Building, Building Management and Services

Highlights

- Over £750m of long-term facilities management contracts secured
- Major hospital schemes in Birmingham and Glasgow commence
- Acquisition of Charter in the US
- Another strong year of social housing growth

Financial summary

- Revenue £2,145m (2005: £1,787m)†
- Profit £43m (2005: £35m)*
- Unexecuted orders £3.6bn (2005: £2.4bn)

†Including £115m share of joint ventures and associates (2005: £113m).
*Profit from operations before £nil exceptional items and amortisation of intangible assets (2005: £8m charges).

Companies

- Balfour Beatty Construction
- Balfour Kilpatrick
- Haden Building Management
- Haden Young
- Heery International
- Mansell

Specialist areas

- Design
- Construction
- Construction and Programme Management
- Electrical Engineering
- Mechanical Engineering
- Building and Facilities Management
- Refurbishment and Fit-out
- Social Housing

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1 The Gaylord Resort and Convention Center: Centex Construction.

2 Your Homes, Newcastle: Mansell.

3 Birmingham Hospital: Balfour Beatty Construction/Haden Young joint venture.

4 Corsicana Stadium: Charter.

5 Victoria and Stobhill Hospital: Balfour Beatty Construction.

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6 Castle Hill Hospital: Haden Young.

7 Royal Mail: Haden Building Management.

8 Whitelee Wind Farms: Balfour Kilpatrick.

9 St. Andrew's High School, North Lanarkshire: Balfour Beatty Construction.

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2006 performance

Profit from operations before exceptional items and amortisation of intangible assets in the building sector improved by 23% to £43m (2005: £35m). This represented a good all round performance in strong markets. There was particularly good progress achieved in UK building construction and a first contribution from Charter in the US, offset by the impact of some issues related to the delivery programme under the London Underground PPP, which also had an effect in the engineering sector.

Review of operations

In **Balfour Beatty Construction**, profits moved ahead, despite the adverse impact of issues relating to the stations delivery programme under the London Underground PPP.

Progress on major projects was good, with work on York College now well advanced, a successful start to a major new office building in Holborn, London and a flying start to the Birmingham Hospital project following substantial advanced works prior to its financial close in June. Work on the rail station and interchange at Heathrow Terminal 5 also progressed well. The Victoria and Stobhill Hospitals project in Glasgow began in August.

In the schools sector, new build programmes in Stoke and Rotherham were completed on time, the schemes at Bassetlaw and in Birmingham proceeded satisfactorily and eight new schools have now been delivered in North Lanarkshire.

There was a particularly strong performance in the London refurbishment market, including successful completion of the Grosvenor House Hotel project. A major new swimming pool in Sunderland and the Paradise Street development in Liverpool, were also commenced during the year.

The delayed stations programme, part of the London Underground PPP, continued to accelerate, with 44 stations due to be completed by the end of March 2007.

Balfour Kilpatrick had another good year. The company is the building services partner on all Balfour Beatty's education PPPs, where activity levels were high and performance good.

Order intake was very satisfactory, including new work for BNFL at Sellafield, for Whitelee Wind Farms in Scotland and for a number of data centre projects for BT. It will also carry out more than £20m of work on the King's Cross St Pancras Underground Station Northern Ticket Hall project, which was awarded in May.

Good progress was made on the project to strengthen the main power ring around Edinburgh and on a £20m upgrade for the renewable energy transmission system in Scotland. Work on the substations programme for London Underground progressed well, with a further tranche of work now in the process of final agreement.

Balfour Kilpatrick plays a key part in the extensive rail works at Heathrow Terminal 5, which progressed well during the year. The works include mechanical and electrical engineering in the rail tunnels, the station and the track transit system.

Building, Building Management and Services (continued)

Haden Building Management's profits were in line with 2005 after absorbing the impact of a reduction in scope of work and slower than anticipated cost reductions in Romec, in which it has a 49% interest. Romec is responsible for facilities management for all the Royal Mail premises.

2006 was, however, a year of very significant progress for Haden Building Management. The company secured over £750m of new orders. Most notable were the £320m nationwide support services contract for the Department for Work and Pensions and the £150m facilities management contract for the Metropolitan Police Authority, both with a seven-year duration and options to extend. Under the former, Haden will deliver a comprehensive range of office support services as part of the modernisation of the organisation. The latter involves a full facilities management service covering over 500 properties in north London.

Other new work won during the year included the facilities management portion of the Group's new PPP schemes in Birmingham, the extension of a major contract for BT and a new contract for the Ministry of Defence at HMS Nelson. The company now has a very significant portfolio in support of the Group's PPP projects, with four more major schemes at preferred bidder stage.

In **Haden Young**, profits held steady during the year despite a decrease in revenues as major projects at Birmingham, Pinderfields and Northern Batched Hospitals took longer than anticipated to reach financial close. Haden Young remains a clear market leader in large, complex M&E schemes, particularly in the healthcare sector.

The new projects in Birmingham and Glasgow commenced towards the end of the year, as did the Highland Schools scheme. The £20m project at the new Liverpool Arena progressed well. The company was successful under the Procure 21 initiative, with a number of small and medium-sized schemes beginning during the year. Work on Castle Hill Hospital in Hull and Queen Margaret College in Edinburgh progressed satisfactorily.

Haden Young has a very strong commercial workload in London, including the major Ludgate West development.

Heery International, the US engineering, architectural and programme management business, had another good year of progress, assisted by a first-time contribution from Charter, the Texas-based construction management business acquired in March 2006.

Although there is some public sector market uncertainty as federal expenditure comes under pressure, Heery's base workload from the K-12 schools programme, from justice, from healthcare and from the private sector has remained strong and its order book has grown.

