's captive insurance company, Network Rail Insurance Limited.

17 Inventories

	2006 Group and Company £m	2005 Group and Company £m
Raw materials and consumables	**44**	35

18 Finance lease receivables

	Minimum lease payments 2006 Group and Company £m	Minimum lease payments 2005 Group and Company £m	Present value of minimum lease payments 2006 Group and Company £m	Present value of minimum lease payments 2005 Group and Company £m
Amounts receivable under finance leases:				
Within one year	**5**	5	**3**	3
In the second to fifth years inclusive	**16**	21	**12**	15
After five years	**9**	13	**7**	10
	30	39	**22**	28
Less: unearned finance income	**(8)**	(11)	**n/a**	n/a
Present value of minimum lease payments receivable	**22**	28	**22**	28
Analysed as:				
Current finance lease receivables (recoverable within one year)			**3**	3
Non-current finance lease receivables (recoverable after one year)			**19**	25
			22	28

The Group has entered into finance lease arrangements with third parties for various types of telecommunications equipment. Leases are due to expire in 2017/18.

The interest rate inherent in the leases is fixed at the contract date for all of the lease term. The average effective interest rate contracted is approximately 8.6% (2005: 9.1%) per annum.

The fair value of the Group's finance lease receivables at 31 March 2006 is estimated at £18m (2005: £20m).

19 Other financial assets
Trade and other receivables

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Trade receivables	**122**	147	**113**	146
Amounts due from construction contract customers	**1**	29	**1**	29
Amounts owed to other group companies	**–**	–	**76**	–
Capital grants receivable	**33**	24	**33**	24
Other receivables	**82**	119	**185**	269
Prepayments and accrued income	**201**	272	**201**	266
	439	591	**609**	734

Average debtor days were 27 days (2005: 26 days). An allowance has been made for estimated irrecoverable amounts from the supply of services of £9m (2005: £18m). This allowance has been made by reference to past default experience.

The Directors consider that the carrying value of trade and other receivables approximates their fair value. All balances are non interest bearing and denominated in sterling.

Cash and cash equivalents
Cash and cash equivalents comprise bank balances held by the Group and money market deposit investments all denominated in sterling at varying interest rates. The carrying amount of these assets approximates to their fair value.

20 Bank overdrafts and loans

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Bank loans and overdrafts	**1,139**	1,514	**339**	1,376
Debt issued under the Debt Issuance Programme (less unamortised discount and fees)	**11,387**	3,647	**–**	–
Debt issued under Medium Term Note Programme (less unamortised discount and fees)	**5,857**	6,708	**–**	–
Loans from subsidiaries	**–**	–	**17,855**	10,493
Debt issued under the Commercial Paper Programme	**–**	3,961	**–**	3,961
	18,383	15,830	**18,194**	15,830
The borrowings are repayable as follows:				
On demand or due within one year	**4,186**	5,122	**4,186**	5,122
Due within one to two years	**1,502**	873	**1,502**	873
Due within two to five years	**6,122**	5,717	**6,122**	5,717
Due in more than five years	**6,573**	4,118	**6,384**	4,118
	18,383	15,830	**18,194**	15,830
Less: amounts repayable within one year (shown under current liabilities):				
Bank loans and overdrafts	**(7)**	(162)	**(7)**	(24)
Debt issued under the Debt Issuance Programme (less unamortised discount and fees)	**(3,306)**	–	**–**	–
Debt issued under Medium Term Note Programme (less unamortised discount and fees)	**(873)**	(999)	**–**	–
Loans from subsidiary	**–**	–	**(4,178)**	(1,137)
Debt issued under the Commercial Paper Programme	**–**	(3,961)	**–**	(3,961)
Amounts repayable within one year	**(4,186)**	(5,122)	**(4,185)**	(5,122)
Amounts repayable after more than one year	**14,197**	10,708	**14,009**	10,708

All borrowings are denominated in or swapped into sterling.

Debt issued under the Debt Issuance Programme is analysed as follows:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
1.5646% sterling index linked bond due 2044 (less unamortised discount and fees)	**201**	196	**–**	–
1.2219% sterling index linked bond due 2040 (less unamortised discount and fees)	**201**	–	**–**	–
4.75% sterling bond due 2035 (less unamortised discount and fees)	**1,219**	1,218	**–**	–
1.6492% sterling index linked bond due 2035 (less unamortised discount and fees)	**305**	–	**–**	–
4.375% sterling bond due 2030 (less unamortised discount and fees)	**868**	–	**–**	–
1.9618% sterling index linked bond due 2025 (less unamortised discount and fees)	**256**	249	**–**	–
4.75% sterling bond due 2024 (less unamortised discount and fees)	**719**	717	**–**	–
4.625% sterling bond due 2020 (less unamortised discount and fees)	**995**	–	**–**	–
4.40% Canadian dollar bond due 2016 (less unamortised discount and fees)	**245**	–	**–**	–
4.875% sterling bond due 2015 (less unamortised discount and fees)	**740**	738	**–**	–
4.375% sterling bond due 2011 (less unamortised discount and fees)	**249**	–	**–**	–
5.50% Australian dollar bond due 2010 (less unamortised discount and fees)	**351**	–	**–**	–
3.875% US dollar bond due 2009 (less unamortised discount and fees)	**574**	529	**–**	–
4.46% sterling bond due 2008 (less unamortised discount and fees)	**50**	–	**–**	–
4.125% US dollar bond due 2008 (less unamortised discount and fees)	**718**	–	**–**	–
4.50% sterling bond due 2008 (less unamortised discount and fees)	**398**	–	**–**	–
Commercial paper	**3,078**	–	**–**	–
Kreditanstalt für Wiederaufbau working capital facility	**228**	–	**–**	–
Fair value of debt (fair value hedges)	**(8)**	–	**–**	–
	11,387	3,647	**–**	–

