

Press Release

28 February 2007

Excellent Year, Compelling Future

Serco Group plc – 2006 Preliminary Results

	2006	2005	
Revenue	£2,548.2m	£2,260.3m	up 12.7%
Profit before tax	£107.4m	£77.9m	up 37.9%
Earnings per share (EPS)	16.62p	11.66p	up 42.5%
Profit before tax, amortisation and gain on sale	£112.2m	£91.5m	up 22.6%
EPS before amortisation and gain on sale	17.13p	14.09p	up 21.6%
Dividend per share	3.60p	2.97p	up 21.2%
Group free cash flow	£85.4m	£73.8m	up 15.7%

Excellent performance

- £3bn of business signed including Docklands Light Railway (£400m), Defence Science & Technology Laboratories (£500m), London Development Agency (£69m) and Acacia Prison (AUS\$155m)
- Appointed preferred bidder on £1.9bn of contracts, including Future Provision of Marine Services (£1bn) and Forth Valley Hospital (£450m)
- Continued to win one in two new bids and maintained rebid win rate at more than 90%
- Created strategic Private Finance Initiative (PFI) investment partnership. Sold six PFI investments for £76.5m with £11.4m gain on sale and retained associated operating contracts
- PBTA margin before gain on sale of PFIs of 4.4%, up from 4.0% in 2005
- Group EBITDA to cash conversion of 98% resulting in 15.7% increase in group free cash flow

Significant visibility of future growth

- Forward contracted order book of £13.9bn at 31 December 2006
- Contracts valued at an additional £3.5bn at preferred bidder stage
- Visibility of 91% of planned revenue for 2007, 77% for 2008 and 64% for 2009
- £23bn of further opportunities identified

Continuing positive outlook

- Unprecedented market opportunities driven by social demands for better public services and reduced tax burden, aligned with the impact of global challenges of security, migration and the environment
- Increasing capacity to grow through deep relationships and capabilities allows us to be confident of double-digit growth
- Continued focus on portfolio management, selective bidding and efficiency will contribute to rising margins

Kevin Beeston, Executive Chairman of Serco Group plc, said: "I am delighted with the Company's performance in 2006. The strength of Serco's reputation and our expertise and ability to deliver high-quality service have seen us deliver tremendous outcomes for customers and excellent results for investors. I am excited by our performance and by the range of opportunities available to us that combined, position us for strong growth. We remain confident of maintaining double-digit growth and improving margins."

Note: PBTA is profit before tax and intangible amortisation. Group EBITDA is earnings from subsidiaries (excluding joint ventures) before interest, tax, depreciation, intangible amortisation and other non cash items. Cash conversion is the ratio of Group operating cash flow to Group EBITDA. Group free cash flow is from subsidiaries and joint venture dividends and is reconciled in Section 4 of the Finance Review.

Presentation

A presentation for investors and analysts will be held at JP Morgan Cazenove & Co, 20 Moorgate, London EC2R 6DA at 09:45am on Wednesday 28th February 2007.

A conference call for investors and analysts will be held today at 16.30 GMT. Participants from the US should call: Tel: 1-210-795-0472. Participants from the UK and other locations should call: +44 (20) 7019 0812. The passcode for the conference call is 'Serco'.

Copies of the presentation slides will be available from 12.00 GMT UK time from www.serco.com.

Overview

Excellent Year, Compelling Future

Building on very strong growth in 2005, Serco has delivered a strong performance in 2006 and the company's prospects are equally compelling.

Revenue grew by 12.7% to £2,548.2m. Profit before tax increased 37.9% to £107.4m and earnings per share grew 42.5% to 16.62p.

Profit before tax, amortisation and the gain on sale of PFI investments rose by 22.6% to £112.2m and earnings per share on the same basis grew 21.6% to 17.13p. The corresponding margin increased from 4.0% to 4.4%, benefiting from our portfolio management, higher value services and efficiency improvements.

Our focus on cash generation delivered excellent results once again, with Group EBITDA to cash conversion of 98% (2005: 90%). Group free cash flow increased 15.7% to £85.4m (2005: £73.8m).

Our policy is to increase the total dividend each year broadly in line with the increase in underlying earnings. The Board has proposed a final dividend of 2.55p per share, representing an increase on the 2005 final dividend of 23.8%. The total dividend for the year is 3.60p, an increase of 21.2%. The final dividend will be paid on 16 May to shareholders on the register on 9 March.

The strength of Serco's reputation and our ability to deliver high-quality service were reflected in maintained win rates of more than 90% on rebids and one in two on new bids. During the year, we signed £3bn of business which includes many contracts under £10m and we were appointed preferred bidder for contracts valued at around £1.9bn.

We rebid two of our larger contracts; firstly, the renewed franchise with Transport for London to operate, maintain and support the Docklands Light Railway. The contract is valued at £400m over nine years and

started in May 2006. In addition, a Serco-led joint venture was selected as preferred bidder for the UK Ministry of Defence's Future Provision of Marine Services contract, valued at £1bn over 15 years. The joint venture will deliver marine support at major UK naval bases in Portsmouth, Devonport and The Clyde.

We also signed the £500m contract with the UK MoD's Defence Science and Technology Laboratories for the design and build of new facilities and the provision of support services.

The London Development Agency selected Serco to provide a new Business Link service to London's 600,000 small and medium sized enterprises from April 2007. The agreement is valued at £69m over three years, plus an option to renew for two additional years, and draws on skills from across the Group.

In Australia we signed a five-year contract to manage and operate Acacia prison for the Government of Western Australia's Department of Corrective Services. The client has the option to extend the AUS\$155m contract up to a further ten years.

We created a strategic PFI investment partnership with Infrastructure Investors Limited (I²) and sold equity and subordinated debt in six PFI projects to an I² subsidiary. We received a cash consideration of £76.5m, resulting in a profit on disposal of £11.4m. Under the partnership, I² will be able to provide equity investment for Serco's future PFI projects, giving us access to a large and competitively priced source of capital and enhancing our ability to compete in this market. Serco has retained the associated long-term operating contracts.

We are continuously working to deliver higher value services to clients, reflecting the increasing skills and capabilities available across the Group. We also rigorously analyse contracts and markets to ensure that conditions exist for strong organic growth and appropriate returns. In addition, we continue to improve our internal structures and systems by, where appropriate, providing standardised systems and by streamlining management structures. As a consequence of this approach, margins have improved and will improve further.

We regularly review the funding profile of our main Group defined benefit pension scheme. As previously announced, £70m has been injected into the scheme representing approximately half the deficit, with £19m added at the end of 2006 and £51m in early 2007. We also increased employer and employee contribution rates from January 2007.

This, together with the sale of our investments in six PFI projects and the corresponding removal of non recourse debt, has resulted in a significant reduction in debt and simplification of the balance sheet.

At the year-end, our order book stood at a record £13.9bn and we were preferred bidder on contracts valued at £3.5bn. We also had bids valued at £4.5bn for which we had been shortlisted to the final two or three

bidders. In addition, we have identified a pipeline of further opportunities across our markets estimated at £23bn.

The visibility of our future revenue remains significant. As at 31 December 2006, we had identified 91% of our planned revenue for 2007, 77% for 2008 and 64% for 2009.