Work secured during the year included the Veterans Medical Center at San Juan and major schools schemes in Palm Beach, California and Charleston, North Carolina. HLM and JCM, the two businesses acquired by Heery in 2004 and 2005 respectively, both performed well during the year. Charter has brought some £100m of additional revenues to Heery and has added over £20m of fee work to its order book since it joined the Group, including for the renovation and expansion of the Cotton Bowl which will create a state-of-the-art 84,000 seater stadium in Dallas, Texas. Substantial synergies are emerging between Heery and Charter and the integration process has been successfully completed.

Mansell continued to make excellent progress and was further augmented by the addition of the building business of Birse, acquired as part of the broader Birse transaction in July 2006. Mansell has a broad portfolio of small and medium-sized building projects. Amongst the most notable are Argyll and Bute Schools, Brentwood Hospital, USAF accommodation at Lakenheath in Suffolk and work arising from participation in the Ministry of Defence Prime Contracts for Scotland, and the East and South-East of England.

Amongst its long-term framework contracts are the Job Centre Plus programme for the Department for Work and Pensions and substantial on-going programmes for BT, BAA, the BBC and Hampshire County Council.

It was another very strong year for the company in the social housing market. The value of framework contracts in this market now exceeds £800m, including relationships with Catalyst, Riverside, Your Homes in Newcastle and Metropolitan Housing in the Midlands. In April, the company won a five-year contract to upgrade all council housing at Sandwell in Birmingham.

Outlook

With order books continuing to grow, we expect very good progress in this sector in 2007, accelerated by the additional benefit of the acquisition of Centex.

Civil and Specialist Engineering and Services

Highlights

- Acquisition of UK regional civil engineer, Birse
- Preferred partner for National Grid Eastern Overhead Line and Cable Alliance
- Northern Gas Networks utilities contract secured
- Improved performance in Hong Kong and Dubai

Financial summary

- Revenue £2,382m (2005: £1,920m)†
- Profit £55m (2005: £49m)*
- Unexecuted orders £4.5bn (2005: £4.0bn)

†Including £705m share of joint ventures and associates (2005: £554m).
*Profit from operations before £21m exceptional charges and £1m amortisation of intangible assets (2005: £nil).

Companies

- Balfour Beatty Civil Engineering
- Balfour Beatty Construction Inc
- Balfour Beatty Infrastructure Services
- Balfour Beatty Management
- Balfour Beatty Power Networks
- Balfour Beatty Utilities
- Stent Foundations
- Devonport Management Ltd (24.5%)
- Balfour Beatty Sakti (49%)
- Dutco Balfour Beatty (49%)
- BK Gulf (49%)
- Gammon (50%)

Specialist areas

- Design
- Construction
- Project Management
- Foundations, Strengthening, Testing
- Civil Engineering
- Electrical Engineering
- Transmission Lines
- Road Management and Maintenance
- Utility Upgrade and Maintenance
- Professional and Technical Services

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1 National Power: Balfour Beatty Power Networks.

2 Roseville Water Treatment Plant: Balfour Beatty Construction Inc.

3 Palm Island, Dubai: BK Gulf.

4 North Yorkshire Road Maintenance: Balfour Beatty Infrastructure Services.

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Civil and Specialist Engineering and Services (continued)

2006 performance

Profit from operations before exceptional items and amortisation of intangible assets in the engineering sector increased by 12% to £55m (2005: £49m). This reflected a good all round UK performance, with strong growth from Balfour Beatty Utilities and Balfour Beatty Management. Outside the UK, there were improved performances from our businesses in Hong Kong and Dubai. In the US, although underlying performance improved, there were some further losses in the central division, which is in the process of closure.

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5 Sumburgh Airport: Balfour Beatty Civil Engineering.

6 Lok Ma Chau Rail Terminus: Gammon Construction.

7 Greater Manchester Gas Alliance: Balfour Beatty Utilities.

8 King's Cross St Pancras Underground Station: Balfour Beatty Management.

Review of operations

Underlying performance in **Balfour Beatty Civil Engineering** was in line with the previous year, although there was an adverse impact from the infrastructure upgrade programmes under the London Underground PPP.

In major projects, the Steg Raron tunnelling project was completed and progress was good on the widening project for Junctions 6-10 of the M1.

The £115m contract to construct a new Northern Ticket Hall at King's Cross St Pancras Underground Station was secured, and in conjunction with Balfour Beatty Rail, the company won the £363m contract to create the new East London rail line. During 2006, two Early Contractor Involvement, Highways Agency schemes, the A3 project at Hindhead, and the A1 between Bramham and Wetherby, were given the go-ahead to proceed.

In the regional civil engineering business, the acquisition of Birse in July has substantially widened the company's regional coverage. Birse contributed in line with expectations and the integration process is proceeding well. The framework contract for Durham County Council was extended for two years and work at Sumburgh Airport in the Shetlands was completed ahead of schedule. The business has a strong order book and excellent tendering opportunities.

The performance of **Balfour Beatty Construction Inc** continued to disappoint, with contract losses in the central division offsetting good performances in the businesses serving the West Coast and Texas and in tunnelling. Appropriate action has been taken to address the central division's issues. The company's underlying quality of earnings is on an improving trend, with closer supervision from UK management and more rigorously-applied control mechanisms.

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In Texas, progress on the $1.3bn SH130 project was good. The future market flow of major road work in Texas will be very significant, some of it let under PPP arrangements.

On the West Coast, project progress has been good and substantial new work was won at good margins, including the $193m I-5 highway project in Orange County, the $120m Freeport water treatment plant and the Roseville Water Treatment plant in Sacramento.

The specialist tunnelling business is close to completing a water project in Rhode Island and has secured a major new tunnel contract in nearby North Dorchester.