20 Bank overdrafts and loans continued

Debt issued under the Medium Term Note programme is analysed as follows:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
4 7/8% sterling Medium Term Note due 2009 (less unamortised discount and fees)	**2,241**	2,239	**–**	–
3 1/8% Euro Medium Term Note due 2009 (less unamortised discount and fees)	**1,739**	1,670	**–**	–
2 5/8% US dollar Medium Term Note due 2008 (less unamortised discount and fees)	**717**	686	**–**	–
2 5/8% US dollar Medium Term Note due 2008 (less unamortised discount and fees)	**287**	276	**–**	–
Floating rate sterling Medium Term Note due 2006 (less unamortised discount and fees)	**–**	999	**–**	–
Floating rate Euro Medium Term Note due 2007 (less unamortised discount and fees)	**873**	838	**–**	–
	5,857	6,708	**–**	–

Bank loans repayable in more than one year are analysed as follows:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
HSBC Bank due 2019 repayable by instalments	**206**	211	**206**	211
Barclays Bank due 2017 repayable by instalments	**58**	59	**58**	59
Royal Bank of Scotland due 2017 repayable by instalments	**68**	67	**68**	67
Kreditanstalt für Wiederaufbau due 2015	**–**	100	**–**	100
Kreditanstalt für Wiederaufbau due 2013	**–**	115	**–**	115
5.57% European Investment Bank due 2013	**200**	200	**–**	200
5.77% European Investment Bank due 2012	**300**	300	**–**	300
6.42% European Investment Bank due 2011	**100**	100	**–**	100
6.42% European Investment Bank due 2009	**100**	100	**–**	100
European Investment Bank due 2007	**100**	100	**–**	100
	1,132	1,352	**332**	1,352

During the year loans from KfW due to mature in 2013 and 2015 were repaid in full and replaced by a 364-day working capital facility which is disclosed in amounts repayable within one year.

The weighted average interest rates on borrowings at 31 March 2005 and 2006 were as follows:

	2006 Group %	2005 Group %	2006 Company %	2005 Company %
Bank loans and overdrafts	**5.31**	5.49	**5.31**	5.49
Debt issued under the Debt Issuance programme	**4.82**	4.78	**–**	–
Debt issued under Medium Term Note programme	**5.26**	5.17	**–**	–
Loans from subsidiary	**–**	–	**–**	–
Debt issued under the Commercial Paper Programme	**4.79**	4.78	**4.79**	4.78

Debt of £16,116m (2005: £11,385m) is arranged or hedged at fixed interest rates and exposes the Group to fair value interest rate risk. Other borrowings were arranged at floating rates, thus exposing the Group to cash flow interest rate risk.

The Directors estimate the fair value of the Group's borrowings as follows:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Bank loans and overdrafts	**(1,422)**	(1,559)	**(332)**	(1,421)
Debt issued under the Debt Issuance Programme (before unamortised discount)	**(11,365)**	(3,688)	**–**	–
Debt issued under Medium Term Note programme (before unamortised discount)	**(5,547)**	(6,716)	**–**	–
Loan from subsidiary	**–**	–	**(17,712)**	(10,542)
Debt issued under the Commercial Paper Programme	**–**	(3,991)	**–**	(3,991)
	(18,334)	(15,954)	**(18,044)**	(15,954)

20 Bank overdrafts and loans continued

At 31 March 2005 and 2006 the Group had the following undrawn committed borrowing facilities.

	2006 Drawn £m	2006 Undrawn £m	2006 Total £m	2005 Drawn £m	2005 Undrawn £m	2005 Total £m
Working capital facility	–	**2,750**	**2,750**	138	3,362	3,500
Standby facility A	–	**4,000**	**4,000**	–	4,000	4,000
	–	**6,750**	**6,750**	138	7,362	7,500

Undrawn committed facilities expire as follows:

	2006 £m	2005 £m
Within one year	**2,750**	3,362
Within one to two years	–	–
Within two to five years	**4,000**	4,000
	6,750	7,362

Not included in the above analysis are the £800m European Investment Bank and £228m Kreditanstalt für Wiederaufbau facilities as these were fully drawn as at 31 March 2006.

In addition the Secretary of State for Transport has provided support facilities in respect of the facilities listed below:

- Unlimited financial indemnity in respect of borrowings under the Debt Issuance Programme.
- Medium Term Note Programme.
- £800m European Investment Bank.
- £230m Kreditanstalt für Wiederaufbau.

The support facilities provided by the Secretary of State for Transport cover amounts payable under the relevant facilities.

An integral part of the Railways Act 2005 (which received Royal Assent on 7 April 2005) was the intention to create a Transfer Scheme which enabled the transfer to the Secretary of State for Transport (SoS) of the property, rights and liabilities of the Strategic Rail Authority (SRA) relating to the indebtedness of Network Rail. This Transfer Scheme took effect on Sunday 26 June 2005 and with effect from this date, the SoS was treated as the same person in law as the SRA. The debt support obligations which were transferred from the SRA to the SoS include those under the Debt Issuance Programme, (being the Financial Indemnity). As a result of the Transfer, the debt support obligations for Network Rail's debt became direct sovereign obligations of the Crown.

21 Derivative financial instruments

The Group and Company uses derivative financial instruments to reduce exposure to foreign exchange risk and interest rate movements.

The Group and Company does not use derivative financial instruments for speculative purposes, however it may wish to designate certain derivatives as hedges. Such derivatives that are not hedge accounted are fair valued immediately through the income statement. The Group and Company has a comprehensive risk management process. The Board have approved and monitor the risk management processes, including documented treasury policies, counterparty limits, controlling and reporting structures.

The use of derivative instruments can give rise to credit and market risk. Market risk is the possibility that future changes in foreign exchange rates and interest rates may make a derivative more or less valuable. Since the Group and Company uses derivatives for risk management, market risk relating to derivative instruments will principally be off set by changes in the valuation of the underlying assets, liabilities or transactions being hedged.

The credit risk with regard to derivative financial instruments and other funds is limited because the counterparties are banks with high credit ratings assigned by international credit-rating agencies. The Group and Company spreads its exposure over a number of counterparties.

