

**NORTHUMBRIAN WATER LIMITED**  
**FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED 31 MARCH 2008**

Registered no: 2366703

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# **FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2008**

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## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW**

### **For the year ended 31 March 2008**

The directors present their annual report and operating and financial review and the audited financial statements for the year ended 31 March 2008.

#### **Principal activities**

The principal activities of the business comprise the supply of potable water in both the northern and southern regions, and the collection, treatment and disposal of sewage and sewage sludge throughout the north east of England.

#### **Directors**

The directors who served during the year were as follows:

Sir D Wanless	Non-Executive Chairman
J A Cuthbert	Executive Managing Director
C M Green	Executive Finance Director
G Neave	Executive Operations Director
A C Jones	Executive Regulation and Scientific Services Director
A G Balls	Independent Non-Executive Director
A M Frew	Independent Non-Executive Director
A J Scott-Barrett	Non-Executive Director
Dr S Lyster	Independent Non-Executive Director
Sir A P Brown	Non-Executive Director
M A B Nègre	Non-Executive Director
J M Williams	Non-Executive Director
C R Lamoureux	Non-Executive Director

#### **BUSINESS OVERVIEW**

##### **Operating Environment**

Northumbrian Water Limited (NWL) is one of the ten regulated water and sewerage businesses in England and Wales, operating in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water. The company's ultimate parent company is Northumbrian Water Group plc (NWG or the Group), a company listed on the UK Stock Exchange.

In the north east the business comprises the supply of both potable and raw water and the collection, treatment and disposal of sewage and sewage sludge to 2.6 million people. This is a region of modest economic growth. There is a declining industrial customer base and consequently, a reducing industrial demand for water, but a growing demand from domestic customers. NWL, with resources such as Kielder Water, has sufficient water to meet anticipated demand and, compared to the rest of England and Wales, benefits from above average rainfall in the region. In addition to its sewerage services, NWL continues to provide expert industrial effluent treatment services through its major treatment works at Bran Sands on Teesside.

In the south the business supplies potable water to 1.8 million people. The southern operating area is in a region that is continuing to experience economic and population growth although it, too, has seen a reduction in demand from heavy industry. NWL has been implementing long term plans to maintain the availability of water supplies to meet additional demand in a region where water resources are already constrained.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Regulatory Environment**

As a monopoly supplier of an essential public service, the UK water industry operates within a demanding regulatory environment.

The Water Services Regulation Authority (Ofwat) regulates prices and levels of customer service, while the Drinking Water Inspectorate (DWI) monitors drinking water quality and the Environment Agency (EA) covers environmental protection. Customers' interests are represented by the Consumer Council for Water (CCWater).

NWL aims to maintain good working relationships with its regulators and with regional organisations, such as local authorities, which can influence the company's business and have an interest in the services it provides. NWL is an active member of Water UK, the industry association which represents all UK water and waste water service suppliers at national and European level. It provides a very effective framework for the industry to engage with Government, regulators, stakeholder organisations and the public and helps to develop policy and improve understanding of the industry. Representatives of the company also meet regularly with national, regional and local authorities and other appropriate organisations to explain NWL's activities and related issues.

### **BUSINESS STRATEGY AND OBJECTIVES**

The NWG mission is to be the national leader in the provision of sustainable water and waste water services, and this is shared by NWL. The company aims to be a leading performer in the industry and all operations are geared to delivering efficient and effective outputs.

In order to deliver this the company focuses on three priorities:

to maintain a strong reputation and relationships by:

- delivering excellent service to customers;
- delivering regulatory outputs;
- creating shareholder value; and
- involving the main stakeholder groups.

to ensure a stable financial profile by:

- maximising revenue;
- delivering operational efficiency; and
- securing low cost long term funds.

to develop a culture of continuous improvement by:

- ensuring a focus on safety and rigorous risk management;
- encouraging employees to fulfil their potential;
- promoting a flexible and proactive attitude; and
- embracing a sustainable and responsible approach.

### **A clear framework**

NWL has identified five key strategic themes: People, Customer, Competitiveness and Environment are important individually and also contribute to the fifth theme, Reputation. These themes drive performance and delivery of the corporate objectives. The themes are mutually supportive and achieving the right balance between them is an essential part of the company's success.

**People** Our people are the key to business success.

**Customer** Our overriding objective is to meet the needs of our customers.

## DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

<b>Competitiveness</b>	To grow our business and meet the challenges of a developing market we need to be competitive.
<b>Environment</b>	Our business is founded on water and environmental engineering and a great deal of what we do influences the environment. We recognise the impact we have on the environment and also on economic and social factors. We will seek to deliver sustainable outputs from our activities.
<b>Reputation</b>	Our ability to develop our business will be influenced by our reputation. A good reputation is often the starting point for good stakeholder relationships on which business growth can be achieved.