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During 2006, RCS, the Group's road management and maintenance company, was renamed **Balfour Beatty Infrastructure Services**. Profits in 2006 were in line with the strong performance achieved in 2005. Steady progress was made in Highways Agency Areas 2, 3 and 4, with one-year extensions being awarded in Areas 3 and 4.

In January 2006, the company secured new work with a potential total value of over £300m. In Scotland, it won the management and maintenance of major trunk roads in the North-West. In England, it won the contract for county roads in Mid and East Essex. In May, its contracts for both North Yorkshire County Council and Hampshire County Council were extended, taking its order book to approximately £750m. The project to maintain roads in the London Borough of Westminster progressed well.

Balfour Beatty Management made excellent progress in 2006 in terms of both market penetration and profitability. Already an integral part of the Greater Manchester Gas Alliance for National Grid, it was instrumental with Balfour Beatty Power Networks in securing the Eastern Overhead Line and Cable Alliance partnership with the same customer, and the £420m Northern Gas Networks contract through United Utilities.

The company has led the successful delivery of the new London Underground Western Ticket Hall and other facilities at King's Cross St Pancras Station for London Underground where its programme management work is on-going.

Amongst its other customers are BAA, the Blood Transfusion Service and the Natural History Museum.

Balfour Beatty Power Networks' results were in line with those of the previous year, with the impact of some issues on its Central Networks contract offsetting good progress elsewhere. A power line project between East Anglia and the East Midlands is nearing completion and projects for the expansion of the Australian power transmission network are proceeding well. In Scotland, the company continued to be active on contracts for Scottish Power.

Work on the Sunderland and South Tyneside Street Lighting projects continued satisfactorily. Preferred bidder status has been achieved in Derby.

In October, the company was appointed preferred partner for a five-year alliance contract with National Grid, likely to be worth up to £550m, to upgrade and develop the electricity transmission network in the eastern half of England. The project, which was converted to contract in March 2007, will involve the connection of new generating capacity to the national grid, and the enhancement and replacement of existing assets.

In the gas and water sectors, **Balfour Beatty Utilities'** revenues and profits continued to improve as its substantial portfolio of long-term contracts won in 2004 and 2005 became fully operational. The company has achieved a leading position in the clean water sector with long-term contracts with United Utilities, Anglian Water, Severn Trent Water and South-West Water amongst others. A bid to extend its successful existing relationship with Yorkshire Water is currently under adjudication.

Last year's good progress on the Greater Manchester Gas Alliance continued. In June, Balfour Beatty was appointed preferred bidder for the seven-year gas mains replacement contract, to be operated by United Utilities for northern England by Northern Gas Networks with a total value likely to be approximately £420m.

Stent, the Group's specialist foundations and ground treatment specialist, had a good year, helped by a first full-year's contribution from Pennine, the specialist ground treatment and preparation contractor, which has been integrated successfully into the business.

Revenues continued to increase. Work at the major White City development in London accelerated and piling work in support of the M1 Junctions 6-10 widening project was intense. The company's penetration of the fast-growing Dubai market also increased. Stent is also carrying out work on the London Underground.

Workload at **Devonport Management Ltd,** in which the Group has a 24.5% interest, was steady. Devonport Royal Dockyard continues to be the mainstay of strategic support for the UK nuclear submarine fleet and has a second business stream in large, bespoke, commercial yachts.

Discussions are underway which seem likely to result in a change in the structure of ownership of the supply base to the Royal Navy.

Dutco Balfour Beatty, the Group's civil engineering and building joint venture in Dubai, improved its performance, significantly, in a fast-growing market.

Good progress has been achieved on the Burj Mall, the world's largest shopping mall, with fitting out due to begin this year.

The Palm Island Interchange and Sheikh Zayed road widening projects were completed, as was the Business Bay Development and the Royal Airwing at Dubai Airport.

Two major new road schemes were secured for the construction of the Jumeirah Lake Towers Interchange on the Sheikh Zayed road, and a widening scheme for 35 km of the Emirates Road.

BK Gulf, also had a very busy and successful year, winning the Atlantis project and making good progress on work for new hotels, theme parks and other facilities.

The performance of **Gammon** in Hong Kong improved significantly. The Shenzhen Western Corridor and Deep Bay Link projects were completed, and good progress was made on the Venetian Hotel and Casino project in Macau, the 70-storey office development at One Island East, and the railway station and immigration centre on the Chinese border at Lok Ma Chau.

The civil engineering works at Kowloon Southern Loop Station for KCRC also progressed satisfactorily. The refurbishment of the Mandarin Hotel was completed to time and budget. While the Hong Kong market remains flat, tendering activity in Macau for the hotel and casino development programme is intense.

In Singapore, the market is accelerating and bidding activity is high.

Outlook

Our engineering markets, particularly in the UK, Dubai and Singapore, remain strong and, with further recovery in the US, we expect to make substantial progress in this sector in 2007.

Rail Engineering and Services

Highlights

- Waterloo and City Line upgrade completed on time
- East London Line contract secured
- Nuremberg-Ingolstadt Line opened on time
- Good progress on major works at Heathrow Terminal 5

Financial summary

- Revenue £770m (2005: £766m)†
- Profit £38m (2005: £32m)*
- Order book £1.0bn (2005: £1.2bn)

†Including £4m share of joint ventures and associates (2005: £3m).
*Profit from operations before £2m exceptional profit (2005: £12m charges).

Companies

- Balfour Beatty Rail UK
  - Infrastructure Services
  - Projects
  - London Underground Services
  - Track Systems
  - Plant
  - Technologies
- Balfour Beatty Rail Germany
- Balfour Beatty Rail Italy
- Balfour Beatty Rail International
- Balfour Beatty Rail Inc

Specialist areas

- Design
- Construction
- Project Management
- Maintenance
- Track Renewals
- Specialist Plant, Products and Systems
- Electrification and Power Supplies
- Signalling

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1 Metro do Porto: Balfour Beatty Rail Italy.