Foreign exchange risk is managed by the use of forward exchange contracts, and currency swaps to limit the effects of movements in exchange rates on foreign currency denominated liabilities.

Interest rate risk is managed by the use of interest rate swaps to manage exposure to interest rate movements on a portion of existing debt.

The obligations and rights of Network Rail Infrastructure Limited under the inter-company loan agreement with its financing companies give rise to embedded derivatives in that agreement which reflects the external currency and interest rates risks to which the financing companies are exposed. The embedded derivatives are treated as separate derivatives and accounted for in accordance with the accounting policy Note 2.

The Group and Company adopted IAS 32 and IAS 39 from 1 April 2005 and therefore balances for the year ended 31 March 2005 are not included in the Group and Company comparative balance sheets and are provided for disclosure purposes only.

	2006 Group		2006 Company	
	Fair value £m	Notional amounts £m	Fair value £m	Notional amounts £m
Cash flow hedges				
Cross-currency swaps to hedge debt issued under Debt Issuance Programme	32	1,224	–	–
Cross-currency swaps to hedge debt issued under Medium Term Note Programme	51	2,518	–	–
Forward starting interest rate swaps	1	1,590	–	–
Currency derivatives	31	1,940	–	–
	115	7,272	–	–
Included in non current assets	65	–	–	–
Included in current assets	50	–	–	–
Derivative financial instrument assets	115	–	–	–
Cash flow hedges				
Cross-currency swaps to hedge debt issued under Debt Issuance Programme	(11)	362	–	–
Cross-currency swaps to hedge debt issued under Medium Term Note Programme	(17)	964	–	–
Interest rate swaps	(1)	328	–	–
Fair value hedges				
Cross-currency swaps to hedge debt issued under Debt Issuance Programme	(7)	250	–	–
Currency derivatives	(11)	650	–	–
Embedded derivatives in the inter-company borrowings	–	–	(130)	–
	(47)	2,554	(130)	–
Included in current liabilities	(2)	–	(130)	–
Included in non current liabilities	(45)	–	–	–
Derivative financial instrument liabilities	(47)	–	(130)	–

21 Derivative financial instruments continued

	2006 Group Fair value £m	2006 Group Notional amounts £m	2005 Group Fair value £m	2005 Group Notional amounts £m
Cash flow hedges				
Cross-currency swaps to hedge debt issued under Debt Issuance Programme	**22**	**1,586**	(15)	531
Cross-currency swaps to hedge debt issued under Medium Term Note Programme	**33**	**3,482**	(42)	4,482
Interest rate swaps	**(1)**	**328**	2	330
Forward starting interest rate swaps	**1**	**1,590**	(30)	3,340
Fair value hedges				
Cross-currency swaps to hedge debt issued under Debt Issuance Programme	**(7)**	**250**	–	–
Currency derivatives	**20**	**2,590**	(14)	2,783
Net derivative financial instruments	**68**	**9,826**	(99)	11,466

	2006 Company Fair value £m	2006 Company Notional amounts £m	2005 Company Fair value £m	2005 Company Notional amounts £m
Embedded derivatives in the inter-company borrowings	**(130)**	**9,826**	(99)	11,466

Some derivatives, while complying with the Group's financial risk management policies, do not qualify for hedge accounting and are therefore classified as held for trading.

The Group and the Company adopted IAS 32 and IAS 39 from 1 April 2005. For the year ended 31 March 2004 changes in the fair value of instruments used as hedges were not recognised in the financial statements until the hedged position matured. The gains and losses that were anticipated were as follows:

	2005 Gains £m	2005 Losses £m	2005 Total net gains/(losses) £m
Unrecognised gains and losses on hedges at 1 April 2004	1	(26)	(25)
Gains and losses arising in the prior year that were recognised in the current year	–	1	1
Gains and losses arising in the prior year that were not recognised in the current year	1	(25)	(24)
Gains and losses arising in the current year that were not recognised in the current year	10	(90)	(80)
Unrecognised gains and losses on hedges at 31 March 2005	11	(115)	(104)
Of which:			
Gains and losses expected to be recognised within one year	3	(36)	(33)
Gains and losses expected to be recognised after more than one year	8	(79)	(71)

22 Deferred tax

The following are the major deferred tax liabilities and assets recognised by the Group and Company and movement thereon during the current and prior years.

Group	Accelerated tax depreciation £m	Revaluation of railway network £m	Retirement benefit obligations £m	Derivatives £m	Tax losses £m	Total £m
At 1 April 2004	1,318	986	(50)	–	(1,176)	1,078
Charge/(credit) to income	547	–	(14)	–	(551)	(18)
Charge/(credit) to equity	–	453	(69)	–	–	384
At 31 March 2005	**1,865**	**1,439**	**(133)**	**–**	**(1,727)**	**1,444**
Impact of adopting IAS32 and IAS39 at 1 April 2005	–	–	–	(34)	–	(34)
At 1 April 2005	**1,865**	**1,439**	**(133)**	**(34)**	**(1,727)**	**1,410**
Charge/(credit) to income	345	–	(14)	7	(317)	21
Charge/(credit) to equity	54	422	31	(43)	–	464
At 31 March 2006	**2,264**	**1,861**	**(116)**	**(70)**	**(2,044)**	**1,895**

22 Deferred tax continued

Company	Accelerated tax depreciation £m	Revaluation of railway network £m	Retirement benefit obligations £m	Derivatives £m	Tax losses £m	Total £m
At 1 April 2004	1,318	986	(50)	–	(1,176)	1,078
Charge/(credit) to income	547	–	(14)	–	(551)	(18)
Charge/(credit) to equity	–	453	(69)	–	–	384
At 31 March 2005	**1,865**	**1,439**	**(133)**	**–**	**(1,727)**	**1,444**
Impact of adopting IAS32 and IAS39 at 1 April 2005	–	–	–	(34)	–	(34)
At 1 April 2005	**1,865**	**1,439**	**(133)**	**(34)**	**(1,727)**	**1,410**
Charge/(credit) to income	345	–	(14)	(19)	(317)	(5)
Charge/(credit) to equity	54	422	31	(17)	–	490
At 31 March 2006	**2,264**	**1,861**	**(116)**	**(70)**	**(2,044)**	**1,895**