Strong start to 2007

Serco has also enjoyed a strong start to 2007. The US Army selected our North American business to provide cost analysis, logistics planning and supply chain consulting services worldwide. The indefinite-delivery/indefinite-quantity contract has a one-year base period, with four annual options and has a potential value of \$225m over five years. Other wins include a contract to manage and operate Yarl's Wood Immigration Removal Centre on behalf of the UK Home Office. The three-year contract starts in April 2007, with optional extensions for a further five. Over the full eight years, the contract is valued at around £85m. The UK's MoD also selected us as preferred bidder for a five-year, Gibraltar-based support services contract valued at around £50m with a further option for two years and the potential for additional work.

Market Development

The world in which we operate is changing faster than ever. Governments, communities and individuals are increasingly experiencing the same challenges: dealing with climate change, declining energy reserves, increasing migration, ageing populations and increasing health needs, the threat of terrorism and challenge of congestion. These transformational issues are further influenced by new technology, globalisation, increasing demands for better services, increasing costs of service provision and citizens' unwillingness to accept higher tax burdens.

Serco is ideally placed to help Governments resolve these challenges. Through a combination of a deep public service ethos and commercial know-how, our teams efficiently deliver service transformations that improve a wide variety of public services around the world. We have grown strongly over the last 20 years, as successive UK governments have led the way in reforming public services and enabling new models of service delivery. This has delivered a very strong and highly visible forward order book and bid pipeline.

As governments around the world are dealing with the very same issues and increasing the rate of reform of their public services, we are increasingly seeing opportunities to transfer our experience to international markets.

What we were delivering for one government a few years ago, we are now delivering for several.

The very nature of Serco's broad portfolio of skills, relationships, contracts, markets and geographies, combined with our inherent ability to deliver through change, means that we are very well placed to continue to grow. Ten years ago, Serco's annual revenue was less than £500m and our businesses in home affairs,

transport and business process outsourcing were just developing. These have become substantial businesses in the UK and are driving growth internationally.

Within Civil Government, our Home Affairs business is helping governments to address common issues including reducing re-offending and the cost of crime, managing increasing migration and tackling the increased threat of terrorism. Serco is the only company competing in each of the market sub-sectors of civil resilience/homeland security, migration control, offender management and law enforcement. We expect more market growth both in the UK home affairs market - already approaching £3bn per annum - and overseas, particularly in Australia and the US.

In the UK local government market, the priority for councils is building better and safer communities with particular focus on children and young people, health, economic development and independent living. To meet the needs in the local markets, we work in partnership with the emergency, health and education services, utilities and private and voluntary organisations. Serco is working across the whole local community to make citizens' lives better, whether through running a Local Education Authority, piloting telecare projects to enable independent living, working to reduce re-offender levels or helping small businesses to grow. The skills, services and support we provide aligns with the Gershon-related drive to improve efficiency through joined-up government, and enables more to be spent on front line services by increasing back office efficiency.

Within health, expansion of the UK publicly-funded health market is driven by the demand for better health outcomes from finite resources. Our growing presence in primary care and occupational health is complemented by an established offering in hospital support services, all of which means we can address a substantial part of this market.

In our education business, improving educational outcomes is driving new ways of organising service delivery. The Children's Services Act requires those working in social services, health and education to work together for the benefit of children. Local authorities throughout England and Wales are using our organisational design and IT transformation capabilities to manage this change programme.

In Transport, better utilisation of existing road and rail infrastructure is proving a more environmentally and economically attractive proposition. Issues of congestion, carbon emissions, safety and journey reliability are being addressed through innovative technology and improved transport integration.

Serco is at the forefront of technology and operational delivery to better manage the movement of vehicles, such as through the UK's Active Traffic Management scheme and England's National Traffic Control Centre.

International commitments have stretched defence budgets in the US and the UK. Private sector provision of back office support releases uniformed troops for frontline service, and can deliver significant cost efficiencies and innovation. In the UK, the MoD's spend on services is expected to increase, driven by

integration across the armed forces on equipment procurement and maintenance. This is evident from the merger of the Defence Logistics Organisation with the Defence Procurement Organisation and the Defence Training Review. This merger is integrating training, where appropriate, across the armed forces. In the US, pressures on defence spending have delayed contracting of some support services. However, significant opportunities remain in the US and more opportunities are emerging in Australia.

An important new market in the UK is for the decommissioning of the country's civil nuclear liabilities. This market is valued at around £70bn in total, equating to an addressable market of more than £2bn per annum.

People

Around the world, people are experiencing a quality of service that makes a difference to their lives. Expectations are met and often surpassed because Serco enables those delivering the service to give their best.

More than 47,000 employees deliver critical services to government and private clients in over 30 countries.

The Board thanks all of our employees for their ongoing dedication, hard work and contribution to realising the strong results we have reported this year.

Board

After 21 years with the Group, including ten on the plc Board, Kevin Beeston announced his intention to move to the role of Non-Executive Chairman from 1 September 2007.

With Serco performing strongly and well-positioned for future growth, and having built a highly-capable management team at all levels, Kevin has decided to diversify his business interests.

As Non-Executive Chairman, he will continue to provide guidance and support, continue to chair the Board and oversee the Company's development on behalf of shareholders. The Group has a high quality management team, led by Chief Executive Chris Hyman, who will continue to deliver sustained success. In April 2006, Leonard V. Broese van Groenou joined the Board as a Non-Executive Director. Leonard is a member of the Remuneration, Audit, Nomination and Training and Development Committees. Leonard was previously Vice-President Human Resources and member of the corporate executive committee of Air Products.

Continuing Positive Outlook

Governments increasingly face the same issues, driven by social demands for better public services and reduced tax burden, aligned with the impact of global challenges of security, migration and the environment. Our breadth and depth of skills and relationships allows us to address new markets and opportunities. Our identified pipeline of opportunities of £23bn and this, together with our high visibility of revenues and opportunities, enables us to be confident of continuing to deliver double-digit growth. At the same time, our continued focus on proactively managing our contract portfolio, bidding selectively and driving internal efficiency will allow us to further improve margins.

Segmental Operating Review

Civil Government

Civil Government is our largest segment and includes home affairs, service transformation, health, education, consulting, and our work in the private sector.

Segmental revenue increased by 9% to £875m, representing 34% of Group revenue (2005:36%).

Home Affairs

Home Affairs encompasses our work in offender management, law enforcement, civil resilience and immigration control. Our Home Affairs teams have succeeded in significantly growing existing services, extending into important new markets and delivering quality services in complex environments.

We began our contract to provide electronic monitoring (EM) of offenders in Scotland. Volumes in both this contract and our contracts in England and Wales have increased as the benefits of EM have been rolled out.

The capacity constraints in the UK prison estate have led to the Home Office ordering extensions to existing prisons and centres managed by us, valued at more than £79m.

In the UK, the National Offender Management Service is the Government's new body which is protecting the public and rehabilitating offenders in new ways, in particular having prison and probations services working closer than ever before and by using the best that the private and voluntary sector has to offer.