2 Greenbush Commuter Line, US: Balfour Beatty Rail Inc.

3 Ingolstadt to Nuremberg electrification: Balfour Beatty Rail Germany.

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4 Heathrow Terminal 5: Balfour Beatty Rail Projects/Balfour Kilpatrick.

5 Waterloo and City Line: Balfour Beatty Rail – London Underground Services.

6 Botniabanan, Sweden: Balfour Beatty Rail International.

7 Berlin Tunnel: Balfour Beatty Rail Germany.

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2006 performance

Profit from operations before exceptional items in the rail sector rose by 19% to £38m (2005: £32m). This reflected an excellent recovery in the second half of the year, with good settlements on projects in the UK, Europe and Asia and steady progress on major works, including those for Metronet and BAA.

Review of operations

Balfour Beatty Rail UK

Balfour Beatty Rail Infrastructure Services' underlying performance was in line with that of the previous year, with similar track renewals workloads for Network Rail. A satisfactory settlement was achieved in respect of work carried out in previous years. Work is undertaken in a very demanding environment and the company has developed a new programme to increase assurance of track quality and reliability. Network Rail has announced its intention to reduce its renewals suppliers from six to four in 2007.

In **Balfour Beatty Rail Projects**, the major works for the West Coast Main Line were completed, as was the final stage of the Watford-Bletchley infrastructure upgrade. Settlement of these projects is currently in the process of finalisation with Network Rail. Work on the £110m programme to deliver 13 feeder stations and 620 miles of high voltage feeder cable progressed well. The project for the Santiago Metro in Chile was completed and commissioned.

Good progress was made on the track-laying project between Sydney and Brisbane in Australia. The major rail integration project at Heathrow Terminal 5 also proceeded well, with the Piccadilly Line put back into full service on schedule.

In October, Balfour Beatty was awarded the £363m contract by Transport for London to create the new East London Line between Dalston Junction in the north and West Croydon in the south. The project, which is the first of two phases, is due for completion in 2010. The project involves track, signalling, telecommunications and electrification.

The company is currently bidding the €300m project for the track and electrification work for the new Gothard rail tunnel, in conjunction with Balfour Beatty Rail International.

During the course of 2006, a new operating division, **Balfour Beatty Rail – London Underground Services**, was created from within Balfour Beatty Rail Projects to service the needs of London Underground under the PPP scheme. This organisation made good progress on the LUL track replacement programme in an extremely challenging operating environment.

In the four months to September 2006, BBR-LUS successfully completed the complex upgrade and refurbishment of the Waterloo and City Line. It also continues to increase the efficiency of delivery under the Metronet track renewal contract.

Rail Engineering and Services (continued)

Performance in **Balfour Beatty Rail Track Systems** improved from the previous year, largely as a result of the acquisition of Edgar Allen, completed in March 2006. Edgar Allen manufactures switches, cast manganese crossings and other rail track products, and augments and broadens Balfour Beatty Rail Track Systems' product range. The integration of Edgar Allen is well advanced.

Early in 2006, Balfour Beatty Rail Track Systems continued its programme of plant investment, with the installation of new forging machines. Demand under its contracts for the London Underground continued to grow, as did its export sales.

In **Balfour Beatty Rail Plant**, profits improved after a disappointing performance in 2005. Investment in new high output plant continues and a programme to improve the reliability and availability of the on-track fleet is being implemented.

Contracts for tamping and ballast regulation, won in late 2005, have developed satisfactorily in their early stages.

Balfour Beatty Rail Technologies continued to develop concepts and products aimed at improving network safety and reliability. A number of new UK sites were secured for XiTRACK, a polymer-based stabilisation technology for track and other infrastructure.

Further development work was undertaken on the CGI system, an extension of solid state interlocking signalling particularly relevant to low-speed lines. A new joint venture for signalling technology was progressed with Alstom in the UK, significantly increasing Balfour Beatty's capability to deliver advanced interlocking signal systems.

Balfour Beatty Rail Germany

In Germany, market conditions were steady, with some further signs of growth as Deutsche Bahn's investment programme continued to recover. The technically complex Ingolstadt to Nuremberg turnkey electrification project was completed to time and budget, as was the contract in the new Berlin main station to project manage, supply and design the infrastructure for the Berlin tunnel.

During the year, the company won the €40m electrification and power supply contract for the line between Hamburg and Lübeck – the largest electrification project tendered in Germany in 2006.

Following the acquisition of SBB, the specialist signalling contractor, in 2005, the company has formed a signalling co-operation with Bombardier, has had some early successes and is currently bidding on a number of new electronic interlocking signalling projects.

Balfour Beatty Rail Italy

In Italy, the company, as part of the joint venture Saturno, completed the new line from Malpensa to Turin, in time for the Winter Olympics. The Rome-Naples line was successfully tested and commissioned and is now also in full service. This is the first fully radio-signalled line in the world and is seen as an important reference project.

Work is underway on three further major high-speed line projects – Malpensa to Milan, Bologna to Milan and Florence to Bologna, as the ambitious Italian high-speed investment programme continues.

Early in the year, the Metro do Porto project in Portugal was successfully commissioned. It is now fully operational and bonus payments for on-time, on-budget delivery have been secured.

Balfour Beatty Rail International

The operation in Spain continued to progress major mass transit projects in both Madrid and Barcelona. In early 2006, an export project for the electrification work on the Tianjin to Shenyang Line was secured – the latest in a series of projects in China with future tenders submitted.

In Sweden, the second year's work on the Botniabanan track project was completed on time and budget. The electrification and track modernisation project on the Blekinge coastline is also proceeding satisfactorily.

In Austria, performance was very satisfactory, and the business secured its first ever sub-station project.