Certain deferred tax assets and liabilities have been offset. The following is the analysis of the gross deferred tax balances:

	2006 £m	2005 £m
Deferred tax liabilities	**4,124**	3,304
Deferred tax assets	**(2,229)**	(1,860)
	1,895	1,444

Network Rail Infrastructure Limited has a potential deferred tax asset relating to the disposal of the track bed which is carried at zero in the accounts. It is not possible to reliably determine the tax base of the asset which would be determined by negotiation with HM Revenue & Customs and therefore it has not be possible to reliably quantify the potential deferred tax asset. Had it been possible to do so, the potential deferred tax asset would not have been recognised in these accounts as it is not considered probable that suitable taxable profits will be available against which the deferred tax asset can be utilised.

23 Obligations under finance leases

	Minimum lease payments		**Present value of minimum lease payments**	
	2006 Group and Company £m	2005 Group and Company £m	**2006 Group and Company £m**	2005 Group and Company £m
Amounts payable under finance leases:				
Within one year	**1**	1	**–**	–
In the second to fifth years inclusive	**4**	3	**2**	1
After five years	**11**	12	**8**	9
	16	16	**10**	10
Less: future finance charges	**(6)**	(6)	**n/a**	n/a
Present value of lease obligations	**10**	10	**10**	10
Less: amounts repayable within one year (shown under current liabilities)			**–**	–
Amounts repayable after more than one year			**10**	10

The Group leases certain fixtures and fittings under finance leases from third parties. All lease obligations are denominated in sterling. The fair value of the Group's lease obligations approximates their carrying amount. The Group's obligations under finance leases are secured by the lessors' charges over the leased assets. For the year ended 31 March 2006, the effective borrowing rate was 5.1% (2005: 5.1%). Interest rates are fixed at contract date. All leases are on a fixed repayment basis and no arrangements have been entered into for contingent rent payments.

24 Trade and other payables

Current liabilities: Trade and other payables

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Trade creditors	**589**	543	**574**	542
Amounts due to construction contract customers	**–**	2	**–**	2
Payments received on account	**11**	40	**11**	40
Taxation and social security	**–**	37	**–**	37
Other creditors	**357**	124	**357**	124
Other interest accruals	**153**	85	**153**	85
Other accruals and deferred income	**973**	1,267	**973**	1,222
	2,083	2,098	**2,068**	2,052

The average credit period taken for trade purchases is 49 days (2005: 59 days).

The Directors consider that the carrying value of trade and other payables approximates to their fair value. All balances are non interest bearing and denominated in sterling.

Non-current liabilities: Other payables

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Deferred development income	**117**	135	**117**	135
Capital grants deferred income	**802**	725	**802**	724
	919	860	**919**	859

25 Provisions: Group and Company

	Environmental provision £m	Other provisions £m	Total £m
At 1 April 2004	33	95	128
Additional provision in the year	–	26	26
Utilisation of provision	(11)	(82)	(93)
At 1 April 2005	**22**	**39**	**61**
Additional provision in the year	–	–	–
Utilisation of provision	(5)	(17)	(22)
At 31 March 2006	**17**	**22**	**39**
Included in current liabilities	5	12	17
Included in non-current liabilities	12	10	22
	17	**22**	**39**

The Group and Company have provided for the anticipated costs of remedial works on land inherited from the British Railways Board which has suffered contamination, and where contractual or other obligations require the Company to clear up these sites. Following a review of the planned expenditure, it is estimated that the provision will be entirely utilised within two to three years. In addition, the Group and Company have provided against a number of commercial claims from third parties for which settlement is expected to be achieved in the next one to two years.

26 Share capital

	2006 Group and Company £m	2005 Group and Company £m
Authorised:		
50,200,000 ordinary shares of 0.1p each	–	–
500,000,000 redeemable shares of £1 each	**500**	500
	500	500
Issued and fully paid:		
50,084,937 ordinary shares of 0.1p each	–	–
160,000,000 redeemable shares of £1 each	**160**	160
	160	160

The Company has the option to repurchase any or all of the redeemable shares at any date after 31 March 2003. No premium is repayable on such redemption and the option to repurchase has no expiry date. The redeemable shareholders have no right to redemption at their instigation. Redeemable shares do not carry voting rights, or rank for dividend, but may do so if the Company passes a resolution to that effect.

27 Reconciliation of changes in equity

Group	Share Capital £m	Share Premium £m	Revaluation Reserve £m	Other Reserve* £m	Hedging Reserve £m	Retained Earnings £m	Total £m
At 1 April 2004	160	85	2,301	1,451	–	(1,407)	2,590
Revaluation of the railway network	–	–	1,663	–	–	–	1,663
Increase in deferred tax liability on the railway network	–	–	(453)	–	–	–	(453)
Actuarial losses on defined benefit pension schemes	–	–	–	–	–	(230)	(230)
Deferred tax on actuarial gains and losses	–	–	–	–	–	69	69
							1,049
Transfer of deemed cost depreciation from revaluation reserve	–	–	(154)	–	–	154	–
Net loss for the year	–	–	–	–	–	(29)	(29)
At 31 March 2005	**160**	**85**	**3,357**	**1,451**	**–**	**(1,443)**	**3,610**
Opening adjustments made on 1 April 2005 on transition to IAS 32 and IAS 39	–	–	–	–	–	–	–
Opening value of derivatives on transition to IAS 32 and IAS 39	–	–	–	–	(85)	(15)	(100)
Opening exchange differences on retranslation of foreign currency debt on transition to IAS 32 and IAS 39	–	–	–	–	(19)	21	2
Opening deferred taxation on transition to IAS 32 and IAS 39	–	–	–	–	34	–	34
							(64)
Revaluation of the railway network	–	–	1,583	–	–	–	1,583
Transfer of deemed cost depreciation from revaluation reserve	–	–	(181)	–	–	181	–
Increase in deferred tax liability on the railway network	–	–	(422)	–	–	(54)	(476)
Actuarial gains on defined benefit pension schemes	–	–	–	–	–	102	102
Deferred tax on actuarial gains and losses	–	–	–	–	–	(31)	(31)
Deferred taxation on all hedging reserve movements/retained earnings	–	–	–	–	42	–	42
Increase/(decrease) in fair value of hedging derivatives	–	–	–	–	1	–	1
Exchange differences on retranslation of foreign currency debt	–	–	–	–	(178)	–	(178)
Transfers							
Transferred to income statement on disposal of cash flow hedges	–	–	–	–	25	–	25
Recycling of balances in hedging reserve to the income statement	–	–	–	–	2	–	2
Net loss for the year						(253)	(253)
At 31 March 2006	**160**	**85**	**4,337**	**1,451**	**(178)**	**(1,492)**	**4,363**