By staying focused, motivated and innovative we are confident we will be able to supply our customers with an excellent service at the right price and, by satisfying our customers, we provide a platform on which we will build, expand and develop our business.



NWL's corporate objectives are:

- to deliver industry leading customer service;
- to be the most efficient water company;
- to be recognised as a great company to work for;
- to be the company of choice for investors; and
- to protect and enhance the natural environment.

The company prepares a detailed medium term business plan and annual budget, which is reviewed and submitted to the Board for approval. Targets are set to measure performance and regular financial forecasts are made. Business plans and budgets include an assessment of the key risks and success factors facing each business unit. Measurement of success against the objectives focuses on key performance indicators (KPIs) which are linked to regulatory and business targets. Performance against the most significant KPIs is monitored by the NWL management team and is reported below.

## DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

### FINANCIAL PERFORMANCE

#### Key Performance Indicators

The definition, purpose and source of each KPI are shown on page 20.

KPI	Target	Performance	
		Current year	Previous year
Gearing to RCV – NWL group (note 11)	<70%	64%	65%
Gearing to RCV – Appointed business only	<65%	58%	57%
Cash interest cover	>3.0x	3.9x	3.6x
Cash flow to net debt	>13%	17%	16%

All financial KPIs remained better than the target for the year. The increase in cash interest cover for the year reflects the positive cash effects of the index linked bond issuance since September 2005.

The company's profit and loss account and balance sheet are set out on pages 22 to 23. The financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. The key accounting policies are summarised in note 1 to the statutory accounts on pages 24 to 27 and these have been applied consistently throughout the current and preceding periods, other than a change in the basis on which the company accounts for pension costs under Financial Reporting Standard (FRS) 17. In previous years NWL adopted the multi-employer exemption within FRS 17 and reported costs on a defined contribution basis. However, the transfer of staff from Analytical & Environmental Services Limited (AES) into the scientific services division within NWL has enabled the company to report costs on a defined benefit basis under FRS 17. Details are provided in note 26 on pages 43 to 46.

Profit after tax for the year was £125.3m (2007: £126.4m).

Turnover increased from £581.2m in 2006/07 to £622.4m for the year to 31 March 2008. This increase is mainly due to the application of new regulatory pricing which resulted in an average price increase to tariff income of 6.7% in April 2007. The K factor allowed for 2007/08 in the 2004 final determination (FD) was 3.2%, however, NWL chose to abate an element of K on the sewerage service and only implemented a K factor of 2.8%. The RPI applicable to tariff basket income in the year was 3.9%.

Operating costs, excluding capital maintenance costs, have increased from £246.6m to £250.8m, principally reflecting the impact of inflation on operating costs although these have been partially offset by reduced energy costs and other efficiencies. Operating costs for the appointed business in 2007/08 are £1.4m lower than those estimated in the FD for the year. Operating costs continue to be dominated by energy prices and, in particular, by the volatility in prices seen over recent years. Energy prices for 2007/08 fell back from the previous year to levels close to those assumed by Ofwat when setting prices. However, there has subsequently been a dramatic increase in energy prices, almost doubling from the low point of February 2007. This will add more than £8.0m to NWL's operating costs in 2008/09, despite continuous efforts to minimise energy usage.

Capital maintenance costs have increased from £95.7m to £118.5m, reflecting additional depreciation charges arising from the commissioning of new assets and a step change in infrastructure depreciation to reflect increased long term maintenance investment. The company is currently updating its long-term investment plans as part of the periodic review process (PR09) and has identified a significant increase in projected investment in infrastructure maintenance over the period to March 2020. This increase has been reflected in the assessment of infrastructure depreciation in the current year.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Key Performance Indicators (continued)**

Net interest payable decreased by £6.1m from £82.0m to £75.9m. However this includes a net credit of £13.2m (note 4) in respect of accounting for the company's defined benefit pension scheme under FRS 17. This is a non-cash item for the company, the £48.4m credit representing the expected return on pension scheme assets and the £35.2m charge representing the interest cost of pension scheme liabilities. The true interest charge has increased by £7.1m reflecting the increase in net debt of £102.0m required to fund the capital investment programme. The indexation element of index-linked loans has increased significantly reflecting higher inflation rates and a full year of indexation on the £200.0m index-linked loans borrowed during 2006/07. Interest payable on external loans has increased due to the £100.0m European Investment Bank loan drawn in March 2007.

In March 2008, NWL entered into a new £28.6m long term finance lease for relined infrastructure assets. The lease is at variable rates linked to RPI and has a final maturity of March 2043. In May 2008, the European Investment Bank (EIB) agreed an additional £120.0m facility with NWL. This offers NWL attractive funding and will be drawn before May 2009.