In Malaysia, the electrification project for the main North-South line between Rawang and Ipoh made good progress, with the first section of 20 km handed over to the customer at the end of the year.

In Ireland, the electrification project for the Dash system was concluded successfully. Prequalification was achieved for the rail electrification programme in Israel, while the company has, as part of a group of four, bid for the rail equipment contract for the Gothard Rail Tunnel at 57 kilometres, the world's longest.

Balfour Beatty Rail Inc

Performance in the United States improved significantly, although progress was held back by an unexpectedly adverse settlement on a legacy project completed some years ago in Texas. The signalling contract in Philadelphia, which has been the source of problems, is now performing in line with forecast.

Major project work on the Goldline in California and on the Greenbush commuter line in Boston both progressed well.

The regional services business has performed well. Its customers include the mineral extraction industry in Wyoming and a range of goods and shunting yards on the US heavy freight network. The Class 1 railway companies who operate on this system are beginning to generate some significant projects, for which Balfour Beatty Rail Inc is well placed.

Outlook

We do not expect an upturn in overall spending in our major markets in the short term. However, steady growth in the world rail infrastructure market is predicted for the longer term.

Investments and Developments

Highlights

- Birmingham Hospital and Schools schemes reach financial close
- Exeter International Airport acquired for £60m in January 2007
- Preferred bidder appointments for Knowsley Schools, Derby Street Lighting, and in January 2007, Fife Hospital
- PPP investment businesses established in the US, Germany and Singapore

Financial summary

- Revenue £555m (2005: £465m)†
- Profit £32m (2005: £20m)*
- Concessions 20 (2005: 18)

†Including £541m share of joint ventures and associates (2005: £431m).
*Profit from operations before £nil exceptional items (2005: £36m profits).

Companies

- Balfour Beatty Capital
  - Aberdeen Environmental Services
  - Connect Roads
  - Consort Healthcare
  - Health Management (UCLH)
  - Metronet
  - Powerlink
  - Transform Schools
- Barking Power
- Exeter International Airport (from January 2007)

Specialist areas

- Healthcare
- Education
- Roads
- Rail
- Integrated Transport
- Power Systems
- Water
- Airports

1 Exeter International Airport: Regional and City Airports.

2 Birmingham Hospital: Consort Healthcare.

3 Fife Hospital: Consort Healthcare.

4 Knowsley Schools: Transform Schools.

Investments and Developments (continued)

The market

UK PPP markets remain robust, with the current proportion of total government capital spend to be sourced through this procurement method expected to stay steady at around 15%. The continuing flow of opportunities is coming most notably: in schools, through the Building Schools for the Future initiative; in hospitals, most particularly in Northern Ireland; and in the affordable housing sector.

There are also a number of projects in transport infrastructure including currently, the New Tyne Crossing and the M25 widening projects, where PPP has been chosen as the optimum procurement route.

The sale of other UK infrastructure assets, such as regional airports and utility systems is also offering Balfour Beatty Capital a range of opportunities outside PPP.

PPP markets are also developing in other countries. A number of US states have enacted primary legislation to allow PPP for infrastructure development. In Western Europe a number of countries, including Germany, are also using the technique. There is also an emerging market in South East Asia, most notably in Singapore and Hong Kong. With a substantial existing Balfour Beatty Group presence in each of these markets, Balfour Beatty Capital is well-placed to take advantage as these PPP markets develop.

Strategy

Balfour Beatty's skills, experience and successful track record in the UK healthcare, education and road transport markets give it significant competitive advantage and it will continue to seek to build on its existing PPP portfolios in these sectors. In territories where Balfour Beatty already has a substantial local presence and existing market knowledge, the Group will seek to establish an appropriate concession base as PPP markets emerge.

The expertise residing in Balfour Beatty Capital's team of over 200 professionals, built up over 10 years as a leading participant in the UK PPP market is clearly relevant to the fast emerging market for non-PPP infrastructure investment in the UK. The targeted asset classes will be those where Balfour Beatty has established contracting expertise – such as airports and utility systems.

While Balfour Beatty Capital has clearly positioned itself as a long-term holder and operator of assets, the potential to take advantage of refinancing opportunities and carefully targeted acquisitions and divestments in the secondary PPP market will continue to be evaluated. Balfour Beatty Capital will use its skills to pursue these opportunities where appropriate.

2006 performance

Profit from operations before exceptional items in the investments sector rose by 60% to £32m (2005: £20m). This reflected significantly better profits in Barking Power, good performance in mature concessions, a reclassification of Connect Roads from subsidiary to joint venture and an increased shareholding in Consort Edinburgh. Performance of the Metronet concessions was less satisfactory as a result of the complexity of the delivery issues, which are the subject of close attention.

During the year, two concessions – Birmingham Hospital and Birmingham Schools – were converted to contract from preferred bidder status. Three new concessions have reached preferred bidder stage, namely Derby Street Lighting, Knowsley Schools and, in January 2007, Fife Hospital. Exeter International Airport was acquired for £60m in January 2007.

Outlook

In 2007 profits will be impacted both by significantly increased bid costs and overheads as we grow the business overseas and the performance of Metronet where further action is being taken to secure the long-term success of the concessions.

We anticipate that the financial performance of our healthcare, education, road and general infrastructure concessions will continue to meet or exceed expectations and that our preferred bidder projects and a strong bid pipeline will see our portfolio continue to grow. We will also continue to increase our presence in overseas PPP markets.

Consort healthcare

Healthcare

Consort Healthcare continued to perform well in 2006, contributing profit and generating cash at anticipated levels.

At 31 December 2006 its portfolio comprised interests in eight major hospital schemes and a committed equity investment of £113m, £28m of which is at preferred bidder stage.