27 Reconciliation of changes in equity continued

Company	Share Capital £m	Share Premium £m	Revaluation Reserve £m	Other Reserve* £m	Hedging Reserve £m	Retained Earnings £m	Total £m
At 1 April 2004	160	85	2,301	1,451	–	(1,407)	2,590
Revaluation of the railway network	–	–	1,663	–	–	–	1,663
Increase in deferred tax liability on the railway network	–	–	(453)	–	–	–	(453)
Actuarial losses on defined benefit pension schemes	–	–	–	–	–	(230)	(230)
Deferred tax on actuarial gains and losses	–	–	–	–	–	69	69
Net loss for the year	–	–	–	–	–	(37)	(37)
							1,012
Transfer of historic cost from retained earnings	–	–	(154)	–	–	–	(154)
Transfer of deemed cost depreciation from revaluation reserve	–	–	–	–	–	154	154
At 1 April 2005	**160**	**85**	**3,357**	**1,451**	**–**	**(1,451)**	**3,602**
Opening adjustments made on 1 April 2005 on transition to IAS 32 and IAS 39	–	–	–	–	–	–	–
Opening value of derivatives on transition to IAS 32 and IAS 39	–	–	–	–	(28)	(72)	(100)
Opening exchange differences on retranslation of foreign currency debt on transition to IAS 32 and IAS 39	–	–	–	–	–	2	2
Opening deferred taxation on transition to IAS 32 and IAS 39	–	–	–	–	11	23	34
							(64)
Revaluation of the railway network	–	–	1,583	–	–	–	1,583
Transfer of deemed cost depreciation from revaluation reserve	–	–	(181)	–	–	181	–
Increase in deferred tax liability on the railway network	–	–	(422)	–	–	(54)	(476)
Actuarial gains on defined benefit pension schemes	–	–	–	–	–	102	102
Deferred tax on actuarial gains and losses	–	–	–	–	–	(31)	(31)
Deferred taxation on all hedging reserve movements/retained earnings	–	–	–	–	17	–	17
Increase/(decrease) in fair value of hedging derivatives	–	–	–	–	(88)	–	(88)
Transfers							
Transferred to income statement on disposal of cash flow hedges	–	–	–	–	25	–	25
Recycling of balances in hedging reserve to the income statement	–	–	–	–	2	–	2
Exchange differences on retranslation of foreign currency debt (hedge accounted hedge – non hedge accounted through income statement)	–	–	–	–	–	–	–
Net loss for the year	–	–	–	–	–	(322)	(322)
At 31 March 2006	**160**	**85**	**4,337**	**1,451**	**(61)**	**(1,622)**	**4,350**

* Other reserves of £1,451m comprise the vesting reserve (2005: £1,451m) on privatisation.

All changes in equity represent recognised income and expenses.

28 Notes to the cash flow statement

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Operating profit from continuing operations	**468**	465	**468**	465
Adjustments for:				
Depreciation of the railway network	**964**	805	**964**	805
Amortisation of capital grants	**(26)**	(27)	**(26)**	(27)
Amortisation of intangible assets	**2**	2	**–**	–
Decrease in provisions	**(22)**	(67)	**(22)**	(67)
Operating cash flows before movements in working capital	**1,386**	1,178	**1,384**	1,176
Decrease/(increase) in inventories	**(9)**	13	**(9)**	13
Decrease/(increase) in receivables	**142**	(186)	**115**	(198)
Decrease in payables	**(195)**	(18)	**(159)**	(1)
Cash generated from operations	**1,324**	987	**1,331**	990
Interest paid	**(669)**	(505)	**(669)**	(505)
Net cash generated from operating activities	**655**	482	**662**	485

Cash and cash equivalents (which are represented as a single class of assets on the face of the balance sheet) comprise cash at bank and money market deposit investments with an average maturity of three days.

29 Analysis of changes in net debt

	At 1 April 2005 £m	Cash flows £m	Non cash movements £m	Amortisation of discount £m	Fair value hedges £m	Foreign exchange differences £m	At 31 March 2006 £m
Cash and cash equivalents	28	3	–	–	–	–	**31**
Borrowings due within one year	(5,122)	2,151	(1,059)	(104)	–	(52)	**(4,186)**
Borrowings due after one year	(10,708)	(4,379)	1,059	(11)	7	(165)	**(14,197)**
Obligations under finance leases	(10)	–	–	–	–	–	**(10)**
Available-for-sale investments	166	(5)	–	–	–	–	**161**
	(15,646)	(2,230)	–	(115)	7	(217)	**(18,201)**

	At 1 April 2004 £m	Cash flows £m	Non cash movements £m	Amortisation of discount £m	Fair value hedges £m	Foreign exchange differences £m	At 31 March 2005 £m
Cash and cash equivalents	14	14	–	–	–	–	28
Borrowings due within one year	(4,912)	969	(999)	(180)	–	–	(5,122)
Borrowings due after one year	(7,802)	(3,897)	999	(8)	–	–	(10,708)
Obligations under finance leases	(41)	31	–	–	–	–	(10)
Available-for-sale investments	145	21	–	–	–	–	166
	(12,596)	(2,862)	–	(188)	–	–	(15,646)

30 Operating lease arrangements
The Group as lessee

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Minimum lease payments under operating leases recognised in income statement in the year	**54**	95	**54**	95

At the balance sheet date, the Group had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Within one year	**43**	60	**43**	60
In the second to fifth years inclusive	**54**	55	**54**	55
After five years	**35**	32	**35**	32
	132	147	**132**	147

Operating lease payments largely represent rentals payable by the Group for certain of its office properties. Leases are negotiated for an average term of seven years and rentals fixed for an average of three years. In addition rentals are paid for land adjacent to the railway as required for maintenance and renewal activities.