During 2007/08, significant improvements were completed to water treatment works at Honeyhill, Lartington and Warkworth in the north east whilst at Layer, in Essex, good progress was made on a project that will increase the reliable output by 20%, to 145 MI/d. Construction of a new 16km trunk main to serve customers in Newcastle is almost finished which will enable 155km of trunk mains supplying South Northumberland and Newcastle to be cleaned over the next few years. Rehabilitation of 373km of water mains was completed during the year.

In respect of water resources, the plan to increase the capacity of the Abberton reservoir, near Colchester in Essex, by around 60% reached a key milestone in December 2007 when applications were submitted for planning permission for the reservoir and two large pipelines. The applications are the culmination of extensive work with environmental scientists, lawyers and planners to produce the environmental statement and supporting documentation. The enhanced transfer facilities and the enlarged reservoir will secure water supplies for customers in one of the driest areas in the United Kingdom.

In the waste water business, investment to reduce the risk of sewer flooding was increased with the completion of 18 schemes to alleviate flooding risk for 156 properties. During the year, 86 unsatisfactory sewerage overflows were improved which will improve local water courses, enhance their visual appearance and reduce pollution incidents.

The directors recommend a final ordinary dividend amounting to £41.0m (2007: £38.8m) which, together with the interim dividend of £40.8m (2007: £38.7m), makes a total for the year of £81.8m (2007: £77.5m). This continues the stated dividend policy for the appointed business of 1.9% real annual growth (see note 9 to the statutory accounts).

## DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

### OPERATIONAL PERFORMANCE

#### Key Performance Indicators

In addition to the financial indicators shown on page 4, NWL also uses non-financial indicators throughout the business. Performance against these indicators is reviewed by the management team each month. The definition, purpose and source of the main KPIs are shown on pages 20 and 21.

North (N) South (S)		Target 2008/09	Target 2007/08	Performance Current year Previous year	
<b>Customer satisfaction</b>					
	N/S	90	Maintain	89	92
	N/S	85	Maintain	83	87
<b>Customer – levels of service</b>					
Properties at risk of low pressure	N	274	274	181	298
	S	126	126	60	130
Properties subject to unplanned interruption of 6 hours or more	N	3,000	3,000	3,318	20,389 <sup>1</sup>
	S	2,000	2,000	3,405	3,967
Properties subject to hosepipe bans at any time during the year	N/S	0	0	0	0
Properties subject to sewer flooding incidents (other causes)	N	150	150	290	183
Properties at risk of sewer flooding incidents (once in ten years)	N	183	78	125	116
Properties at risk of sewer flooding incidents (twice in ten years)	N	331	51	329	229
Billing contacts responded to (within five working days) (%)	N	99.2	99.0	99.3	99.3
	S	99.2	99.0	99.6	99.2
Written complaints responded to (within ten working days) (%)	N	99.8	99.8	99.9	99.9
	S	99.8	99.8	99.7	99.9
Bills based on meter readings (%)	N	99.95	99.95	99.80	99.84
	S	99.95	99.95	99.96	99.94
All telephone lines busy (%)	N	0.25	0.25	0.03	0.20
	S	0.25	0.25	0	0
Abandoned telephone calls (%)	N	2.5	2.5	2.8	3.2
	S	2.5	2.5	3.3	2.3
<b>Water</b>					
Water quality (%)	N/S	>99.9	Maintain >99.9	99.9	99.9
Leakage (Ml/d)	N	≤153.0	≤154.5	135.93	145.94
(Ml/d)	S	≤67.3	≤67.9	68.26	67.99
<b>Environment</b>					
Sewage treatment works (%)	N	100	100	98.4	99.8
Bathing waters Mandatory Standard (%)	N	100	100	100	100
Pollution incidents	N	96	116	119	142
<b>Employees</b>					
Employee turnover (rolling %) <sup>2</sup>	N/S	-	Industry average 10.3	7.4	8.2
Lost time reportable accidents (per 1,000 employees)	N/S	5	6	6	8
Sickness absence (%)	N/S	2.85	2.95	3.25	3.01

1. Performance affected by two major bursts, one in Middlesbrough on Teesside and one in Bedlington in Northumberland.
2. No target set, data for information



## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Key Performance Indicators (continued)**

NWL carries out regular quarterly tracking surveys and during the year customer satisfaction levels remained very high, with 89% of customers satisfied or very satisfied with the service NWL provides and 83% feeling it provides value for money. NWL is committed to providing a high standard of customer service that meets the expectations of both customers and regulators and maintained its high levels of customer service in the year.

The quality of the drinking water supplied by NWL remained excellent in 2007/08 and the leakage targets agreed with Ofwat have been met. On waste water compliance, the company again achieved 100% compliance on the EU Mandatory Standard for bathing waters and continued the improvement trend in pollution incidents that has been recorded for the last four years.

Employee turnover and sickness absence remain below the industry average and lost time reportable accidents improved on the previous best performance at six per 1,000 employees.

