Group financial review

Operating profit

Total adjusted operating profit increased by £86m or 17% on a headline basis, to £592m in 2006 from £506m in 2005. Adjusted operating profit excludes amortisation and adjustment of acquired intangibles and other gains and losses on the sale of subsidiaries, joint ventures, associates and other financial assets that are included within continuing operations. For the purposes of our adjusted operating profit we add back the profits from discontinued operations. In 2006 these relate to the disposal of the Group's interest in Government Solutions and in 2005 to both the disposal of Government Solutions and Recoletos.

Statutory operating profit increased by £24m or 5%. This was a lower increase than seen in the adjusted operating profit due to an increased intangible amortisation charge and the absence of the Marketwatch profit on disposal recorded in 2005.

Net finance costs

Net finance costs reported in our adjusted earnings comprise net interest payable and net finance income relating to post-retirement plans. Net interest payable in 2006 was £94m, up from £77m in 2005. Although we were partly protected by our fixed rate policy (see page 21), the strong rise in average US dollar floating interest rates had an adverse effect. Year on year, average three month LIBOR (weighted for the Group's borrowings in US dollars, euros and sterling at the year end) rose by 1.5% to 4.9%. Combining the rate rise with an increase in the Group's average net debt of £40m, the Group's average net interest rate payable rose by 1.1% to 7.0%. In 2006 the net finance income relating to post-retirement plans was an income of £4m compared to a cost of £7m in the previous year, giving an overall net finance cost reflected in adjusted earnings of £90m in 2006 compared to £84m in 2005.

Our interest charge in 2007 will reflect the receipt of the sale proceeds from Government Solutions, a £100m cash payment into our UK Group pension plan, and higher interest rates.

Taxation

The tax rate on adjusted earnings increased slightly from 30.3% in 2005 to 30.9%. Our overseas profits, which arise mainly in the US, are generally subject to tax rates which are higher than the UK corporation tax rate of 30%. But this factor was again offset by releases of provisions following further progress in agreeing our tax affairs with the authorities and reassessment of the provisions required for uncertain items.

For 2007, we expect our effective tax rate on adjusted earnings per share to be in the 28-30% range. Our tax position benefits from deductions relating to amortisation of goodwill arising on acquisitions, and from 2007 we will reflect these deductions in adjusted earnings per share. The amount of tax paid (£59m in 2006) is not affected.

The reported tax charge on a statutory basis of £11m represents just over 2% of reported profits. This low tax rate was mainly accounted for by two factors. First, in the light of the announcement of the disposal of Government Solutions, we are required to recognise a deferred tax asset in relation to capital losses in the US where previously we were not confident that the benefit of the losses would be realised prior to their expiry. Second, in the light of our trading performance in 2006 and our strategic plans, together with the expected utilisation of US net operating losses in the Government Solutions sale, we have re-evaluated the likely utilisation of operating losses both in the US and the UK; this has enabled us to increase the amount of the deferred tax asset carried forward in respect of such losses. The combined effect of these two factors was to create a non-recurring credit of £127m.

The Group's reported statutory tax rate for 2007 is expected to be significantly higher than normal, as a result of the tax on the disposal of Government Solutions; taxable profit will be higher than the statutory profit expected to be reported, although actual cash tax on the transaction will be substantially reduced by the losses brought forward, recognised in 2006.

Minority interests

Following the disposal of our 79% holding in Recoletos and the purchase of the 25% minority stake in Edexcel in 2005, our minority interests now comprise mainly the minority share in IDC. In January 2006 we increased our stake in IDC reducing the minority interest from 39% to 38%.

Dividends

The dividend accounted for in our 2006 financial statements totalling £220m, represents the final dividend (17.0p) in respect of 2005 and the 2006 interim dividend of 10.5p.