In January 2007, Consort was appointed preferred bidder for the £152m Fife Hospital project in Scotland, which will involve a £7.5m equity commitment. It is expected that this scheme will reach financial close in 2007.

North Durham, Edinburgh Royal Infirmary and University College London Hospital entered 2006 fully operational. Blackburn began full service provision on schedule in July.

In June, Consort achieved financial close on the £553m project for acute and adult psychiatric hospitals for the University Hospital Birmingham NHS Foundation Trust and the Birmingham and Solihull Mental Health NHS Trust.

Consort has continued to progress the Pinderfields and Pontefract hospitals scheme, with a currently anticipated capital value of £300m, and the £200m Northern Batched Hospitals Project, which comprises two hospitals, at Salford and at Tameside. These projects are expected to reach financial close during 2007.

Consort Healthcare remains a clear market leader in UK PPP hospitals with a proven track record, a differentiated approach and high levels of client satisfaction.

Bids are in preparation for hospitals in Enniskillen, Blackpool, and Bremen in Germany, with a total value of approximately £400m.

University Hospital of North Durham	50%
Edinburgh Royal Infirmary	73.9%
University College London Hospital	33.3%
Royal Blackburn Hospital	50%
Birmingham Hospitals	40%
Fife Hospital†*	50%
Pinderfields and Pontefract Hospitals†	50%
Salford Hope Hospital†	50%
Tameside Hospital†	50%

†Preferred bidder *Appointed in January 2007

Transform schools

Education

Balfour Beatty's market leading brand in the UK education market, Transform Schools, continued to perform well in 2006. Its portfolio consists of six large-scale schools schemes covering some 154 schools in total, with £50m of committed equity investment, £21m of which is at preferred bidder stage. The Stoke concession, which commenced in 2000, remains the largest grouped schools scheme in England, covering 98 schools.

Construction programmes and operations are proceeding well at all our schools schemes, with 20 new schools completed during the year and 34 more currently under construction.

In March 2006, Transform reached financial close for the £89m scheme in Birmingham. This concession will provide 12 new and refurbished schools, including two secondary schools, nine primary schools and an early years centre.

In December, Transform was appointed preferred bidder for the £157m Building Schools for the Future PPP concession at Knowsley on Merseyside. Under this 25-year concession seven new state-of-the-art learning centres will be created, which will replace all of the borough's existing secondary schools over a three year period. This project is due to reach financial close in 2007.

Bids are in preparation for schools schemes in West Dunbartonshire, Islington and Nottingham, with an aggregate capital value of approximately £270m.

A bid is also in preparation for the Institute of Technical Education in Singapore through our newly established business there. This concession has an approximate capital value of £70m.

Stoke Schools	50%
Rotherham Schools	50%
North Lanarkshire Schools	50%
Bassetlaw Schools	50%
Birmingham Schools	50%
Knowsley Schools†	100%

†Preferred bidder

Investments and Developments (continued)

Connect roads

METRONET

Roads and street lighting

Connect Roads, the brand for the Group's road and street lighting concessions, continued to perform in line with expectations. With the exception of the Derby street lighting project which is at preferred bidder stage, all the concessions are fully operational.

The total committed equity in the roads sector is £63m, of which £2m is at preferred bidder stage.

During 2006, Balfour Beatty acted as an intermediary when I^2 acquired the 50% shareholding of the Group's previous partner in Connect M1-A1, through Balfour Beatty exercising its pre-emption rights over its partner's interest and selling it on to I^2.

The street lighting schemes in Sunderland and South Tyneside are the only Balfour Beatty Capital PPP concessions to remain 100% owned and whose non-recourse debt appears on the Group's balance sheet.

During 2006, Balfour Beatty Capital's new US business, based in Atlanta, was one of twelve organisations which submitted a prequalification for a road scheme concession (SH161) in Dallas, Texas.

In the UK, bids are in preparation for the Surrey street lighting scheme, the New Tyne Crossing, the M80 and the M25 widening project.

The capital value of these bids, in aggregate is approximately £2,100m, of which the M25 scheme is at £1,500m.

M1-A1	50%
A50 Stoke/Derby link	85%
A30/A35	85%
M77/Glasgow Southern Orbital	85%
Sunderland Street Lighting	100%
South Tyneside Street Lighting	100%
Derby Street Lighting†	100%

†Preferred bidder

London Underground

Since April 2003, Metronet, in which Balfour Beatty is a 20% shareholder, has operated and maintained the Bakerloo, Central and Victoria lines and the sub-surface lines for London Underground and is undertaking a £17bn investment and upgrade programme under the 30-year concession. Balfour Beatty is investing £70m in these concessions.

The underlying operational performance of the assets inherited by Metronet from London Underground continues on an improving trend with December 2006 the best ever month for reliability.

In November 2006, the report of the independent Arbiter, appointed under the contract at Metronet's request, rated Metronet's average performance over the first three years of the contract as not to be economic and efficient and not to meet best industry practice in some areas. Many of the actions necessary to address this situation were already in hand at the time of the Arbiter's report. Further changes in the procurement and delivery system have been finalised recently.

Metronet subsequently asked the Arbiter to produce an opinion on where responsibility for certain unforeseen and uncontracted costs incurred under the projects would lie between Metronet and London Underground. Commercial negotiations with London Underground continue. In the event of the failure of those negotiations, these and other matters can be dealt with under an extraordinary review process, should Metronet so choose.

Metronet BCV	20%
Metronet SSL	20%

Infrastructure
projects

Other infrastructure concessions

Powerlink and PADCO, which operate and maintain London Underground's high voltage power system, have continued negotiations with the customer about restructuring the project following the completion of the initial capital works and with the developing needs of the London Underground PPPs becoming clearer. Concession performance was satisfactory, as it was at Aberdeen Environmental Services, which is responsible for wastewater treatment in Aberdeen.