The Group as lessor
Operating lease rentals earned in the year were £479m (2005: £455m). The majority of this income is earned from station and depot leases to train operating companies. Further rentals are earned from investment properties, other station lettings, advertising, telecoms and rail contractors.

At the balance sheet date the Group had contracted with customers for the following future minimum lease payments:

	2006 Group £m	2005 Group £m	2006 Company £m	2005 Company £m
Within one year	**375**	402	**375**	402
In the second to fifth years inclusive	**942**	864	**942**	864
After five years	**1,337**	574	**1,337**	574
	2,654	1,840	**2,654**	1,840

31 Retirement benefit scheme
Defined contribution schemes
With effect from 1 April 2004 the Company introduced a defined contribution pension scheme, the Network Rail Defined Contribution Pension Scheme (NRDCPS). This scheme is the only Company-sponsored pension offered to all new employees of Network Rail, except those who have the legal right to join the Railway Pension Scheme (RPS) or who join directly from another employer participating in the scheme and were an active RPS member with that employer immediately before joining the Company. Any employee who wishes to transfer from the Network Rail Section of the RPS to the NRDCPS is entitled to do so.

At 31 March 2006, the NRDCPS has 6,510 members and the average employer contribution rate in the year was 5%.

Defined benefit schemes
The principal pension scheme in which the Group participates is the Railway Pension Scheme (RPS), which was established by statutory instrument, commenced on 1 October 1994 and is a funded defined benefit arrangement. The assets and liabilities under the predecessor scheme, the British Rail Pension Scheme (BRPS), were transferred to the RPS on that date. The RPS is an industry-wide scheme for all eligible employees within the railway industry. There are different sections within it for different employers. The assets and liabilities of each section are identified separately from those of the other sections. The Group has its own section, the Network Rail Shared Cost Section (the 'Network Rail Section'). This scheme, the assets of which are held separately from the Group, is contributory and provides pensions related to pay at retirement.

The assets transferred to the RPS from the BRPS on 1 October 1994 were apportioned amongst the various sections of the RPS in accordance with the methods and assumptions specified in The Railways Pensions (Transfer and Miscellaneous Provisions) Order 1994 (the 'Transfer Order') which effected the transfer. The amount credited to the Network Rail Section included a share of the surplus at that time.

Since 1 April 2004, new members can only join the Network Rail Section of the RPS after completing five years' service unless they join directly from another employer participating in the scheme and they were an active member immediately before joining the Company. Benefits for existing members and employees joining up to and including 31 March 2004 were not affected by the revised eligibility rules. In addition to deferring entry to the scheme to new entrants the Company announced its decision to cap its contribution to British Railways Additional Superannuation Scheme (BRASS) matching at the current levels in November 1993 for existing employees and to dispense with matching for new employees. The Company will continue to match regular contributions but will not increase them in cash terms in the future.

31 Retirement benefit scheme continued

A full funding actuarial valuation of the Network Rail Section was carried out by the scheme actuary at 31 December 2004. Qualified actuaries Watson Wyatt have valued the scheme on an IAS19 basis at 31 March 2006 and 31 March 2005.

The total contribution rate payable under the RPS is normally split in the proportion 60:40 between the Group and the members. The Group reflects it's share of the contribution in the financial statements.

The Group and members pay contributions of 14.25% and 9.5% of section pay respectively.

If a surplus or deficit arises, the provisions in the RPS rules mean that the Company and members benefit from or pay for this respectively in the proportion 60:40.

	2006 %	2005 %
Key assumptions used:		
Discount rate	**5.00**	5.40
Expected return on equity assets	**8.00**	6.25
Expected return on bond assets	**4.00**	4.25
Expected return on property assets	**6.00**	6.25
Expected rate of salary increases*	**4.50**	4.40
Future pension increases	**3.00**	2.90

* Inclusive of a promotional salary scale of 0.5% per annum.

	Male	Female
Average life expectancy for mortality tables used to determine defined benefit obligations:		
– Member aged 65 now	17.8	20.1
– Member aged 65 in 20 years' time	18.7	21.2

Amounts recognised in income in respect of the defined benefit scheme are as follows:

	2006 £m	2005 £m
Current service cost	**112**	86
Interest cost	**92**	96
Expected return on scheme assets	**(71)**	(86)
Past service costs	**–**	–
	133	96

The current service cost has been included in employee costs, the expected return on scheme assets less interest on liabilities has been included in finance costs.

Actuarial gains and losses have been reported in the statement of recognised income and expense.

The amount included in the balance sheet arising from the Group's obligations in respect of its defined benefit scheme is as follows:

	2006 £m	2005 £m
Present value of defined benefit obligations	**(3,234)**	(2,527)
Fair value of scheme assets	**2,635**	1,849
Deficit in scheme	**(599)**	(678)
Company's share (60%) of the scheme deficit recognised in the balance sheet	**(359)**	(414)
This amount is presented in the balance sheet as follows:		
Included in current liabilities	**–**	–
Included in non-current liabilities	**(359)**	(414)
	(359)	(414)

Cumulative actuarial gains or losses are recognised in equity.