We are proposing a final dividend for 2006 of 18.8p, bringing the total paid and payable in respect of 2006 to 29.3p, a 8.5% increase on 2005. This final 2006 proposed dividend was approved by the board in February 2007, is subject to shareholder approval at the forthcoming AGM and will be charged against 2007 profits. For 2006, the dividend is covered 1.4 times by adjusted earnings.

We seek to maintain a balance between the requirements of our shareholders for a rising stream of dividend income and the reinvestment opportunities which we identify around the Group.

In recent years, our dividend policy has been to increase the dividend ahead of the rate of inflation. Looking ahead, the board expects to raise the dividend more in line with earnings growth, while building our dividend cover towards two times earnings.

Pensions

Pearson operates a variety of pension plans. Our UK Group plan is by far the largest and includes a significant defined benefit section. We also have some smaller defined benefit plans in the US and Canada. Outside the UK, most of our companies operate defined contribution plans.

The income statement expense for defined benefit plans is determined using annually derived assumptions as to salary inflation, investment returns and discount rates, based on prevailing conditions at the start of the year. The assumptions for 2006 are disclosed in note 24 to our accounts, along with the year end deficits in our defined benefit plans. We recognise actuarial gains and losses arising when assumptions diverge from reality through the statement of recognised income and expense (SORIE).

Our charge to profit in respect of worldwide pensions and post-retirement benefits amounted to £60m in 2006 (2005: £68m) of which a charge of £64m (2005: £61m) was reported in operating profit and the net finance benefit of £4m (2005: charge £7m) was reported against interest.

Pension funding levels are kept under regular review by the company and the Fund trustees. Following the completion of the latest actuarial valuation of the UK Group pension plan as at January 2006, it was agreed that during 2007 additional payments amounting to £100m would be made by the company to the plan.

Corporate responsibility

Alongside our commitment to our financial goals, Pearson has a clear social purpose: to provide education, information and entertainment and help our customers get on in their lives. Each one of our businesses pays great attention to the quality and accuracy of its content and services; in education, for example, we are investing in a series of long-term studies to measure the efficacy of our programmes in enhancing student achievement.

Beyond those basic products and services, we invest in a range of activities to enhance Pearson's overall contribution to society and to minimise any negative impacts. These activities include the work of our charitable arm, The Pearson Foundation; our efforts to reduce our environment impact; and our policies on employment, diversity, labour standards and the supply chain. We publish a detailed annual report on corporate responsibility providing details of our progress and plans in all these areas, which is available at www.pearson.com/community/csr_report2006

Pearson is a founder member of the UN Global Compact on labour standards, human rights, the environment and anti-corruption. We have also been selected for inclusion in the FTSE4Good, Dow Jones Sustainability and Business in the Community Corporate Responsibility indices.

People

The following table shows for 2006 and 2005 the average number of people employed in each of our operating divisions.

Average number employed	2006	2005
School	11,064	10,133
Higher Education	4,368	4,196
Professional	3,754	3,809
Penguin	3,943	4,051
FT Publishing	2,285	1,952
IDC	2,200	1,956
Other	1,669	1,573
Continuing operations	29,283	27,670
Discontinued operations	5,058	4,533
Total	34,341	32,203

Our goal is to be the best company to work for and each year we get closer to achieving that. We provide benefits, incentive plans and opportunities that rival those offered by our competitors.

We maintain our policies to reflect a good work-life balance, and introduce new initiatives to reflect the changing expectations of our people, and we continue to provide training and management development opportunities around the world to help people progress. We believe that all this helps to build a strong culture and reinforces our values of being brave, imaginative and decent.

Communicating with our people is high on our list of priorities. We have an internal communications programme which enables us to reach people through e-mails, employee roadshows and visits from our senior managers. We try to listen as much as we talk so that we can act upon ideas, suggestions and views.

In addition to the training and development we provide in each part of the business, we have a number of cross-Pearson initiatives to help build the skills and knowledge of our people for the future. Building the skills base of our company also includes knowing who our very best talent are and how they plan to make the most of their skills to reach their potential.