### **FUTURE DEVELOPMENTS**

#### **Looking to the future**

NWL consulted key stakeholders before publishing 'Looking to the future', its long term operational strategy for the next 25 years. Two versions were published, one for each operational area, and they have been well received by a range of stakeholders.

The strategy set out NWL's long term aims as well as intermediate targets for the period to 2015 for the key areas of:

- customer satisfaction;
- water quality;
- availability of water;
- waste water services;
- sustainability, the environment and climate change;
- finance; and
- employees.

The strategy builds on the achievements of the past 20 years and re-affirms NWL's commitment to long term planning and investment to deliver value to all of its stakeholders.

The company identified three key challenges for the future:

- maintaining and, where appropriate, improving services whilst keeping bills affordable;
- maintaining healthy and stable finances to ensure that NWL can continue to borrow money to meet the investment needed in the business; and
- dealing with climate change. The company needs to further reduce greenhouse gas emissions and also future-proof its operations against a changing climate.

The full versions of 'Looking to the future' are available on the company's websites at [www.nwl.co.uk](http://www.nwl.co.uk) and [www.eswater.co.uk](http://www.eswater.co.uk).

#### **Putting customers first**

NWL has only increased prices by inflation for 2008/09 and has not used the 1% real increase that Ofwat's price limits allow. This is the second consecutive year in which NWL has not implemented the maximum price increase.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Putting customers first (continued)**

The company has already stated that it does not intend to use the increase allowed by Ofwat in 2009/10 and average bills will, again, only rise by inflation. By 2010, it is expected that the combined water and sewerage bill in the north east will be the lowest in the country and, in the Essex and Suffolk region, water bills will compare favourably with other local suppliers.

NWL will submit its draft business plan covering the period from April 2010 to March 2015 to Ofwat in August 2008 and this will set out the short term actions to deliver the 25 year strategy published in 'Looking to the future'. The significant investment programme will continue to deliver high levels of service to customers and value to stakeholders. However, there will be a significant switch from achieving new quality standards to maintaining the high standards already achieved. The company will also be working to tackle the challenges posed by climate change and to improve the resilience of its assets. NWL believes that it is well placed to deliver these objectives and aims to keep prices low without compromising its ability to deliver safe and secure water supplies and its commitment to protect the environment.

### **RISKS & UNCERTAINTIES**

#### **Financial risks**

The principal financial risks, including energy prices, have been described in the section headed Financial Performance. The management of financial risks relating to liquidity and treasury policies are covered below under Capital Structure.

#### **Non-financial risks**

The company identifies and assesses the impact of risks to the business under five headings; environment, external, operations, finance and reputation. For each risk the likelihood and consequences are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed. The management team reviews the approach to risk management in detail every year and the Audit Committee considers the outcome of this review. The management team also reviews the significant risks every month and summary reports on these reviews are submitted to the NWL board.

The principal non-financial risks identified are summarised below.

#### Regulatory risk

In February 2008, the Government announced a study (the 'Cave review') into the scope for innovation and competition in water services and, in May, Ofwat published the second part of its own competition review. The latter is intended to inform the Cave review and effectively forms Ofwat's view of the legislative action which may be required to introduce competition to the sector. Government is proposing to introduce a Water Bill in the next parliamentary session which will propose various measures to tidy up water related legislation but may also include reference to introducing measures in response to the Cave review. This may result in enabling legislation that provides Ministers with powers to pass secondary legislation to enact recommendations from the review. However, a Water Act is unlikely to materialise for at least two years.

#### Environmental, social and governance risks

There are two principal environmental, social or governance risks considered to be significant to the value of the company.

The first relates to the use of sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, the sector would need to find or develop alternative ways to re-use or dispose of its sewage sludge. This could mean higher capital and revenue costs to provide additional sludge processing facilities. The development of the 'Safe Sludge Matrix' and the proposed revision of the Sludge (Use in Agriculture) Regulations have

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Non-financial risks (continued)**

#### Environmental, social and governance risks (continued)

reduced the immediate risk in this area. NWL is introducing advanced digestion to both reduce sludge volumes and the carbon impact of its activities. NWL will retain a facility to dry sludge and produce pellets as a fuel replacement, as a viable alternative way of using sludge in the medium term.

The second is the potential for sewer flooding. As rainfall patterns become more variable and intense storms more frequent, localised heavy rainfall can result in sewers becoming overloaded. NWL welcomes the focus on integrated flood management in Defra's strategic document 'Future Water' and in the 'Pitt Review' on recent flooding.

New and proposed legislation that will have a significant impact on the business includes:

- the Traffic Management Act, which was implemented in April 2008; and
- the transfer of private drains and sewers, which will increase the network owned and maintained by NWL by about 60%.