In the first award of its kind in an emerging market, Serco and third-sector bodies Turning Point and Rainer were chosen to provide employment and rehabilitation support to offenders returning to the community. The

contract, with the East of England Regional Offender Management Pathfinder Project, is valued at around £1.4m to Serco over 2 years.

Additionally in 2006 we created a strong foothold in the changing Australian offender management market. We were selected by the Government of Western Australia's Department of Corrections to manage and operate the medium security Acacia Prison. The contract is valued at AUS\$155m over five years with the potential to extend by up to ten years. Serco's proven success of Home Affairs prisoner rehabilitation and re-integration programs and the specific local Indigenous Strategy were crucial elements to the successful awarding of the contract.

Further home affairs service opportunities have been identified in Australia including prison management, electronic monitoring provision, transport and migration management.

Our successful operations at Colnbrook Immigration Removal Centre, near Heathrow, were instrumental in securing the contract to run Yarl's Wood Immigration Removal Centre. The contract starts in April 2007 for an initial period of three years, with potential to extend for a further five years. Over the full eight years the contract is valued at around £85m.

Together with our partners Raytheon, Accenture and Detica, we are part of the Trusted Borders consortium, one of two consortia selected for the final stage of the e-Borders procurement, a UK Home Office initiative to provide electronic screening and tracking of travellers arriving and departing from the UK.

The law enforcement market is developing in the UK, with proposals to merge police forces being dropped in favour of greater collaboration between forces and even the sharing of services in order to improve efficiency and improve service.

IT services and BPO

Serco is benefiting from the skills and capabilities Solutions has brought to the Group.

Building on the contract win in 2005 to run the UK Government's Businesslink.gov web portal, the London Development Agency selected us to run the Business Link service in London. The £69m, three-year agreement is focused on helping the capital's 600,000 small and medium-sized enterprises to increase their competitiveness, including regeneration opportunities created by the 2012 Olympics.

Serco was also successful in rebidding the Envirowise contract for the Department of Environment, Food and Rural Affairs. This contract, in conjunction with our partner Momenta, advises and supports UK businesses in minimising waste and reducing environmental impact.

Additional business has been contracted over the year, with customers including the London boroughs of Southwark and Enfield, Coventry and Cambridge city councils.

We continue to invest in the business' capacity and capability and we have implemented a planned restructuring to enhance Solutions' ability to grow and we look forward to strong growth in this sector.

In other aspects of our local government business, we signed and started two new streetscene services partnerships, with Welwyn Hatfield Council and Restormel Borough Council in Cornwall valued at approximately £50m and £45m respectively. Our services are key to helping councils meet climate change related targets and frees up savings for reinvestment in a full range of local improvements.

Amongst private sector clients, MAN B&W extended its SAP FM Support contract with Serco until the end of 2008 and awarded a separate contract to provide SAP Application Support for the same period. Red Bee Media selected us for an IT-enabled change programme valued at £7.1m over five years.

Education

At Education Bradford and Education Walsall, pupils have achieved significantly improved GCSE and A' level results, exceeding the GCSE targets set by our customers. The UK Department for Education and Skills has awarded a two-year contract to the Together for Children partnership which is led by Serco. The contract, valued at around £10m to Serco, supports the development of 3,500 children's centres across England.

Health

Serco was appointed preferred bidder to provide support services for the new NHS Forth Valley Acute Hospital, valued at around £450m over 30 years. We have drawn on our healthcare experience to influence the design of the new hospital, including the innovative use of robotics. In addition to providing health services to the Serco-run prisons, our healthcare business is providing services to Home Office-run prisons and we have been awarded three-year contracts to supply medical services at Cardiff, Bullingdon and Leicester prisons.

Consulting

New awards by our successful consulting business include work with the BBC, the Home Office, HM Revenue & Customs, the Department for Environment, Food and Rural Affairs, Carlisle City Council, and Cheshire Constabulary. Projects underway include helping a consortium comprising the Cabinet Office, Department for Education and Science and the Department of Health to manage the provision of electronic government services through an external contractor.

Defence

Revenue in Defence increased by 14% to £645m, representing 25% of Group revenue (2005: 25%). Growth in the period benefited from the inclusion of the former RCI business for the full 12 months. It was first consolidated from 21 March 2005.

Our defence customers operate in an increasingly pressurised environment characterised by stringent budgetary constraints, operational complexity, demanding performance measures and intense public scrutiny. We enable them to succeed in this tough environment by designing, integrating and applying the best possible combination of people, processes, resources and technology to enhance their operations.

The Ministry of Defence's new Defence Industrial Strategy emphasises a shift from new platform design and development to the upgrade and maintenance of equipment. The aim is to enhance capability and availability of equipment through its lifespan. To succeed, this requires a new way of working between suppliers, and between Government and industry.

This is reflected in a number of contract wins in 2006. For example, we signed a £125m 25-year manpower services contract with AgustaWestland under the Integrated Merlin Operational Support (IMOS) programme. IMOS is transforming logistics support for the MoD EH101 Merlin helicopter fleet while improving availability and reducing through-life support costs for the platform.

In June, Rolls-Royce won a £110m contract to ensure engine availability for the Hercules C-130 and engaged Serco to provide engineers for servicing work on the fleet at RAF Lyneham. Serco and Rolls-Royce's relationship was further strengthened through a Memorandum of Understanding signed to provide a joint service offering in the defence sector.

Our selection as preferred bidder for the MoD's Future Provision of Marine Services contract will enhance the operational capability of the Royal Navy at Portsmouth, Devonport and the Clyde. The contract is valued at around £1bn over 15 years, a substantial increase from the previous contract, and will be delivered by Serco Denholm, a joint venture between Serco and J&J Denholm.

In July we signed a strategic partnership with the UK Defence Science and Technology Laboratories (Dstl), for which we were appointed preferred bidder in 2005. Under the £500m, 15-year contract we are managing the design and build of new facilities and providing integrated support services across the Dstl estate.

Our support for the Government's drive to transform through-life capability management will continue throughout the coming year. We are developing the technology that will enable the MoD to predict and plan for the cost of equipment throughout its operational life. The whole-life costing and optimisation (WLCO) model has the potential to deliver significant savings to the MoD at the same time as enhancing the through-life availability and capability of equipment to the front line.

In addition, our defence experts are working in close collaboration with technical and security specialists in Serco Science and Serco Home Affairs to explore the potential of the government's Defence Technology Strategy (DTS). The DTS describes the technologies that the MoD regards as critical to maintaining the UK's defence and security capabilities, playing to Serco's strengths in defence technology, Chemical, Biological, Radiological and Nuclear (CBRN) and homeland security.

Our contract to provide secure communications to the armed forces through the Skynet 5 satellite programme was extended by the Defence Communications Services Agency and the prime contractor, Paradigm Secure Communications. This takes the contract to 2020, with a value of approximately £58m.

In North America, our solid reputation for providing key services to the military meant we won contracts, including several for larger, longer and more complex services, against a backdrop of reduced spending for non-combat operations. In particular, the existing family support and personnel services provided a platform to expand the reach of those services into other branches of the military. We won a Military Family Support services contract for the Navy valued at \$28m over two years. This is the first such service we have provided outside of the Army.