We believe that the best way for people to profit from the success of the company is for them to become shareholders. Further detail of our employee share plans is shown on page 30 of the Directors' Report.

We undertook Pearson's biennial employee survey in September 2006. Over 9,700 Pearson colleagues from around the world, and from every part of our business, responded to the survey. Each operating company reviewed the feedback in detail as it affected their part of Pearson. We shared the overall results of the survey via the Pearson intranet.

We aim to be a diverse company – a company that reflects the societies in which we operate. We want to attract the very best candidates, at all levels, regardless of race, gender, age, physical ability, religion or sexual orientation. We do not set specific, numerical targets for recruitment or promotion of particular groups, but we place great emphasis on ensuring that the pool of applicants for our jobs is diverse. We also aim to be a fair company – where pay, retention, promotions and redundancies are determined without discrimination – and a company which uses diversity to help achieve our commercial goals and targets new opportunities in growing markets.

Suppliers

To be a successful and sustainable business we have to ensure that we balance our objective of securing cheaper supplies without compromising our standards of quality, causing harm to the environment or damaging our suppliers and their workers wherever they are in the world.

We were one of the founder signatories to the United Nations Global Compact. This sets out a series of principles on labour standards, human rights, the environment and anti-corruption. We have set out a series of commitments that reflect these principles against which we monitor and report our performance.

We carry out supplier audits against our commitments and ensure that our commercial purchasing teams have received training on our supply chain labour standards.

Details of our supplier payment policy are shown on page 30 of the Directors' Report.

Environment

Pearson does not directly operate in industries where there is a potential for serious industrial pollution. Our main products are based on intellectual property. However, our offices and distribution centres do have an impact and we are committed to playing our part in tackling climate change. We set targets to reduce our energy use and emissions. We also work with our suppliers to help understand and reduce their environmental impact.

For further information you can read about our Environmental policy and practices at www.pearson.com/environment

Risk Management

We conduct regular risk reviews to identify risk factors which may affect our business and financial performance. Our internal audit function reviews these risks with each business, agreeing measures and controls to mitigate these risks wherever possible. It is not possible to identify every risk that could affect our businesses, similarly the actions taken to mitigate the risks described below cannot provide absolute assurance that a risk will not materialise and/or adversely affect our business or financial performance. Our principal risks and uncertainties are outlined on the following pages.

Government regulation

The manufacture of certain of our products in various markets is subject to governmental regulation relating to the discharge of materials into the environment. Our operations are also subject to the risks and uncertainties attendant to doing business in numerous countries. Some of the countries in which we conduct these operations maintain controls on the repatriation of earnings and capital and restrict the means available to us for hedging potential currency fluctuation risks. The operations that are affected by these controls, however, are not material to us. Accordingly, these controls have not significantly affected our international operations. Regulatory authorities may have enforcement powers that could have an impact on us. We believe, however, that we have taken and continue to take measures to comply with all applicable laws and governmental regulations in the jurisdictions where we operate so that the risk of these sanctions does not represent a material threat to us.

Principal risks and uncertainties

Our intellectual property and proprietary rights may not be adequately protected under current laws in some jurisdictions and that may adversely affect our results and our ability to grow.

Our products largely comprise intellectual property delivered through a variety of media, including newspapers, books and the internet. We rely on trademark, copyright and other intellectual property laws to establish and protect our proprietary rights in these products.

We cannot be sure that our proprietary rights will not be challenged, invalidated or circumvented. Our intellectual property rights in countries such as the US and UK, jurisdictions covering the largest proportion of our operations, are well established. However, we also conduct business in other countries where the extent of effective legal protection for intellectual property rights is uncertain, and this uncertainty could affect our future growth. Moreover, despite trademark and copyright protection, third-parties may copy, infringe or otherwise profit from our proprietary rights without our authorisation.