#### Affordability and customer debt

Although NWL's average household bills are relatively low, affordability is an issue for the company with income deprivation levels in the northern area the highest of all water and sewerage companies and, in the southern area, close to the national average.

Providing customers with a range of payment facilities and frequencies that suit their individual circumstances is a critical element of successful income collection and debt prevention. The company ensures that customers are aware of options which help reduce charges and ease the establishment of payment arrangements.

Customers who deliberately avoid paying charges are actively pursued and the company continues to work with Ofwat and Defra to seek changes to legislation to assist the industry to impose and collect charges.

#### Water resources

The way that water resources are retained, recycled and distributed is a central part of the business. Whilst NWL has sufficient water resources in the north east, it is still important to manage the demand for water so that it does not exceed levels that can be supplied in a sustainable way.

In the Essex and Suffolk area, however, water resource availability is a key issue. Although NWL did not have to impose a hosepipe ban during the drought of 2006, it needs to continue to invest to achieve its aim of ensuring that customers have access to the water they need. In spring 2008, the company published its draft 'Water Resources Management Plan' and this is now out for consultation.

In December, NWL submitted applications for planning permission for the Abberton scheme which will increase the capacity of the Abberton reservoir by around 60%. Once this is in operation in 2014, the company predicts that it will not need to develop major resources, such as reservoirs, in the next 25 years.

NWL will continue to lead the industry on water efficiency measures and to encourage customers to use water wisely. The company will work with other stakeholders to develop a co-ordinated strategy for reducing water use to sustainable levels.

In areas where water is scarce, water meters have a key role to play in reducing demand. NWL aims to achieve as near to universal metering as possible in Essex by 2020 and in Suffolk by around 2023. On current policies it will take considerably longer to achieve full metering in the north east and there is no economic, environmental or social driver to move more quickly.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Non-financial risks (continued)**

#### Changing weather patterns

The water cycle and the changing British weather has a direct influence on the provision of water and waste water services. NWL's employees are experienced in managing the effects of too much or too little rainfall, but changing weather patterns will remain a challenge for the business.

The water industry is a major user of energy in its processes. The company has carried out research into the impact of climate change on all of its assets and water resources and this has been incorporated in the 'Climate Change Policy' as part of its corporate responsibility work. The company will continue to explain to customers that energy is also being wasted when water is being wasted.

#### Employees

People are NWL's key asset and if the company is to continue to meet the needs of its customers, and to achieve its regulatory obligations, it needs to continue to recruit and retain talented and skilled people as a leading employer in its regions. NWL will continue to offer all employees terms and conditions at least commensurate with other major employers as well as appropriate training and development to support their career development. This will include comprehensive management, graduate and apprentice programmes, as well as initiatives such as NVQ programmes which reach many employees.

## **CAPITAL STRUCTURE**

### **Cash flows and liquidity**

The level of capital expenditure that the company is obliged to incur is such that it cannot be wholly financed by internally generated sources. As a result, the company must rely upon raising additional finance on a regular basis, to be principally used to fund the long term assets required in its regulated business. The strategy of the company is to finance such investment by raising medium to long term debt, providing a balance sheet match with long term assets, and to fix a major proportion of interest rates.

### **Credit rating**

The credit rating for NWL has remained consistent throughout the year at BBB+ stable (Fitch and Standard & Poors) and Baa1 stable (Moody's).

### **Treasury policies**

The company's Board is responsible for the financing strategy of the company which is determined within treasury policies set by the company's ultimate parent company, NWG. The aim of this strategy is to assess the ongoing capital requirement and to raise funding on a timely basis, taking advantage of any favourable market opportunities. The Treasury department of NWG carries out treasury operations on behalf of the company. Surplus funds are invested based upon forecast requirements, in accordance with the treasury policy. On occasion, derivatives are used as part of this process but the treasury policies prohibit their use for speculation.

### **Risks arising from the company's financial instruments**

The main risks arising from the company's financial instruments are liquidity risk and interest rate risk. As noted above, the company's financing strategy is developed in accordance with the treasury policies of NWG, whose board reviews and agrees policies for managing each of these risks. These are summarised below. The treasury activities of the company are conducted in accordance with these policies.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Liquidity risk**

As regards day to day liquidity, the company is responsible for cash management and has sufficient committed facilities to cover 3 years forecast cash outflow. The Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0m and with a bank agreement availability period of no less than 3 months. At 31 March 2008, NWL had £75.0m (2007: £75.0m) available in standby committed bank facilities.

### **Interest rate risk**

The company finances its operations through a mixture of retained profits and borrowings. It borrows at both fixed and floating rates of interest and, as noted above, on occasion uses derivatives to generate the desired interest profile and to manage its exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2008, 63% (2007: 65%) of the borrowings of the Group were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

The current pressures within the financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance (such as index linked bonds) and a significant increase in the cost of corporate debt. It is not clear how long current difficult market conditions will persist. However, as the company has sufficient funding in place to 2011, the effects are minimal.