Our extensive experience in providing administration support to the Army and Navy enabled us to win a two year, \$6.5m contract with another new customer - the Air National Guard - to provide administrative support services. We were also selected by the Chief of the Naval Reserve Command for a \$12m contract to assist with their recruiting.

Other examples of expansion of our military services included a five-year contract valued at a potential \$34m for the US Army Military Personnel Division (MPD) in Korea and a similar \$12.8 million contract with the MPD for the Army Reserve at Fort Dix.

Our San Diego-based engineering unit was included in a \$56.6m multiple award to provide systems development, engineering support, evaluation and logistics for the submarine command in the U.S. Navy Space and Naval Warfare Systems Center (SPAWAR). This win is a strategically important contract for us since it moves us into an area of more complex and integrated services that allow us to showcase our capabilities in a broader range of C4I services.

In Australia, we have succeeded in significantly expanding our presence in the defence market. Our Serco Sodexo Defence Services (SSDS) 50:50 joint venture now has a presence on every operational and training base in Australia after being appointed to the Australian Defence Forces National Clothing Stores contract. The contract is valued at up to AUS\$60m to SSDS over six years and presents considerable opportunities for organic growth.

SSDS has also been selected for two other major garrison support services contracts on the east coast of Australia. These nine year contracts are valued at more than AUS\$400m.

Transport

Transport revenues grew by 14% to £626m, representing 25% of Group revenue (2005: 24%).

Rail

Northern Rail and Merseyrail - our two joint ventures with NedRailways - have grown passenger numbers on the back of rising levels of customer satisfaction. At Northern Rail, train punctuality and reliability have been consistently above target and Merseyrail continues to deliver the levels of service, which has made it one of the UK's best performing franchises.

Both Northern and Merseyrail continue to deliver excellent safety performance with Northern winning the prestigious Sir Robert Horton Award for Safety at the 2006 National Rail Awards.

With NedRailways, we are bidding to run the West Midlands train franchise from November 2007.

In Australia, our new timetable for The Ghan commenced, with two weekly services now undertaking the 2,000 mile continental crossing between Adelaide and Darwin. We have also committed to a fleet expansion programme, currently in the design phase, which will provide additional capacity and potential for revenue growth from late 2007.

Urban Transportation

Key developments in the year included signing the new franchise agreement to continue to operate, maintain and support the highly successful Docklands Light Railway in London. The seven-year contract may be extended for a further two years and is valued at around £400m over this extended period. The new franchise further improves services through more frequent trains, enhanced security and higher targets for punctuality, customer satisfaction and availability of ticket machines, escalators and information displays. We are also one of three companies bidding for the Dubai Metro project which will be the world's largest driverless urban transport system.

We were disappointed not to renew the Manchester Metrolink contract at rebid. We have been operating Metrolink for ten years, overseeing significant extensions and improvements to the service; this contract will end in 2007. Our contract to operate the Copenhagen Metro is also coming to an end this year.

Transportation Technologies

Serco operates the National Traffic Control Centre (NTCC) on behalf of the Highways Agency. NTCC is a world-first facility, giving a real-time analysis of what is happening across England's motorway and trunk road network and helping drivers to plan their journeys better. While full implementation has taken longer than expected, we were delighted that Transport Secretary Alistair Darling officially opened the NTCC on 30 March 2006. We continue to work closely with the Highways Agency to achieve formal completion.

Other developments in the traffic management sector include new pilots to increase the capacity of motorways in England and motorway technology services. The Highways Agency has selected Serco to develop and maintain a new control system for the Active Traffic Management pilot scheme on the M42 to better manage the roadspace and utilise the hardshoulder during periods of congestion. This contract applies to a 17 km section of the motorway and is valued at £4.5m up to 2010.

Our traffic management, experience is attracting interest from outside of the UK and we have been selected to run traffic management systems in Sweden, Hong Kong and China.

Air

In the United Arab Emirates, we successfully renewed our contract to provide air traffic control and engineering services at the Emirates Area Control Centre, based in Abu Dhabi. The new contract is valued at £11.5m over three years, a substantial increase from the previous contract.

Science

Science revenues grew by 18% to £403m, representing 16% of Group revenue (2005: 15%).

Serco enhanced its position in 2006 as a leading partner in the practice and management of science and knowledge transfer, and has continued to grow its business in the UK civil and defence nuclear markets.

The National Physical Laboratory (NPL) has had a vital impact on industry and society in 2006. In addition to NPL's focus on leading edge research in biotechnology, nanotechnology and advanced materials, the laboratory has established a national framework for training in measurement skills, in partnership with Rolls Royce. NPL increased its commercial income by 18%, including a £1.2m contract to run a knowledge transfer network for Government and work worth £1.9m to provide equipment and expertise to the new micro and nano manufacturing centre of excellence.

NPL has played a key role in addressing the global challenge of climate change. Its measurement work monitoring emissions from power stations, airports and industrial locations has enabled carbon pricing to be based on robust, scientifically sound and internationally accepted measurements.

Our strong position in the civil and defence nuclear markets was further enhanced during the year through our work at the Atomic Weapons Establishment (AWE) and our technical assurance business.

2006 was another successful year for our work at the AWE, a facility we manage and operate through a joint venture with Lockheed Martin and BNFL. This was the first full year of the programme to upgrade skills and facilities. Within this challenging programme, all major projects are on track and the key performance indicators are showing record levels of performance in almost all areas of activity.

Our Assurance business increased its presence in the civil nuclear market, with contract awards from BNG to help with the clean up of the Sellafield site and from British Energy and Magnox Electric in support of generating stations. In addition, we are assisting the Ministry of Defence in a multi-million pound study looking at future nuclear propulsion reactor designs.

Serco's expertise in the civil and defence nuclear fields is being brought to bear on a developing UK market for the decommissioning of the country's civil nuclear liabilities.

In 2006, Serco created a world-class consortium to address the Sellafield decommissioning and operations opportunity. The consortium, called SBB Nuclear, brings together three leading international companies - Serco, Bechtel and BWXT – all with proven track records of service delivery, nuclear site management and clean-up capability. SBB Nuclear is committed to the Nuclear Decommissioning Agency's process of selecting a Parent Body Organisation for the Sellafield Site Licence Company and to the safe, secure and environmentally sensitive management of the site and to supporting the economic regeneration of the surrounding community in West Cumbria.

The science business also combines the technical, financial and management expertise to deliver some of the government's most ambitious science-based programmes.

We have unrivalled experience in managing flagship government-owned, contractor-operated (GOCO) facilities at NPL and AWE. Combined with our safety and technical assurance expertise and track record in delivering big, complex programmes on time and on budget, this puts Serco in a good position to help the government achieve its National Nuclear Laboratory programme, and potentially other science management programmes which are currently emerging in the marketplace.

Finance Review

1. Financial performance

Serco's financial results for 2006 demonstrate the strong growth in the business, a significant increase in margins and a good cash performance, together with a simplified balance sheet.

Serco's income statement for 2006 is summarised in Figure 1 below. This includes the results of joint ventures, which are proportionately consolidated.