These unauthorised activities may be more easily facilitated by the internet. The lack of internet-specific legislation relating to trademark and copyright protection creates an additional challenge for us in protecting our proprietary rights relating to our online business processes and other digital technology rights. The loss or diminution in value of these proprietary rights or our intellectual property could have a material adverse effect on our business and financial performance. In that regard, Penguin Group (USA) Inc. and Pearson Education have joined three other major US publishers in a suit brought under the auspices of the Association of American Publishers to challenge Google's plans to copy the full text of all books ever published without permission from the publishers or authors. This lawsuit seeks to demarcate the extent to which search engines, other internet operators and libraries may rely on the fair-use doctrine to copy content without authorisation from the copyright proprietors, and may give publishers more control over online users of their intellectual property. If the lawsuit is unsuccessful, publishers and authors may be unable to control copying of their content for purposes of online searching, which could have an adverse impact on our business and financial performance.

We seek to mitigate this type of risk through general vigilance, co-operation with other publishers and trade associations, as well as recourse to law as necessary.

Our US educational textbook and testing businesses may be adversely affected by changes in state educational funding resulting from either general economic conditions, changes in government educational funding, programmes and legislation (both at the federal and state level), and/or changes in the state procurement process.

The results and growth of our US educational textbook and testing business is dependent on the level of US and state educational funding, which in turn is dependent on the robustness of state finances and the level of funding allocated to educational programmes. Federal and/or state legislative changes can also affect the funding available for educational expenditure, e.g. the No Child Left Behind Act.

Similarly changes in the state procurement process for textbooks, learning material and student tests, particularly in the adoptions market can also affect our markets. For example, changes in curricula, delays in the timing of adoptions and changes in the student testing process can all affect these programmes and therefore the size of our market in any given year.

There are multiple competing demands for educational funds and there is no guarantee that states will fund new textbooks or testing programmes, or that we will win this business.

Education remains a priority across the US political spectrum. Our customer relationship teams have detailed knowledge of each state market. We are investing in new and innovative ways to expand and combine our product and services to provide a superior customer offering than our competitors, thereby reducing our reliance on any particular funding stream in the US market.

Our newspaper businesses may be adversely affected by reductions in advertising revenues and/or circulation either because of competing news information distribution channels, particularly online and digital formats, or due to weak general economic conditions.

Changes in consumer purchasing habits, as readers look to alternative sources and/or providers of information, such as the internet and other digital formats, may change the way we distribute our content. We might see a decline in print circulation in our more mature markets as readership habits change and readers migrate online, although we see further opportunities for growth in our less mature markets outside Europe. If the migration of readers to new digital formats occurs more quickly than we expect, this is likely to affect print advertising spend by our customers, adversely affecting our profitability.

Our newspaper businesses are highly geared and remain dependent on advertising revenue; relatively small changes in revenue, positive or negative, have a disproportionate affect on profitability. We are beginning to see an increase in advertising revenues compared to prior years, however any downturn in corporate and financial advertising spend would negatively impact our results.

The diversification of the FT Group into other business models and revenue streams, e.g. subscription based businesses, conferences and its global reach, goes some way to offsetting reliance on newspaper advertising, particularly in the UK.

A control breakdown in our school testing businesses could result in financial loss and reputational damage.

There are inherent risks associated with our school testing businesses, both in the US and UK. A breakdown in our testing and assessment products and processes could lead to a mis-grading of student tests and/or late delivery of test results to students and their schools. In either event we may be subject to legal claims, penalty charges under our contracts, non-renewal of contracts and/or the suspension or withdrawal of our accreditation to conduct tests. It is also possible that such events would result in adverse publicity, which may affect our ability to retain existing contracts and/or obtain new customers.

Our robust testing procedures and controls, combined with our investment in technology, project management and skills development of our people minimise the risk of a breakdown in our student marking.

Our professional services and school testing businesses involve complex contractual relationships with both government agencies and commercial customers for the provision of various testing services. Our financial results, growth prospects and/or reputation may be adversely affected if these contracts and relationships are not managed.