Balfour Beatty has committed £8m of equity to these concessions.

In September, a Balfour Beatty Capital-led concession company was short-listed for the Oakland Connector project in California, a rail line which will connect the airport to the Bay Area Rapid Transit system. The project has an anticipated capital value of $300m.

Non-PPP asset investments

Barking Power had an excellent year with profit from operations before exceptional items well ahead of last year's results, itself a major improvement on the previous year. The 1000 MW gas-fired station operated with high reliability, efficiency and consistency. The 28% of station output which is sold on the open market attracted increasingly good returns as gas fuel prices fell and electricity prices increased.

In January 2007, Balfour Beatty Capital, through Regional and City Airports, reached financial close on its acquisition of Exeter International Airport from Devon County Council for £60m, of which half has been financed with equity.

Exeter International Airport is one of the fastest growing regional airports in the UK and will handle over 1m passengers in the financial year to March 2007. Continuing strong growth in passenger numbers is anticipated and a clear operational and development plan is in place for the airport's future. The airport serves a strong local economy, and is expected both to increase its market share and benefit from an increasing propensity for the local population to use the airport.

The airport will be redeveloped with new terminal facilities, new aircraft stands and taxiway extensions on a phased basis to meet increasing demand. Regional and City Airports has subsequently submitted a bid for Leeds Bradford Airport.

PPP outside the UK

During the year new businesses were established to pursue PPP opportunities in the US, Germany and Singapore. In each case the new bidding teams will build on the local knowledge of Balfour Beatty's existing contracting business and seek opportunities in which the chances of success will be increased by their participation.

Powerlink/PADCO	10%/25%
Aberdeen Environmental Services	45%

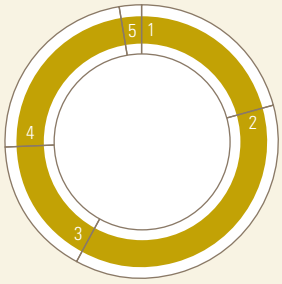
Barking Power	25.5%
Exeter International Airport*	100%

*Acquired January 2007

Directors' valuation of PPP concessions

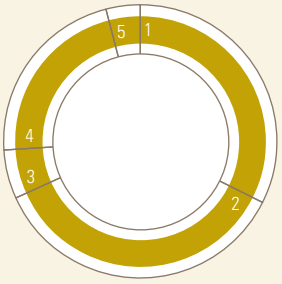
Our portfolio
Total equity committed by sector

		2006	2005
1	Connect: 7 projects	**£63m**	£61m
2	Consort: 8 projects	**£113m**	£112m
3	Transform: 6 projects	**£50m**	£30m
4	Metronet: 2 projects	**£70m**	£70m
5	Other: 2 projects	**£8m**	£10m
		£304m	£283m



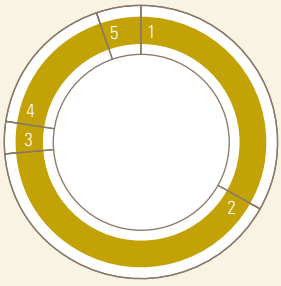
Our portfolio
Cash invested by December

		2006	2005
1	Connect: 7 projects	**£56m**	£56m
2	Consort: 8 projects	**£62m**	£59m
3	Transform: 6 projects	**£10m**	–
4	[illegible]	**£38m**	[illegible]
5	[illegible]	**£7m**	[illegible]
		£173m	[illegible]



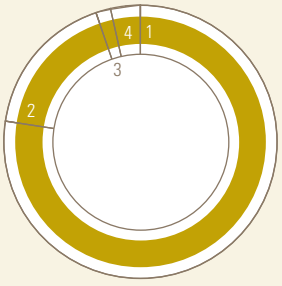
Portfolio valuation
Value by sector

		2006	2005
1	Connect	**£113m**	£123m
2	Consort	**£138m**	£116m
3	Transform	**£13m**	£3m
4	Metronet	**£59m**	£33m
5	Other	**£18m**	£14m
		£341m	£289m



Portfolio valuation
Value by phase

		2006	2005
1	Operations	**£264m**	£243m
2	Metronet	**£59m**	£33m
3	Preferred bidder	**£6m**	£7m
4	Construction	**£12m**	£6m
		£341m	£289m



Movement in value 2005/2006 (£m)

2005	Equity invested	Distributions	Unwind of discount	Rebased	New projects at preferred bidder	Preferred bidder projects achieving financial close	Reserve movements on book projects	Operational performance gains	2006	Growth
289	21	(28)	25	**307**	2	4	18	10	**341**	11.0%

Introduction

Balfour Beatty's PPP concession portfolio has grown in recent years to become a very significant part of the Group's business and a major driver of shareholder value. At 31 December 2006, Balfour Beatty had total committed equity and subordinated debt of £304m across 25 projects, five of which were at preferred bidder stage. At that date, £173m had already been invested and £131m is due over the next six years.

Valuations of PPP equity often rely on the use of multiples to produce a proxy cash flow valuation. This produces somewhat crude benchmarks as such an approach takes no account of the time value of money, expected rate of return of the asset, the performance of the asset or the potential for capital restructuring.