### **Foreign currency risk**

The Group's policy is that any foreign currency exposure in excess of £100,000 sterling equivalent of a transactional nature, or £3m sterling equivalent of a translation nature, should be covered immediately on recognition. At 31 March 2008, the company had no currency exposures (2007: nil).

### **Market price risk**

The company's exposure to market price risk principally comprises interest rate exposure. The company's policy is to accept a degree of interest rate risk. On the basis of the company's analysis, it is estimated that a 1% rise in interest rates would not have a material affect.

## **CORPORATE RESPONSIBILITY**

### **Corporate responsibility**

NWL is expected to provide a secure supply of water, a basic necessity for health, and to protect or enhance the environment when returning waste to it. However, stakeholders also expect the company to:

- behave fairly and responsibly;
- use resources wisely;
- improve quality of life; and
- contribute to economic development.

The company takes its corporate responsibilities seriously, aiming to balance social and environmental priorities. This approach underpins all of the company's activities and is integral to the way that the company does business. The company has developed its own model to focus on corporate responsibility as an essential part of normal business practice in NWL. This model is published on the company's websites with links to policies, action plans, key performance indicators and case studies for 25 key areas of the business.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Corporate responsibility (continued)**

The Corporate Responsibility Committee (CRC) is a subcommittee of the NWL board and comprises non-executive directors, management team members and senior managers from the business. The CRC is responsible for policy review and agreeing and monitoring the targets and activities for the corporate responsibility themes. Specialist working groups are responsible for investigating, advising on and driving change on specific projects. The Managing Director is directly accountable to the NWL and NWG Boards for both the environment and sustainable development policies.

NWG was again ranked as one of the top 100 'Companies for corporate responsibility' based on an assessment of the widely recognised Business in the Community (BITC) indices. It was ranked as a 'Platinum' company, which is the top rank, as well as being rated as the leading company in the sector. NWG was also one of only eight companies that received the BITC 'Big Tick' for its impact on society. These indices enable the company to measure, manage and report its responsible business practice underpinned by a rigorous external review process.

#### Environment policy

The company is committed to preventing pollution, minimising its adverse environmental impacts, in the context of its activities as a water supply and sewerage undertaker, and promoting positive environmental outcomes. This is demonstrated through research to promote and deliver innovative solutions, together with a continuing commitment to improve its environmental performance across all its activities. This includes asset design, construction, operation and disposal, focusing specifically on air and climate systems, the water environment, resource and raw material use, waste, conservation of biodiversity and heritage and local communities.

#### Sustainable development policy

The sustainable development policy seeks to ensure that the company's business management systems and decision-making processes take account of environmental, social and economic issues. These include operating in an ethical manner, maintaining compliance with relevant legislation, regulations and requirements and continuously improving our performance in a cost-effective manner. Details of supporting policies covering operations, business partners, the natural environment, employees and innovation are available on the company's websites.

#### Environmental partnerships

The company has developed key partnerships to help the conservation of biodiversity on its sites. NWL's contribution to the partnerships includes funding of project officers. Current partnerships include Northumberland Wildlife Trust, Durham Wildlife Trust, Essex Wildlife Trust, the Broads Authority and the Davy Down Trust.

### **Climate change**

Over the last five years the company has reduced the amount of energy it uses by almost eight per cent by improving operations throughout the business, for example, by introducing anaerobic processes at Bran Sands, and by encouraging customers to use water resources wisely.

NWL has been working with independent experts and has carried out detailed assessments to identify and understand the impact climate change will have on the business. The UK Climate Impacts Programme will publish its climate change scenarios in November 2008 and the company will revisit its assessment in the light of the new science that emerges. However, the water industry is one of the largest users of energy in the UK and NWL has been working hard to reduce its carbon footprint as part of its normal business. Detailed below are some activities which reduce NWL's impact on climate change:

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Climate change (continued)**

- A new work management system will not only improve customer service and introduce a more efficient way of working but will also reduce mileage significantly in the vehicle fleet.
- Reducing tertiary UV disinfection outside of the bathing water season at five major works will reduce energy consumption and carbon emissions with no detrimental effect on the marine environment.
- Developing and implementing a sludge strategy to introduce an anaerobic digestion process will help power the plant at three smaller sites initially, and two larger sites over the next seven years and will increase total renewable energy to over 20%.
- Generation of renewable energy with hydroelectric plants at four reservoirs and biogas combined heat and power at three sewage treatment works. New opportunities are continually sought and reviewed.
- Funding grip blocking on blanket bog in the North Pennines Area of Outstanding Natural Beauty will enable the wet peat to work effectively and lock in carbon.
- The company's 'Water is precious' campaign encourages customers to use water wisely and to recognise that if they waste water, they also waste energy. A water carbon footprint calculator is now available for customers on our websites to encourage this link.