These businesses are characterised by multi-million pound contracts spread over several years. As in any contracting business, there are inherent risks associated with the bidding process, start-up, operational performance and contract compliance (including penalty clauses) which could adversely affect our financial performance and/or reputation.

Several of these businesses are dependent on either single or a small number of large contracts. Failure to retain these contracts at the end of the contract term would adversely impact our future revenue growth. At Edexcel, our UK Examination board and testing business, any change in UK Government policy to exam marking and student testing could have a significant impact on our present business model.

In addition to the internal business procedures and controls implemented to ensure we successfully deliver on our contractual commitments, we also seek to develop and maintain good relationships with our customers, whether they be commercial or governmental. We also look to diversify our portfolio to minimise reliance on any single contract.

We operate in a highly competitive environment that is subject to rapid change and we must continue to invest and adapt to remain competitive.

Our education, business information and book publishing businesses operate in highly competitive markets. These markets constantly change in response to competition, technological innovations and other factors. To remain competitive we continue to invest in our authors, products, services and people. There is no guarantee that these investments will generate the anticipated returns or protect us from being placed at a competitive disadvantage with respect to scale, resources and our ability to develop and exploit opportunities.

Specific competitive threats we face at present include:

– Students seeking cheaper sources of content, e.g. online, used books or re-imported textbooks. To counter this trend we introduced our own digital text book programme (called SafariX) and are providing students with a greater choice and customisation of our products.

– Competition from major publishers and other educational material and service providers in our US educational textbook and testing businesses.

– Penguin: authors' advances in consumer publishing. We compete with other publishing businesses to purchase the rights to author manuscripts. Our competitors may bid to a level at which we could not generate a sufficient return on our investment, and so, typically, we would not purchase these rights.

– People: the investments we make in our employees, combined with our employment policies and practices, we believe are critical factors enabling us to recruit and retain the very best people in our business sectors. However, some of our markets are presently undergoing radical restructuring with several of our competitors up for sale, particularly in the Education sector. New owners, particularly private equity, may try to recruit our key talent as part of this industry restructuring.

At Penguin, changes in product distribution channels, increased book returns and/or customer bankruptcy may restrict our ability to grow and affect our profitability.

New distribution channels, e.g. digital format, the internet, used books, combined with the concentration of retailer power pose multiple threats (and opportunities) to our traditional consumer publishing models, potentially impacting both sales volumes and pricing.

Penguin's financial performance can also be negatively affected if book return rates increase above historical average levels. Similarly, the bankruptcy of a major retail customer would disrupt short-term product supply to the market as well as result in a large debt write off.

We develop new distribution channels wherever possible by adapting our product offering and investing in new formats. We take steps to challenge illegal distribution sources. To minimise returns we are careful about how we supply orders, taking account of expected sell through. The application of strict credit control policies is used to monitor customer debt.

We operate in markets which are dependent on Information Technology systems and technological change.

All our businesses, to a greater or lesser extent, are dependent on technology. We either provide software and/or internet services to our customers or we use complex information technology systems and products to support our business activities, particularly in business information publishing, back-office processing and infrastructure.

We face several technological risks associated with software product development and service delivery in our educational businesses, information technology security (including virus and hacker attacks), e-commerce, enterprise resource planning system implementations and upgrades. The failure to recruit and retain staff with relevant skills may constrain our ability to grow as we combine traditional publishing products with online and service offerings.

We mitigate these IT risks by employing project management techniques to manage new software developments and/or system implementations and have implemented an array of security measures to protect our IT assets from attack.

Operational disruption to our business caused by a major disaster and/or external threat such as Avian Flu, restricting our ability to supply products and services to our customers.

Across all our businesses we manage complex operational and logistical arrangements including distribution centres, third-party print sites, data centres and large office facilities. Failure to recover from a major disaster, e.g. fire, flood etc, at a key facility or the disruption of supply from a key third-party vendor could restrict our ability to service our customers. Similarly external threats, such as Avian Flu, terrorist attacks, strikes etc, could all affect our business and employees, disrupting our daily business activities.