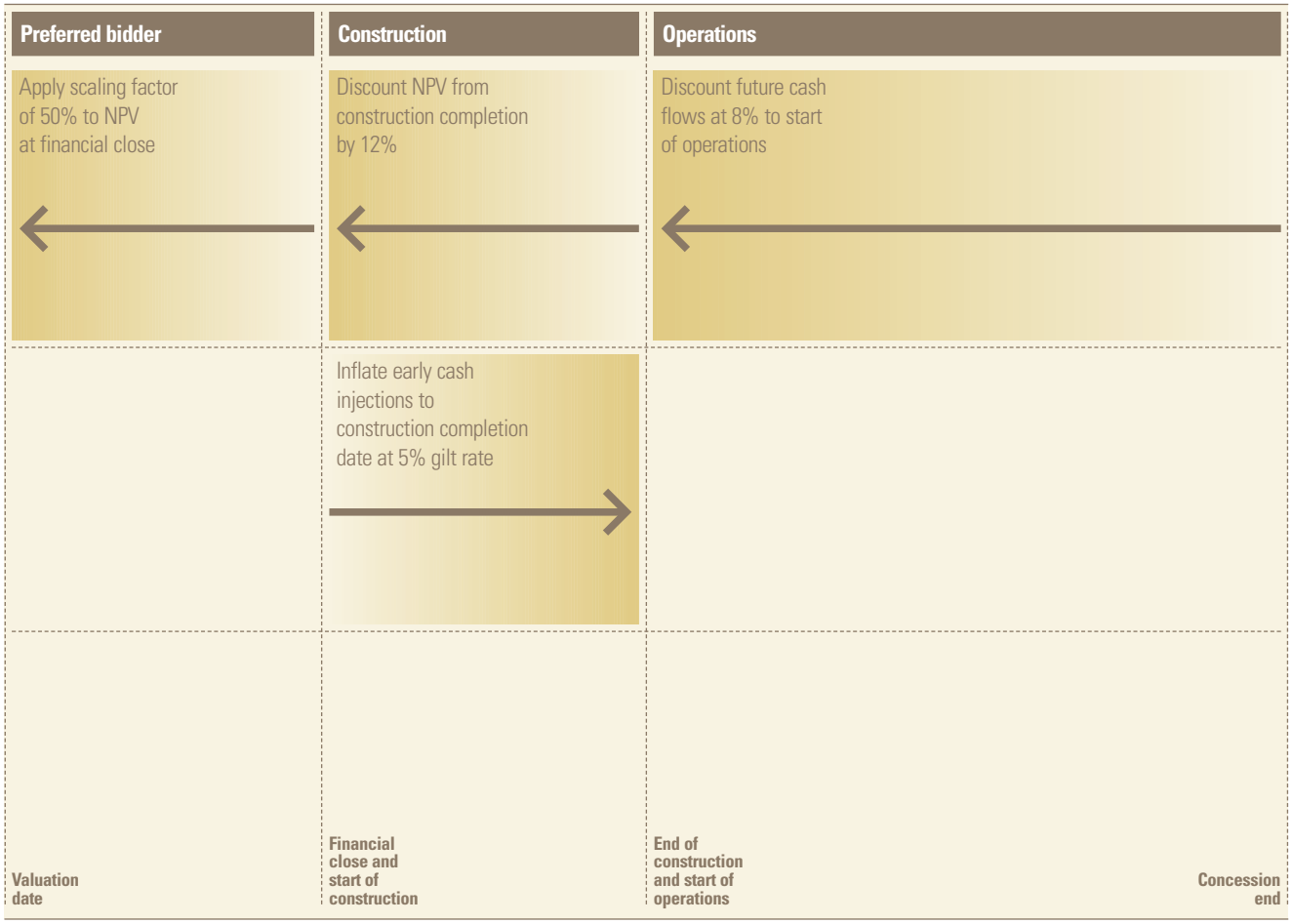
In order to provide a more reliable indicator of value, Balfour Beatty has decided to publish its own valuation benchmark for the Group's PPP investments, based largely on discounting expected future cash flows but without taking into account potential refinancing gains.

2006 valuation

At 31 December 2006, the Directors' valuation of Balfour Beatty's portfolio stood at £341m, at a weighted average, post-tax nominal discount rate of 8.1%; compared with £289m at the end of 2005 (8.2%). The movement in value arises both through shareholder cash inflows and outflows and through underlying growth in the portfolio arising from the unwinding of the discount from year to year. A 1% change in the discount rate impacts value by approximately £35m.

The valuation method

The valuation does not set out to estimate the market value of the investments in the portfolio, but rather, through the application of a consistent methodology, illustrates movements in underlying values between periods and highlights the impact of intervening transactions. The valuation covers 20 concessions that have reached financial close and five at preferred bidder stage. One of two methods has been used to establish the value of individual concessions.



DCF

The principal method used to value the portfolio is discounted cash flow (DCF). This is applied to the future forecast cash flows to which Balfour Beatty as a shareholder and a holder of subordinated debt is entitled in order to create a net present value (NPV). DCF has been used on 22 of the 25 investments. For projects which have reached financial close, forecast future cash flows are extracted from detailed financial models, updated in line with operational experience and lenders' requirements. For projects at preferred bidder stage, the current financial model has been used.

The DCF methodology discounts forecast cash flows at differing discount rates depending on the project phase, and therefore the risk associated with the cash flows.

- Any investment cash flows occurring during the construction period are rolled forward at a risk free rate (5%) to the final injection of equity at construction completion.
- Cash flows anticipated to occur during the operations period are discounted back to the beginning of the operations phase at 8%.
- A net present value is calculated at the end of the construction period by deducting the investment cash flows that occur at this time from the value of the discounted cash flows at the beginning of operations.
- The net present value at the end of the construction period is then discounted back to financial close at 12%.
- Any projects at preferred bidder have a scaling factor of 50% applied to the NPV at financial close.

A diagrammatic illustration of the process is shown above.

Book value

For the other three concessions, the current carrying value in the accounts (book value) has been used. Metronet is at too early a stage in its 30-year concessions to forecast cash flows with the same degree of certainty as the majority of the Group's concessions. In the case of Powerlink, discussions are currently in hand with London Underground over restructuring the concession framework.

Assurance

The calculations underpinning the valuation have been independently checked to ensure that the valuation has been accurately carried out in accordance with the specified methodology. However, the detailed financial models have not been audited.