Figure 1: Income statement

Year ended 31 December	2006 £m	2005 £m	Increase
Revenue	2,548.2	2,260.3	12.7%
Gross profit	365.7	325.0	12.5%
Administrative expenses	(235.7)	(214.3)	
Investment revenue and finance costs	(17.8)	(19.2)	
Profit before tax, amortisation and gain on sale	112.2	91.5	22.6%
Gain on sale of PFI investments	11.4	-	
Profit before tax and amortisation	123.6	91.5	35.1%
Amortisation	(16.2)	(13.6)	
Profit before tax	107.4	77.9	37.9%
Tax	(27.9)	(23.5)	
Profit for the year	79.5	54.4	46.1%
Effective tax rate	26.0%	30.2%	
Earnings per share	16.62p	11.66p	42.5%
Earnings per share before amortisation and gain on sale of PFI investments	17.13p	14.09p	21.6%
Dividend per share	3.60p	2.97p	21.2%

2.1 Revenue

Revenue grew by 12.7% to £2,548.2m. Excluding revenue from Serco Solutions and RCI, revenue growth was 11.4%.

Joint venture revenue increased by 20.0% to £643.3m. This increase was primarily due to growth in our contract to operate the Atomic Weapons Establishment.

During 2006, Serco Solutions contributed revenue of £216.2m (2005: £190.6m). RCI contributed revenue of £185.8m (2005: £143.3m). These businesses were acquired in February 2005 and March 2005 respectively.

2.2 Gross margin

Gross margin – the average contract margin across our portfolio – was 14.4% in 2006, consistent with the margin in 2005.

2.3 Investment revenue and finance costs

Investment revenue and finance costs totalled a net cost of £17.8m (2005: £19.2m). The decrease was primarily due to lower net finance cost on the assets and liabilities of our defined benefit pension schemes.

2.4 Profit before tax and amortisation (PBTA)

PBTA before the gain on sale of PFI investments was £112.2m in 2006 which was an increase of 22.6% from 2005. This represented a margin of 4.4% in 2006, up from 4.0% in 2005.

Serco Solutions contributed PBTA of £16.8m (2005: £14.3m), representing a PBTA margin of 7.8% (2005: 7.5%), while RCI added £12.4m to PBTA (2005: £9.3m), at a PBTA margin of 6.7% (2005: 6.5%).

Excluding the profits generated by Serco Solutions and RCI and their associated funding costs and the gain on sale, growth in PBTA was 22.0%.

2.5 Intangible amortisation

The charge for intangible amortisation in the period was £16.2m (2005: £13.6m). The increase resulted from a full year of the amortisation of intangible assets arising on the acquisition of ITNET and RCI and increased amortisation of software and development expenditure.

2.6 Profit before tax

Profit before tax increased by 37.9% to £107.4m (2005: £77.9m).

2.7 Tax

The tax charge of £27.9m (2005: £23.5m) represents an effective rate of 26.0%, compared with 30.2% in 2005. This decrease is principally due to the gain on the sale of the PFI investments not being taxable.

2.8 Earnings per share (EPS)

EPS grew by 42.5% to 16.62p. EPS before amortisation and the gain on sale of PFI investments rose by 21.6% to 17.13p.

EPS is calculated on an average share base of 471.2m during the period (2005: 458.1m). The increase resulted from a combination of share options issued in the year and the full year effect of shares issued during the first half of 2005, in part consideration for the acquisition of ITNET.

3. Dividends

Serco's policy is to increase the total dividend per share each year broadly in line with the underlying increase in earnings. The proposed final dividend of 2.55p per share represents a 23.8% increase on the final dividend of 2005. The total dividend for 2006 is 3.60p per share, an increase of 21.2%. The final dividend will be paid on 16 May 2007 to shareholders on the register at the close of business on 9 March 2007.

4. Cash flow

The Group generated a free cash inflow of £85.4m, an increase of 15.7% compared with 2005.

Figure 2 analyses the cash flow. As in previous periods, we have designed the analysis to show the true cash performance of the Group – the cash flows generated by subsidiaries plus the dividends received from joint ventures. It therefore differs from the consolidated cash flow on page 26, which proportionately consolidates the cash flows of joint ventures. The adjustment line in Figure 2 reconciles the movement in Group cash to the consolidated cash flow.

Figure 2: Cash flow

Year ended 31 December	2006 £m	2005 £m
Operating profit excluding joint ventures	87.9	62.4
Non cash items	35.0	45.2
Group EBITDA	122.9	107.6
Working capital movement	(2.1)	(11.2)
Group operating cash flow	120.8	96.4
Interest	(10.6)	(15.7)
Tax	(6.7)	(1.0)
Expenditure on tangible and intangible assets	(47.7)	(31.6)
Dividends from joint ventures	29.6	25.7
Group free cash flow	85.4	73.8
Cash received on sale of PFI investments	76.5	-
Cash disposed of and transaction costs on sale of PFI's	(58.3)	-
Acquisitions	-	(281.7)
Other financing	(98.6)	253.8
Special pension contribution	(19.0)	-
Dividends paid	(14.5)	(12.5)
Group net (decrease)/increase in cash and cash equivalents	(28.5)	33.4
Adjustment to include joint venture cash impacts	10.3	4.1
Net (decrease)/increase in cash and cash equivalents	(18.2)	37.5

Note: Group EBITDA is earnings from subsidiaries (excluding joint ventures) before interest, tax, depreciation, intangible amortisation and other non cash items

4.1 Group operating cash flow

The Group operating cash inflow was £120.8m (2005: £96.4m), an increase of 25.3%. This represents a conversion of Group EBITDA into cash of 98% (2005: 90%). This EBITDA conversion and working capital performance is particularly notable given the strong level of organic growth.

4.2 Interest

Net interest paid in 2006 was £10.6m, compared to £15.7m in 2005. The decrease was principally due to the timing of the sale of the PFI investments.

4.3 Tax

Tax paid in 2006 excluding joint ventures was £6.7m compared to £1.0m in 2005. This increase is primarily due to a tax refund received in 2005.

Cash tax is below the equivalent tax charge in the income statement. The difference reflects timing differences, including a continued residual level of accelerated capital allowances, and the availability of tax relief on the special pension contribution.

4.3 Expenditure on tangible and intangible assets

Expenditure on tangible and intangible assets in the period was £47.7m (2005: £31.6m). This represents 2.5% of revenue excluding joint ventures (2005: 1.8%). The increase mainly resulted from expenditure on designing and building our new SAP accounting system and shared service centre. The total cost of the initial programme is estimated to be approximately £35m, of which £20m was incurred in 2006 and £7m in 2005.

4.4 Dividends from joint ventures

Dividends received from joint ventures totalled £29.6m (2005: £25.7m), equivalent to 98% (2005: 101%) of joint ventures' profit after tax and minority interest. The high level of conversion in both years reflects dividend payments made by joint ventures from reserves retained in previous years.

4.5 Other financing

The movement in other financing is primarily as a result of repayments on our loan facility.

5. Net debt

Serco's net debt has reduced significantly during 2006. Group recourse net debt has decreased by £92.1m to £171.9m and total net debt has decreased by £389.3m to £205.9m. Figure 3 analyses Serco's net debt at 31 December 2006 and 31 December 2005.