We have developed business continuity arrangements, including IT disaster recovery plans, to minimise any business disruption in the event of a major disaster. However, despite regular updates and testing of these plans there is no guarantee that our financial performance will not be adversely affected in the event of a major disaster and/or external threat to our business. Insurance coverage may minimise any losses in certain circumstances.

Investment returns outside our traditional core US and UK markets may be lower than anticipated.

To minimise dependence on our core markets, particularly the US, we are seeking growth opportunities outside these markets, building on our existing substantial international presence. Certain markets we may target for growth are inherently more risky than our traditional markets. Political, economic, currency and corporate governance risks (including fraud) as well as unmanaged expansion are all factors which could limit our returns on investments made in these non-traditional markets.

We draw on our experience of developing businesses outside our core markets and our existing international infrastructure to manage specific country risks. The diversification of our international portfolio, and relative size of 'emerging markets' in relation to the group, further minimises the effect any one territory could have on the overall group results.

Our reported earnings and cash flows may be adversely affected by changes in our pension costs and funding requirements.

We operate a number of pension plans throughout the world, the principal ones being in the UK and US. The major plans are self-administered with the plans' assets held independently of the Group. Regular valuations, conducted by independent qualified actuaries, are used to determine pension costs and funding requirements.

It is our policy to ensure that each pension plan is adequately funded, over time, to meet its ongoing and future liabilities. Our earnings and cash flows may be adversely affected by the need to provide additional funding to eliminate pension fund deficits in our defined benefit plans. Our greatest exposure relates to our UK defined benefit pension plan. Pension fund deficits have/may arise because of inadequate investment returns, increased member life expectancy, changes in actuarial assumptions and changes in pension regulations, including accounting rules and minimum funding requirements.

The latest valuation of our UK defined benefit pension plan has been completed and future funding arrangements have been agreed between the company and the pension fund Trustee. Additional payments amounting to £100m will be made by the company in 2007. We review these arrangements every three years and are confident that the pension funding plans are sufficient to meet future liabilities without unduly affecting the development of the company.

Social, environmental and ethical risk

We consider social, environmental and ethical (SEE) risks no differently to the way we manage any other business risk. Our 2006 risk assessments did not identify any significant under-managed SEE risks, nor have any of our most important SEE risks, many concerned with reputational risk, changed year on year. These are:

- Journalistic/author integrity;
- Ethical business behaviour;
- Compliance with UN Global Compact principles on labour standards, human rights, environment and anti-corruption;
- Environmental impact;
- People;
- Data privacy.

Our risk reporting systems together with our approach to managing the key SEE risks above are described in 'Our Business and Society', the Pearson corporate responsibility report. The web link is available at www.pearson.com/community/csr_report2006

Changes in our tax position can significantly affect our reported earnings and cash flows.

There are several risk factors which may affect our reported tax rate and/or level of tax payments in the future. The most important are as follows:

– Changes in corporate tax rates and/or other relevant tax laws in the UK and/or the US could have a material impact on our future reported tax rate and/or our future tax payments.

– A material shortfall in profits of our US businesses below the level projected in our strategic plans would require us to reconsider the amount of the deferred tax asset relating to US net operating losses in our balance sheet (£126m at 31 December 2006). This could lead to a material increase in the reported tax rate.

We have internal tax professionals in the UK and US who review all significant arrangements around the world and respond to changes in tax legislation. They work closely with local management and external tax advisers.

We generate a substantial proportion of our revenue in foreign currencies, particularly the US dollar, and foreign exchange rate fluctuations could adversely affect our earnings and the strength of our balance sheet.

As with any international business our earnings can be materially affected by exchange rate movements. We are particularly exposed to movements in the US dollar to sterling exchange rate as approximately 65% of our revenue is generated in US dollars. We estimate that if 2005 average rates had prevailed in 2006, sales for 2006 would have been £48m or 1% higher.