31 Retirement benefit scheme continued

Movements in the present value of defined benefit obligations in the current year were as follows:

	2006 £m	2005 £m
At 1 April	**(2,527)**	(1,525)
Current service cost including members' share	**(178)**	(139)
Interest cost	**(153)**	(96)
Benefits paid	**(375)**	(710)
Less transfers in	**225**	392
Actuarial gains and losses	**(226)**	(449)
Past service cost	**–**	–
At 31 March	**(3,234)**	(2,527)

Movements in the present value of fair value of scheme assets in the current year were as follows:

	2006 £m	2005 £m
At 1 April	**1,849**	1,253
Expected return on scheme assets	**118**	89
Actuarial gains and losses	**376**	79
Contributions from scheme members	**53**	35
Contributions from Employer	**89**	75
Benefits paid	**375**	710
Less transfers in	**(225)**	(392)
At 31 March	**2,635**	1,849

The analysis of the scheme assets and the expected rate of return at the balance sheet date was as follows:

	Expected return		Fair value of assets	
	2006 %	2005 %	2006 £m	2005 £m
Equity instruments	**8.00**	6.25	**2,131**	1,287
Debt instruments	**4.00**	4.25	**312**	410
Property	**6.00**	6.25	**174**	152
Other	**4.00**	–	**18**	–
			2,635	1,849

The expected return on assets assumption was determined as the average of the expected returns on the assets held by the Network Rail Section on the accounting date. The rates of return for each class are set out in the table above and were determined as follows:

- Equities and property: The rate adopted is consistent with the median assumption used in Watson Wyatt's Asset Liability Modelling work.
- Bonds: The overall rate has been set to reflect the yields on the bond holdings.
- Other assets: This class is mostly made up of cash holdings and the rate adopted reflects current short-term returns on such deposits.

The history of experience adjustments is as follows:

	2006 £m	2005 £m
Present value of defined benefit obligations	**(3,234)**	(2,527)
Fair value of scheme assets	**2,635**	1,849
Deficit in the scheme	**(599)**	(678)
Deficit in the scheme (employer's share)	**(359)**	(414)
Experience adjustments on scheme liabilities		
Amount (£m)	**(67)**	(217)
Percentage of scheme liabilities (%)	**2.07%**	8.59%
Experience adjustments on scheme assets		
Amount (£m)	**229**	79
Percentage of scheme assets (%)	**8.69%**	4.27%

The estimated amount of contributions expected to be paid to the scheme during the year ended 31 March 2007 is £105m.

32 Related party transactions

Transactions between the company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

The Company's ultimate parent company and controlling entity is Network Rail Limited, a company limited by guarantee without shares. The Company's immediate parent company is Network Rail Holdco Limited. Both parent companies are incorporated in Great Britain and registered in England and Wales. The largest group of undertakings of which the Company is a member and for which group accounts are drawn up is Network Rail Limited. Copies of the parent companies' financial statements can be obtained by contacting the Company Secretary at 40 Melton Street, London, NW1 2EE.

33 Explanation of transition to IFRS: Group

Reconciliation of equity at 1 April 2004 (date of transition to IFRS)

	Note	UK GAAP £m	Effect of transition to IFRSs £m	IFRSs £m
Assets				
Non-current assets				
Intangible assets		81	–	81
Property, plant and equipment – the railway network	i	18,498	(725)	17,773
Investment property	i	78	725	803
Available for sale investments	iv	–	141	141
Finance lease receivables		28	–	28
		18,685	141	18,826
Current assets				
Inventories	iv	77	(29)	48
Trading investments	iv	147	(147)	–
Finance lease receivables		3	–	3
Trade and other receivables	iv	656	35	691
Cash and cash equivalents	iv	8	6	14
		891	(135)	756
Total assets		19,576	6	19,582
Current liabilities				
Trade and other payables	iv	(2,153)	(8)	(2,161)
Bank loans and overdrafts		(4,912)	–	(4,912)
Short term provisions	iv	–	(106)	(106)
		(7,065)	(114)	(7,179)
Net current liabilities		(6,174)	(249)	(6,423)
Non-current liabilities				
Bank loans		(7,802)	–	(7,802)
Other payables		(707)	–	(707)
Retirement benefit obligation	ii	(59)	(104)	(163)
Deferred tax liabilities	iii	(182)	(896)	(1,078)
Long term provisions	iv	(128)	106	(22)
Obligations under finance leases		(41)	–	(41)
		(8,919)	(894)	(9,813)
Total liabilities		(15,984)	(1,008)	(16,992)
Net assets		3,592	(1,002)	2,590
Equity				
Share capital		160	–	160
Share premium account		85	–	85
Revaluation reserves	i,iii	3,917	(1,616)	2,301
Other reserve	i,iii	1,209	242	1,451
Retained earnings	i,ii,iii	(1,779)	372	(1,407)
Total shareholders' funds		3,592	(1,002)	2,590

33 Explanation of transition to IFRS continued

Reconciliation of equity at 31 March 2005 (date of last UK GAAP financial statements)

	Note	UK GAAP £m	Effect of transition to IFRS £m	IFRS £m
Assets				
Non-current assets				
Intangible assets		79	–	79
Property, plant and equipment – the railway network	i	23,011	(790)	22,221
Investment property	i	83	789	872
Available for sale investments	iv	–	166	166
Loan to immediate parent company		307	–	307
Finance lease receivables		25	–	25
		23,505	165	23,670
Current assets				
Inventories	iv	62	(27)	35
Trading investments	iv	192	(192)	–
Finance lease receivables		3	–	3
Trade and other receivables	iv	562	29	591
Cash and cash equivalents	iv	2	26	28
		821	(164)	657
Total assets		24,326	1	24,327
Current liabilities				
Trade and other payables	iv	(2,095)	(3)	(2,098)
Bank loans and overdrafts		(5,122)	–	(5,122)
Short term provisions	iv	–	(53)	(53)
		(7,217)	(56)	(7,273)
Net current liabilities		(6,396)	(220)	(6,616)
Non-current liabilities				
Bank loans		(10,708)	–	(10,708)
Other payables		(860)	–	(860)
Retirement benefit obligation	ii	(101)	(313)	(414)
Deferred tax liabilities	iii	(152)	(1,292)	(1,444)
Long term provisions	iv	(61)	53	(8)
Obligations under finance leases		(10)	–	(10)
		(11,892)	(1,552)	(13,444)
Total liabilities		(19,109)	(1,608)	(20,717)
Net assets		5,217	(1,607)	3,610
Equity				
Share capital		160	–	160
Share premium account		85	–	85
Revaluation reserves	i,iii	5,671	(2,314)	3,357
Other reserve	i,iii	1,209	242	1,451
Retained earnings	i,ii,iii	(1,908)	465	(1,443)
Total shareholders' funds		5,217	(1,607)	3,610