Figure 3: Net debt

At 31 December	2006 £m	2005 £m
Group - cash and cash equivalents	177.8	210.0
Group - loans	(334.4)	(453.1)
Group - obligations under finance leases	(15.3)	(20.9)
Group recourse net debt	(171.9)	(264.0)
Joint venture recourse net cash	28.2	18.0
Total recourse net debt	(143.7)	(246.0)
Group non recourse debt	(62.2)	(326.8)
Joint venture non recourse debt	--	(22.4)
Total non recourse debt	(62.2)	(349.2)
Total net debt	(205.9)	(595.2)

5.1 Group recourse net debt

Group recourse net debt reduced from £264.0m at 31 December 2005 to £171.9m at 31 December 2006.

Included within Group recourse net debt is £10.6m (2005: £22.7m) of encumbered cash, comprising cash of PFI and other project companies securing credit obligations and customer advance payments.

5.2 Group non recourse debt

The Group's debt is non recourse if no Group company other than the relevant borrower - such as a special purpose company for a PFI - has an obligation to repay the debt under a guarantee or other arrangement. The debt is excluded from all of our credit agreements and other covenant calculations, and therefore has no impact on the Group's ability to borrow.

Group non recourse debt reduced by £264.6m to £62.2m during the year, primarily as a result of the sale of the PFI investments (see section 7). At 31 December 2006 the remaining non recourse debt related to the Kilmarnock prison contract and our Driver Examination Services contract in Canada.

5.3 Joint venture non recourse debt

The joint venture non recourse debt recorded in 2005 resulted from debt taken on in the course of operating a contract where we have a right of full cost reimbursement. A debtor equal to the value of this non recourse debt was included in Serco's accounts to reflect this. During the first half of 2006, we renegotiated certain terms of this loan. This allows us to offset the debtor and non recourse debt in our accounts, thereby reflecting the economic reality of the contract.

6. Pensions

At 31 December 2006, the net liability included in the balance sheet arising from our defined benefit pension scheme obligations was £120.0m (2005: £149.9m). Figure 4 provides further analysis.

Figure 4: Defined benefit pension schemes

At 31 December	2006 £m	2005 £m
Group schemes – non contract specific	(157.8)	(200.4)
Contract specific schemes		
– reimbursable	(67.6)	(84.9)
– not certain to be reimbursable	(23.9)	(21.3)
Net retirement benefit liabilities	(249.3)	(306.6)
Intangible assets arising from rights to operate franchises and contracts	20.6	19.0
Reimbursable rights debtors	67.6	84.9
Deferred tax assets	41.1	52.8
Net balance sheet liabilities	(120.0)	(149.9)

Serco has three main types of scheme which are accounted for as defined benefit pension schemes. Each type has its own accounting treatment under IFRS. These are:

- Schemes which do not relate to specific contracts or franchises (non contract specific) – principally the Group scheme. For these schemes, we charge the actuarial gain or loss for the period to the consolidated statement of recognised income and expense (the SORIE), and
- Schemes where we have a right of full cost reimbursement and therefore include both the pension scheme deficit and offsetting reimbursable rights debtor in the balance sheet (reimbursable), and
- Schemes relating to specific contracts or franchises, where the deficit will pass back to the customer or to the next contractor at the end of the contract (not certain to be reimbursable). For these schemes, we charge the actuarial gain or loss on our share of the deficit for the period to the SORIE, recognise a recoverable intangible asset on the balance sheet at the start of the contract or franchise and amortise the intangible asset to the income statement over the contract or franchise life.

At 31 December 2006, the principal non contract specific scheme was the Serco Pension and Life Assurance Scheme (SPLAS). This scheme was closed to new members in 2001. Prior to the special pension contributions at the end of the year, the scheme had a gross deficit of £136m. Following a detailed funding review in the second half of 2006, we have made a special cash contribution of £70m into the scheme. A payment of £19m was made in December 2006 and the remaining £51m was paid in January 2007. We have agreed an increase in employer and employee contributions from January 2007.

Figure 5 shows the sensitivity of the liabilities of our pension schemes to changes in discount rates and to adjustments in the actuarial assumptions for the rate of inflation, members' salary increases and life expectancies.

Figure 5: Pension assumption sensitivities

	Change in assumption	Change in liability
Discount rate	+0.5%	(9)%
	(0.5)%	+10%
Price inflation	+0.5%	+7%
	(0.5)%	(7)%
Salary	+0.5%	+3%
	(0.5)%	(3)%
Longevity	Increase by one year	+2.75%

7. Private Finance Initiatives (PFIs)

7.1 Sale of PFI investments

On 2 December 2006 Serco sold its equity investments relating to six PFI projects to Infrastructure Investors Limited Partnership (I²). As part of this transaction we retain the long term operating contracts associated with the PFIs, as well as providing management services to I², such as acting as the day-to-day interface with the customer.

The investments were sold for a total cash consideration of £76.5m resulting in a gain on sale of £11.4m. Net assets of £46.8m were disposed of, including cash of £56.6m, PFI debtors of £329.8m and non recourse loans of £242.3m. The cash disposed of was held in the special purpose companies primarily to honour forthcoming debt repayments.

7.2 Remaining PFI portfolio

At 31 December 2006, Serco continued to hold a 100% equity investment in one PFI special purpose company and a minority shareholding in two others. Serco retains operating contracts in eleven PFI projects. We continue to recognise our remaining PFI debtors at amortised cost, as defined by IAS 39, maintaining an accounting treatment consistent with UK GAAP and existing IFRS. IFRIC 12 'Service Concession Arrangements' has been issued but is not mandatory until 1 January 2008. We will review the impact of the IFRIC during 2007.

8. Provisions

At 31 December 2006, the Group held provisions amounting to £22.3m (2005: £26.3m). Provisions include amounts relating to long-term service awards, terminal gratuities, property, contracts and restructuring. The decrease in provisions includes a reduction as a result of the completion of a planned restructuring in Serco Solutions.

9. Treasury

The Group's principal debt finance consists of a £400m bank credit facility comprising a term loan facility and a revolving credit facility. At 31 December 2006 we had £163m (2005: £279m) outstanding on the term loans and the revolving facility was undrawn. Interest is charged at a rate of 50 basis points over LIBOR on borrowings under the facility. The facility is unsecured and matures in December 2009.

Serco has also issued loan notes under two private placements. The first private placement, for £43.2m, matures in December 2007 and the second, for £117.0m, amortises evenly from 2011 to 2015.

At 31 December 2006, Serco also had £62.2m (2005: £349.2m) of non recourse debt that is used to fund remaining PFI and similar activities. In all cases, no entity other than the relevant borrower has an obligation, as a result of a guarantee or other arrangement, to repay non recourse debt.