This is predominantly a currency translation risk (i.e., non-cash flow item), and not a trading risk (i.e., cash flow item) as our currency trading flows are relatively limited.

Pearson generates about two-thirds of its sales in the US and each 5¢ change in the average £:$ exchange rate for the full year (which in 2006 was £1:$1.84) would have an impact of 1p on adjusted earnings per share.

We estimate that a 5¢ change in the closing exchange rate between the US dollar and sterling in any year could affect our reported adjusted earnings per share by 1p and shareholders' funds by approximately £85m.

The Group's policy on managing currency risk is described on page 23.

Financial risk

This section explains the Group's approach to the management of financial risk.

Treasury policy

The Group holds financial instruments for two principal purposes: to finance its operations and to manage the interest rate and currency risks arising from its operations and its sources of finance. The Group finances its operations by a mixture of cash flows from operations, short-term borrowings from banks and commercial paper markets, and longer term loans from banks and capital markets.

The Group borrows principally in US dollars, euros and sterling, at both floating and fixed rates of interest, using derivative financial instruments ('derivatives'), where appropriate, to generate the desired effective currency profile and interest rate basis. The derivatives used for this purpose are principally rate swaps, rate caps and collars, currency rate swaps and forward foreign exchange contracts.

The main risks arising from the Group's financial instruments are interest rate risk, liquidity and refinancing risk, counterparty risk and foreign currency risk. These risks are managed by the chief financial officer under policies approved by the board, which are summarised below. All the treasury policies remained unchanged throughout 2006. As described in the section below, in February 2007 the board approved a change in a definition used in the currency of debt policy. The audit committee and a group of external treasury advisers, receives reports on the Group's treasury activities, policies and procedures. The treasury department is not a profit centre and its activities are subject to regular internal audit.

Interest rate risk

The Group's exposure to interest rate fluctuations on its borrowings is managed by borrowing on a fixed rate basis and by entering into rate swaps, rate caps and forward rate agreements. The Group's policy objective has continued to be to set a target proportion of its forecast borrowings (taken at the year end, with cash netted against floating rate debt) to be hedged (i.e. fixed or capped) over the next four years, subject to a maximum of 65% and a minimum that starts at 40% and falls by 10% at each year end. At the end of 2006 the hedging ratio was approximately 49%. A simultaneous 1% change on 1 January in the Group's variable interest rates in each of US dollar, euro and sterling, taking into account forecast seasonal debt, would have a £7m effect on profit before tax.

Use of interest rate derivatives
The policy in the section above creates a group of derivatives, under which the Group is a payer of fixed rates and a receiver of floating rates. The Group also aims to avoid undue exposure to a single interest rate setting. Reflecting this, it swaps its fixed rate bond issues to floating rate at their launch. These create a second group of derivatives, under which the Group is a receiver of fixed rates and a payer of floating rates.

The Group's accounting objective in its use of interest rate derivatives is to minimise the impact on the income statement of changes in the mark-to-market value of its derivative portfolio as a whole. It uses duration calculations to estimate the sensitivity of the derivatives to movements in market rates. The Group also identifies which derivatives are eligible for fair value hedge accounting (which reduces sharply the income statement impact of changes in the market value of a derivative). The Group then divides the total portfolio between hedge-accounted and pooled segments, so that the expected movement on the pooled segment is minimal.

Liquidity and refinancing risk
The Group's objective is to secure continuity of funding at a reasonable cost. To do this it seeks to arrange committed funding for a variety of maturities from a diversity of sources. The Group's policy objective has been that the weighted average maturity of its core gross borrowings (treating short-term advances as having the final maturity of the facilities available to refinance them) should be between three and ten years. At the end of 2006 the average maturity of gross borrowings was 4.5 years and non-banks provided £1,566m (90%) of these borrowings (down from five years and 95% respectively at the beginning of the year).