33 Explanation of transition to IFRS continued

Reconciliation of loss for the year ended 31 March 2005

	Note	UK GAAP £m	Effect of transition to IFRS £m	IFRS £m
Revenue		3,800	–	3,800
Operating costs	i,ii	(3,340)	58	(3,282)
Transitional reorganisation costs		(53)	–	(53)
		(3,393)	58	(3,335)
Profit from operations		407	58	465
Profit on sale of properties		69	66	135
Investment income		23	–	23
Finance costs		(663)	(7)	(670)
Loss before tax		(164)	117	(47)
Tax		30	(12)	18
Loss for the period		(134)	105	(29)

Notes to the reconciliation of equity at 1 April 2004 and 31 March 2005 and loss for the year ended 31 March 2005

i. Investment properties and fixed assets

IAS 40 'Investment Properties' significantly widens the definition of an investment property. The standard states that an investment property is land and/or a building or part of a building, held to earn rentals and/or capital appreciation. For Network Rail IAS 40 applies to the majority of the Spacia estate and a number of serviced offices. This has resulted in a £789m reclassification from property, plant and equipment to investment properties at 31 March 2005 (£725m as at 1 April 2004). Items have been reclassified to investment properties at the same value that they were held within property, plant and equipment. The rationale for this is that net assets should not be increased or decreased by the transfer, given that in setting the Regulatory Asset Base, the Regulator is determining a single overall economic value for the business.

Under IAS 40 movements in the fair value of investment properties are recorded through the income statement whereas currently under UK GAAP movements are taken through the revaluation reserve. £81m of investment property revaluations have been credited to the IFRS income statement for the year ended 31 March 2005.

Any revaluation surplus attributable to properties previously classified as investment properties under UK GAAP is transferred to retained earnings when restating financial information under IFRS. £65m of revaluation surplus was transferred on transition at 1 April 2004, £70m was transferred in restating the UK GAAP balance sheet at 31 March 2005 under IFRS.

In addition the revaluation surplus attributable to the properties transferred from the railway network valuation to investment properties discussed above is also transferred to retained earnings. £134m was transferred on transition at 1 April 2004 and £219m was transferred in restating the UK GAAP balance sheet at 31 March 2005 under IFRS.

As permitted by IFRS 1, the Company has chosen the railway network fixed asset valuation at 1 April 2002 to be the deemed cost of the network. This was the date of implementation of depreciated replacement cost accounting for railway network fixed assets under UK GAAP and from that date the Company has maintained appropriate accounting records to enable it to undertake accounting for fixed assets on an IFRS compliant basis. IFRS requires that the revaluation surplus existing at the date at which fair value was deemed as cost be transferred to a non-distributable reserve. The revaluation surplus existing at 1 April 2002 transferred on transition was £346m before the netting of deferred taxation.

A transfer from the revaluation reserve to retained earnings is made for the difference between depreciation charged on the valuation of the railway network and the amount that would have been charged on a deemed historic cost basis. The transfer on transition for the period from 1 April 2002 to 31 March 2004 is £84m and an additional £155m was transferred for the year ended 31 March 2005.

The reduced balance of the railway network under IFRS has resulted in a depreciation charge under IFRS £30m less than that charged under UK GAAP for the year ended 31 March 2005.

33 Explanation of transition to IFRS continued

ii. Pensions

IAS 19 'Employee Benefits', the IFRS for pensions, takes a similar valuation approach to FRS 17 (disclosed in UK GAAP accounts) and in accordance with IFRS the Company's share of the full pension deficit has been recognised on the IFRS balance sheet at the transition date on 1 April 2004. Actuarial gains and losses are recognised immediately in the balance sheet through the statement of recognised income and expense, outside the income statement.

£104m was provided on transition to reflect the Company's share of the full scheme deficit at 1 April 2004. In the year ended 31 March 2005, the income statement charge for pensions under IAS 19 was £96m, £21m less than that charged under UK GAAP. Under IFRS, scheme deficits are recognised in full whereas under UK GAAP, deficits were spread over the average future service lives of scheme members.

Actuarial losses of £230m in the year ended 31 March 2005 arising primarily as a result of improved life expectancy and allowances for generous AVC (additional voluntary contributions) commutation were recognised directly in the balance sheet through the statement of recognised income and expense. This resulted in a Company share of the scheme deficit of £414m at 31 March 2005.

iii. Deferred taxation

Significant additional deferred taxation provisions are required under IFRS principally due to the tax treatment of the revaluation of the railway network. Under IAS 12, deferred taxation is provided in full on temporary differences arising between the tax bases of assets and liabilities and their carrying value in the financial statements. The additional deferred taxation provision is treated principally as a reduction in the revaluation reserve.

iv. Other adjustments

Other adjustments consist of reclassifications between balance sheet categories and a small number of other adjustments. Trading investments classified as current assets under UK GAAP have been reclassified as cash and cash equivalents or available-for-sale investments under non current assets. Provisions have been split between amounts due within one year and amounts due in more than one year, and long-term construction contract balances have been moved from inventory under UK GAAP to their appropriate headings within debtors and creditors under IFRS.

The transition to IFRS has not had any impact on NRIL's reported net cash flows. The presentation of the cash flow has changed as required by IFRS. Since there is no impact on net cash flows, no reconciliation is presented.