Consolidated income statement

For the year ended 31 December 2006

	Note	2006 £m	2005 £m
Continuing operations			
Revenue	2	2,548.2	2,260.3
Cost of sales		(2,182.5)	(1,935.3)
Gross profit		365.7	325.0
Administrative expenses		(235.7)	(214.3)
Other expenses – amortisation of intangibles		(16.2)	(13.6)
Total administrative expenses		(251.9)	(227.9)
Gain on sale of PFI investments	5	11.4	-
Operating profit	2	125.2	97.1
Investment revenue	3	31.7	33.6
Finance costs	3	(49.5)	(52.8)
Profit before tax		107.4	77.9
Tax		(27.9)	(23.5)
Profit for the year		79.5	54.4
Attributable to:			
Equity holders of the parent		78.3	53.4
Minority interest		1.2	1.0
Earnings per share (EPS)			
Basic EPS	4	16.62p	11.66p
Diluted EPS	4	16.43p	11.46p

Consolidated statement of recognised income and expense

For the year ended 31 December 2006

	Note	2006 £m	2005 £m
Net actuarial gain/(loss) on defined benefit pension schemes	8	78.9	(58.4)
Actuarial (loss)/gain on reimbursable rights	8	(53.4)	35.6
Net exchange (loss)/gain on translation of foreign operations	8	(12.3)	6.9
Fair value gain on cash flow hedges during the year	8	2.2	6.1
Tax (charge)/credit on items taken directly to equity	8	(7.0)	2.0
Net income/(expense) recognised directly in equity		8.4	(7.8)
Profit for the year		79.5	54.4
Total recognised income and expense for the year		87.9	46.6
Attributable to:			
Equity holders of the parent		87.1	45.6
Minority interest		0.8	1.0

Consolidated balance sheet

At 31 December 2006

	Note	2006 £m	2005 £m
Non-current assets			
Goodwill		528.5	544.5
Other intangible assets		126.1	107.8
Property, plant and equipment		93.6	103.0
Trade and other receivables		110.5	459.8
Deferred tax assets		73.7	91.2
		932.4	1,306.3
Current assets			
Inventories		51.7	36.4
Trade and other receivables		463.3	528.8
Cash and cash equivalents		217.9	240.7
		732.9	805.9
Total assets		1,665.3	2,112.2
Current liabilities			
Trade and other payables		(541.9)	(531.1)
Current tax liabilities		(13.0)	(19.5)
Obligations under finance leases		(8.3)	(8.2)
Loans		(57.9)	(64.8)
Financial instruments		(10.6)	(4.9)
		(631.7)	(628.5)
Non-current liabilities			
Trade and other payables		(10.4)	(5.0)
Obligations under finance leases		(11.5)	(18.2)
Loans		(346.1)	(744.7)
Financial instruments		(14.2)	(30.8)
Retirement benefit obligations		(249.3)	(306.6)
Provisions		(22.3)	(26.3)
Deferred tax liabilities		(19.9)	(92.1)
		(673.7)	(1,223.7)
Total liabilities		(1,305.4)	(1,852.2)
Net assets		359.9	260.0
Equity			
Share capital	8	9.5	9.4
Share premium account	8	283.5	269.5
Capital redemption reserve		0.1	0.1
Retained earnings	8	196.6	132.8
Retirement benefit obligations reserve	8	(119.5)	(139.0)
Share-based payment reserve	8	25.5	16.6
Own shares reserve		(16.4)	(16.4)
Hedging and translation reserve	8	(21.3)	(15.1)
Equity attributable to equity holders of the parent		358.0	257.9
Minority interest		1.9	2.1
Total equity		359.9	260.0

Consolidated cash flow statement

For the year ended 31 December 2006

	Note	2006 £m	2005 £m
Net cash inflow from operating activities	6	159.5	140.8
Investing activities			
Interest received		32.4	32.8
Disposal of subsidiary and business undertakings	5	18.2	-
Proceeds from disposal of property, plant and equipment		1.4	0.4
Acquisition of subsidiaries, net of cash acquired		-	(281.7)
Purchase of other intangible assets		(30.4)	(13.1)
Purchase of property, plant and equipment		(27.8)	(22.3)
Net cash outflow from investing activities		(6.2)	(283.9)
Financing activities			
Interest paid		(42.2)	(47.6)
Dividends paid		(14.5)	(12.5)
Dividend paid to minority interest		(1.0)	-
Repayment of borrowings		(103.4)	(5.8)
New loan advances		9.4	272.0
Capital element of finance lease repayments		(8.6)	(8.4)
Proceeds from issue of share capital		14.1	4.4
Decrease in non recourse loans		(25.3)	(21.5)
Net cash (outflow)/inflow from financing activities		(171.5)	180.6
Net (decrease)/increase in cash and cash equivalents		(18.2)	37.5
Cash and cash equivalents at beginning of year		240.7	200.5
Net exchange (loss)/gain		(4.6)	2.7
Cash and cash equivalents at end of year	7	217.9	240.7

Notes to the preliminary announcement

1. General Information

The basis of preparation of this preliminary announcement is set out below.

The financial information in this announcement, which was approved by the Board of Directors on 28 February 2007, does not constitute the Company's statutory accounts for the years ended 31 December 2006 or 2005, but is derived from these accounts.

Statutory accounts for 2005 have been delivered to the Register of Companies and those for 2006 will be delivered following the Company's annual general meeting. The auditors have reported on these accounts; their reports were unqualified and did not contain statements under S237 (2) or (3) of the Companies Act 1985.

The preliminary announcement has been prepared in accordance with International Financial Reporting Standards (IFRS) adopted for use in the European Union.

The financial statements have been prepared on the historical cost basis.

Interest paid within the cash flow statement has been re-presented and is shown within financing activities in accordance with latest guidance (interest paid was previously shown within investing activities).

2. Segmental Information

The Group manages its business on a market segment basis and these segments are the basis on which the Group reports its primary segment information.

Market segments

Year ended 31 December 2006	Civil government £m	Defence £m	Transport £m	Science £m	Total £m
Revenue	875.0	644.8	625.7	402.7	2,548.2
Result					
Segment result	42.0	41.2	26.7	36.9	146.8
Unallocated expenses					(33.0)
Gain on sale of PFI investments (note 5)					11.4
Operating profit					125.2
Investment revenue					31.7
Finance costs					(49.5)
Profit before tax					107.4
Tax					(27.9)
Profit for the year					79.5

Year ended 31 December 2005	Civil government £m	Defence £m	Transport £m	Science £m	Total £m
Revenue	803.6	565.6	548.7	342.4	2,260.3
Result					
Segment result	37.5	33.3	25.0	31.4	127.2
Unallocated expenses					(30.1)
Operating profit					97.1
Investment revenue					33.6
Finance costs					(52.8)
Profit before tax					77.9
Tax					(23.5)
Profit for the year					54.4

Geographical segments

Year ended 31 December 2006	United Kingdom £m	North America £m	Europe and Middle East £m	Asia Pacific £m	Total £m
Revenue	1,886.5	295.3	213.4	153.0	2,548.2

Year ended 31 December 2005	United Kingdom £m	North America £m	Europe and Middle East £m	Asia Pacific £m	Total £m
Revenue	1,661.7	254.5	205.2	138.9	2,260.3

3. Investment revenue and finance costs

	2006 £m	2005 £m
Interest receivable by PFI companies	25.6	26.7
Interest receivable on other loans and deposits	6.1	6.9
Investment revenue	31.7	33.6
Interest payable on non recourse loans	(18.0)	(19.9)
Interest payable on obligations under finance leases	(0.6)	(0.8)
Fair value adjustment on fair value hedges and non IAS 39 designated hedges	(0.5)	0.4
Interest payable on other loans	(28.5)	(27.8)
Net interest payable on retirement benefit obligations	(1.9)	(4.7)
Finance costs	(49.5)	(52.8)

4. Earnings per share

Basic and diluted earnings per share (EPS) have been calculated in accordance with IAS 33 'Earnings Per Share'. EPS is shown both before and after amortisation of intangible assets and the gain on sale of PFI investments to assist in the understanding of the impact of the underlying performance of the business.