The Group believes that ready access to different funding markets also helps to reduce its liquidity risk, and that published credit ratings and published financial policies improve such access. All of the Group's credit ratings remained unchanged during the year. The long-term ratings are Baa1 from Moody's and BBB+ from Standard & Poor's, and the short-term ratings are P2 and A2 respectively.

The Group's policy is to strive to maintain a rating of BBB+/Baa1 over the long term. The Group will also continue to use internally a range of ratios to monitor and manage its finances. These include interest cover, net debt to operating profit and cash flow to debt measures. The Group also maintains undrawn committed borrowing facilities. During the year the Group renegotiated its revolving credit facility which increased the amount and extended the maturity date. At the end of 2006 the committed facilities amounted to £894m and their weighted average maturity was 4.5 years.

Net borrowings fixed and floating rate stated after the impact of rate derivatives:

All figures £ millions	2006	2005
Fixed rate	514	549
Floating rate	545	447
Total	1,059	996

Gross borrowings:

All figures £ millions	2006	2005
Bank debt	177	105
Bonds	1,566	1,854
Total	1,743	1,959

Gross borrowings by currency:

All figures £ millions	As reported 2006	Currency derivatives 2006	Combined 2006	2005
US dollar	966	287	1,253	1,455
Sterling	356	(150)	206	207
Euro	421	(137)	284	297
Total	1,743	–	1,743	1,959

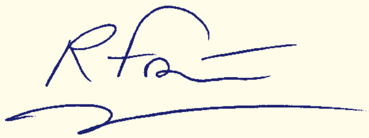
Counterparty risk
The Group's risk of loss on deposits or derivative contracts with individual banks is managed in part through the use of counterparty limits. These limits, which take published credit limits (among other things) into account, are approved by the chief financial officer within guidelines approved by the board. In addition, prior to their maturity

in February 2007, for a currency rate swap that transformed a major part of the 6.125% Euro Bonds due 2007 into a US dollar liability, the Group entered into a mark-to-market agreement which significantly reduced the counterparty risk of that rate swap transaction.

Currency risk
Although the Group is based in the UK, it has its most significant investment in overseas operations. The most significant currency for the Group is the US dollar. The Group's policy on routine transactional conversions between currencies (for example, the collection of receivables, and the settlement of payables or interest) remains that these should be completed at the relevant spot exchange rate. The majority of our operations are domestic within their country of operation. No unremitted profits are hedged with foreign exchange contracts, as the company judges it inappropriate to hedge non-cash flow translational exposure with cash flow instruments. However, the Group does seek to create a natural hedge of this exposure through its policy of aligning approximately the currency composition of its core net borrowings with its forecast operating profit (from February 2007 the policy was amended slightly to align core net borrowings with forecast operating profit before depreciation and amortisation). This policy aims to dampen the impact of changes in foreign exchange rates on consolidated interest cover and earnings.

The policy above applies only to currencies that account for more than 15% of Group operating profit before depreciation and amortisation, which currently is only the US dollar. However, the Group still borrows small amounts in other currencies, typically for seasonal working capital needs. In addition, the Group currently expect to hold legacy borrowings in euro and sterling to their maturity dates: our policy does not require existing currency debt to be terminated to match declines in that currency's share of Group operating profit before depreciation and amortisation. Included within year end net debt, the net borrowings/(cash) in the three principal currencies above (taking into account the effect of cross currency swaps) were: US dollar £979m, euro £158m and sterling £30m. The euro-denominated bonds mature in 2007 and the net debt profile will then more closely match the currency profile of group operating profit before depreciation and amortisation.

Use of currency debt and derivatives
The Group uses both currency denominated debt and derivative instruments to implement the above policy. Its intention is that gains/losses on the derivatives and debt offset the losses/gains on the foreign currency assets and income. Each quarter the value of hedging instruments is monitored against the assets in the relevant currency and, where practical, a decision is made whether to treat the debt or derivative as a net investment hedge (permitting foreign exchange movements on it to be taken to reserves) for the purposes of IAS 39.



Robin Freestone, *Chief financial officer*