### **Social and Community Issues**

The company has a continuing commitment to support projects and organisations within the geographic areas in which it operates and to contribute to the long term sustainability not only of the business, but also of the environment, society and communities served. Corporate responsibility is integral to how the company does business and as part of this commitment it is looking at different ways to work within the community to promote lasting change on key issues.

#### Community support

Currently 23% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 5,431 hours to the community. The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments totalling £49,890 for nominated charities: Great North Air Ambulance Service, Mencap's Dilston College, RNLI, St Teresa's Hospice and East Anglia's Children's Hospices.

#### Education

In July 2007, the company launched the 'Northumbrian Water GLOBE' programme in a unique venture which links up with the international GLOBE programme, an environmental education initiative set up by Al Gore in 1996. As part of this, NWL donated 85 fully automated weather stations to schools throughout the northern region to collect weather data in areas where Meteorological Office coverage is poor. This data will help NWL and external scientists understand the impact of climate change and will be a valuable curriculum tool.

The 'Northumbrian Water Schools Awards', now in their second year in the northern region, are designed to recognise and celebrate the achievements being made by schools. They cover both community and curriculum based projects and honour whole schools, classes and individuals. In the southern operating area the company supports 'Cash for Schools' which recognises excellence, with a focus on environmental projects from primary and secondary schools.

Building began in March at the site of the Castle View Enterprise Academy where the company is the lead sponsor for the development of the Academy. Sunderland City Council is pioneering its own model for academies as part of its wider Building Schools for the Future programme. An Education Leadership Board, chaired by Baroness Estelle Morris, has also been set up to oversee the development of education in Sunderland and sponsors will be involved with this. The Department for Education and Skills has approved the outline business case for the Academy. The consultation and design process to meet the vision of the new Academy is underway and is planned to be ready in autumn 2009.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Social and Community Issues (continued)**

#### Water for health

NWL is at the forefront in the water industry in communicating the health benefits of drinking tap water. Over £225,000 has been provided to date for water coolers in schools and over 500 have been supplied in over 300 schools. The trials, and associated research, with water coolers in a day centre and care home for older people, as well as two prisons, have continued. NWL also assisted Water UK and Unison in the national launch of 'Water@Work' which encourages employers to ensure that employees have adequate access to drinking water.

#### Sustainable communities

The company is working with partners to create models of sustainable change and also methods of evaluating their success, which can be replicated in other communities. The focus has been on health, education, economy and affordable housing as well as creating new ways to support areas helped by NWL's chosen charity WaterAid.

#### Community Foundations

Endowment funds contributed by NWL over the last sixteen years, totalling nearly £1.0m, are held with Community Foundations covering the company's areas of supply. These are long term investments with the income from the funds used to support community initiatives.

#### Health

Healthworks opened in November 2007 in Easington Colliery after NWL reached an agreement with County Durham Primary Care Trust (PCT) to provide a 99 year lease on a redundant building. NWL is working in partnership with the PCT, the District of Easington Council, the Neighbourhood Management Pathfinder and other stakeholders to develop services for the local community in an area where census records show one of the worst health records in the country.

#### Affordable housing

The nature of the business means that it owns areas of land, often in rural areas with low commercial or development value. Where land can be developed, without affecting the core activity of maintaining and delivering a clean, safe water supply, then priority will be given to providing affordable rural housing. NWL has supported HRH The Prince of Wales' Affordable Rural Housing Initiative since it was launched in 2003 and is leading the industry in this initiative.

#### WaterAid

NWL continued to raise funds and awareness for the work of WaterAid which brings sustainable water and sanitation solutions as well as hygiene education to the poorest parts of Africa and Asia. The company's fundraising committee have raised £2.5m since 1997, with the help of the company, and last year focused its fundraising support on specific projects in Malawi and India.

#### Charitable donations

During the year, the company made charitable donations of £134,702 (2007: £128,505).

## **RELATIONSHIPS**

### **Employees and Employment Policies**

NWL's key asset is its employees and one of its strengths is employee loyalty; employee turnover is relatively low at 7.4%, well below the UK water industry average of 10.3%. NWL continues to seek the views of employees and this year's survey was completed by 45% who gave their views on their working life, training, communications, managers and the company. The results were reported back to all employees and discussed with representative bodies. Overall, employee satisfaction levels remain very high with over 75% of respondents stating that they are proud to work for the company.



## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Employees and Employment Policies (continued)**

The key employment policies in operation are outlined below.

#### Equal Opportunities

The company operates an equal opportunity policy, incorporated into NWG's Code of Conduct. The company promotes equality of opportunity in recruitment, employment continuity, training and career development. The policy is designed to ensure that no applicant or employee receives less favourable treatment on the grounds of age, gender, disability, race, religion or sexual orientation.