The calculation of the basic and diluted EPS is based on the following data:

Number of shares

	2006 millions	2005 millions
Weighted average number of ordinary shares for the purpose of basic EPS	471.2	458.1
Effect of dilutive potential ordinary shares: share options	5.5	8.0
Weighted average number of ordinary shares for the purpose of diluted EPS	476.7	466.1

Earnings	2006		2005	
	Earnings £m	Per share amount Pence	Earnings £m	Per share amount Pence
Earnings for the purpose of basic EPS being net profit attributable to the equity holders of the parent	78.3	16.62	53.4	11.66
Less:				
Gain on sale of PFI investments	(11.4)	(2.42)	-	-
Add back:				
Amortisation of intangible assets, net of tax of £2.4m (2005 - £2.4m)	13.8	2.93	11.2	2.43
Basic earnings before amortisation of intangible assets and gain on sale of PFI investments	80.7	17.13	64.6	14.09
Earnings for the purpose of basic EPS	78.3	16.62	53.4	11.66
Effect of dilutive potential ordinary shares	-	(0.19)	-	(0.20)
Diluted EPS	78.3	16.43	53.4	11.46

5. Disposals

On 2 December 2006, the Group sold its investments in ten wholly-owned subsidiaries which carried out six Private Finance Initiatives (PFI) projects. The subsidiaries were sold to Infrastructure Investors Limited (I²) for a cash consideration of £76.5m resulting in a gain on sale of £11.4m.

The subsidiaries disposed of were as follows:

Defence Management (Holdings) Limited
 Defence Management (Watchfield) Limited
 Traffic Information Services (TIS) Holdings Limited
 Traffic Information Services (TIS) Limited
 Premier Custodial Investments Limited
 Premier Custodial Finance Limited
 Pucklechurch Custodial Services Limited
 Lowdham Grange Prison Services Limited
 Medomsley Training Services Limited
 Moreton Prison Services Limited

Net assets disposed of were:

	£m
Intangible assets	0.2
PFI debtor	329.8
Other debtors	11.1
Cash	56.6
Creditors	(22.2)
Non recourse loans	(242.3)
Financial instruments	(16.5)
Tax	(69.9)
Net assets disposed of	46.8

The gain on sale is calculated as follows:

	£m
Cash consideration	76.5
Less:	
Net assets disposed of	(46.8)
Transaction and other costs	(7.0)
Amounts transferred from hedging and translation reserve in relation to financial instruments disposed of	(9.0)
Recognition of financial instrument on sale	(2.3)
Gain on sale of PFI investments	11.4

Transaction and other costs includes liabilities triggered by the disposal.

The net cash inflow arising on disposal is as follows:

	£m
Cash consideration received	76.5
Less:	
Cash disposed of	(56.6)
Transaction costs paid during the year	(1.7)
Net cash inflow	18.2

6. Reconciliation of operating profit to net cash inflow from operating activities

	2006 £m	2005 £m
Operating profit for the year	125.2	97.1
Adjustments for:		
Share-based payment expense	4.8	5.7
Depreciation of property, plant and equipment	30.0	30.3
Amortisation of intangible assets	16.2	13.6
Loss on disposal of property, plant and equipment	1.1	0.4
Loss on disposal of intangible assets	-	0.1
Gain on sale of PFI investments	(11.4)	-
Operating cash inflow before movements in working capital	165.9	147.2
Increase in inventories	(13.9)	(1.9)
Decrease/(increase) in receivables	10.7	(47.2)
Increase in payables	21.8	51.0
Movement in provisions	(4.5)	(6.4)
Special contribution to defined benefit pension scheme	(19.0)	-
Cash generated by operations before PFI asset expenditure	161.0	142.7
Movement on PFI debtor	17.4	15.3
Expenditure on PFI assets in the course of construction	-	(7.8)
Cash generated by operations after PFI asset expenditure	178.4	150.2
Tax paid	(18.9)	(9.4)
Net cash inflow from operating activities	159.5	140.8

7. Analysis of net debt

	At 1 January 2006 £m	Cash flow £m	Disposals £m	Exchange differences £m	Non cash movements £m	At 31 December 2006 £m
Cash and cash equivalents	240.7	(36.4)	18.2	(4.6)	-	217.9
Non recourse loans (related to PFI assets)	(278.2)	19.7	242.3	-	(8.6)	(24.8)
Other non recourse loans	(71.0)	5.6	-	5.6	22.4	(37.4)
Other loans	(460.3)	94.0	-	18.1	6.4	(341.8)
Obligations under finance leases	(26.4)	8.6	-	0.3	(2.3)	(19.8)
	(595.2)	91.5	260.5	19.4	17.9	(205.9)

Non cash movements primarily relate to a joint venture non recourse debt. Certain terms of this debt were renegotiated in 2006 and this allows us to offset a related debtor and the non recourse debt in our accounts, thereby reflecting the economic reality of the contract.

8. Reserves

	Share capital	Share premium account	Retained earnings	Retirement benefit obligations reserve	Share-based payment reserve	Hedging and translation reserve
	£m	£m	£m	£m	£m	£m
At 1 January 2006	9.4	269.5	132.8	(139.0)	16.6	(15.1)
Shares issued	0.1	-	-	-	-	-
Premium on shares issued	-	14.0	-	-	-	-
Profit for the year attributable to equity holders of the parent	-	-	78.3	-	-	-
Dividends paid	-	-	(14.5)	-	-	-
Net actuarial gain on defined benefit pension schemes	-	-	-	78.9	-	-
Actuarial loss on reimbursable rights	-	-	-	(53.4)	-	-
Credit in relation to share-based payment expense	-	-	-	-	4.8	-
Net exchange loss on translation of foreign operations	-	-	-	-	-	(12.3)
Amounts transferred to income statement in relation to sale of PFI investments (note 5)	-	-	-	-	-	9.0
Fair value gain on cash flow hedges during the year	-	-	-	-	-	2.2
Tax charge on cash flow hedges	-	-	-	-	-	*(5.0)
Tax (charge)/credit on items taken directly to equity	-	-	-	*(6.0)	*4.1	*(0.1)
At 31 December 2006	9.5	283.5	196.6	(119.5)	25.5	(21.3)

* £(7.0)m tax charge as shown in the SORIE

9. Joint ventures

The Group's interests in joint ventures are reported in the consolidated financial statements using the proportionate consolidation method. The effect of the Group's joint ventures on the consolidated income statement is as follows:

	2006 £m	2005 £m
Revenue	643.3	536.1
Operating profit	37.3	34.7
Profit before tax	39.3	36.4
Tax	(8.6)	(10.4)
Profit for the year	30.7	26.0
Minority interest	(0.6)	(0.5)
Share of post-tax results of joint ventures	30.1	25.5

Operating profit is after £4.0m (2005 - £6.6m) of costs incurred by Group.