The company gives full consideration to applications for employment from disabled people where the requirements of the job are appropriate or can be suitably adapted. Where existing employees become disabled, it is the company's policy, wherever practicable, to provide continuing employment under normal terms and conditions and to provide training and career development and promotion to disabled employees.

#### Consultation

The company engages with its employees through formal consultation processes. These ensure that all employees understand and have an opportunity to discuss issues which affect the company. The company has recently adopted a new, more representative, employee relations framework.

#### Training and Development

The company trains and develops its employees to benefit both the company and the individual. Annual appraisals are given high priority, as is the identification of training needs, in recognition of the importance of training and development in achieving the company's goals and policies.

NWL introduced an extensive People Plan in 2007 in which it sets out a five year programme to support and develop employees. It is committed to the continuous development of occupational skills and has signed the Government's 'Skills Pledge', stating that it will ensure that 90% of employees will be qualified to the National Vocational Framework Level 2 by 2009 and 95% as soon as possible thereafter.

The company has re-introduced its apprenticeship scheme with 13 apprentices commencing a four year development programme with guaranteed employment for those who successfully complete their training. The company is also recruiting for its Graduate Development Programme to provide potential leaders of the future and continues to implement its Management Development Framework, working in partnership with the Newcastle Business School, to cover training for potential managers through to director level.

#### Communication

The company uses a wide range of communication methods, including team briefing, magazines, newsletters, intranet, noticeboards and regular team meetings. 'Unplugged', the Group magazine, contains articles on activities and news from across the business, focusing on employees and their achievements.

#### Whistleblowing

The company encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be illegal or unethical. During the year, the Audit Committee reviewed and updated its Disclosure Policy in accordance with best practice. The Committee continues to monitor the effectiveness of the policy.

#### Health and Safety

A safe working environment is given a high priority in the business. The health and safety policy is maintained and implemented through the company's health and safety team. The emphasis on the importance of health and safety within NWL has resulted in major improvements to the safety record in recent years. This year, lost time reportable accidents improved on the previous best performance with six per 1,000 employees. This has been accompanied by a further reduction in days lost through accidents. The Group's medical advisor, Grosvenor Health, continues to provide occupational health services.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### Health and Safety (continued)

The company continues to develop programmes to promote healthy eating and discourage smoking in the workforce and offers excellent health screening and medical insurance schemes. Around 1,700 employees have been through the health screening and fitness standards programmes, both of which now include lifestyle advice elements. The company has introduced a new service in partnership with RehabWorks, who specialise in the prevention and management of muscular-skeletal injury, providing support for employees to help them return to fitness more quickly and providing training to show staff how they can avoid these sorts of injuries.

### Employee Share Incentive Plan (SIP)

The directors believe that employee investment strengthens the ties between the company's employees and the Group and more than a third of NWL employees participate in the Group SIP. The scheme provides one free matching share for every three shares purchased by an employee. Shares for the SIP are purchased at market price by the Trustee and dividends are paid in cash directly to participants. There are no performance conditions attached to the SIP, but free shares not held in trust for at least 12 months are forfeited.

## **Customers**

### Domestic customers

NWL's relationship with its customers is vital to the success of its business. The company's reputation for providing value for money and working to maintain high levels of customer satisfaction has undoubtedly helped achieve a positive response to appeals to use water carefully.

NWL keeps its customers informed about its activities through leaflets sent out with bills and also through an annual magazine called 'Source'. Customers also have access to a range of information about services and any supply issues on the company's websites at [www.nwl.co.uk](http://www.nwl.co.uk) and [www.eswater.co.uk](http://www.eswater.co.uk). Customers directly affected by works receive prior notification explaining the need for, and timing of, the work. NWL also communicates with local communities through public meetings and written material when it needs to explain the impact of work due to be carried out.

CCWater has carried out its second annual survey for domestic customers on a number of key themes, including value for money. This year's survey again concluded that, of all water companies' customers, NWL's are the most satisfied with the fairness of charges and value for money.

During the year, NWL carried out specific research for the Periodic Review of prices which identified the 'stated preference' of customers for service improvement as well as willingness to pay for them. This research also confirmed that the level of customer satisfaction is very high and communicated that over 40% of customers do not require any improvements in service. Where customers would like to see improvements, the willingness to pay more to achieve these improvements is limited. These points will be considered when the Draft Business Plan is submitted in August 2008.

### Business customers

The company is actively involved in the business community in its operating areas through direct membership and involvement in the councils/boards of the CBI, Chambers of Commerce and other similar organisations.

NWL has long-standing relationships with its key industrial and commercial customers in the areas in which it serves. The north east, in particular, has a strong industrial base and existing customers and potential investors in the region value the availability of not only high quality potable and raw water but also access to reliable effluent treatment services.

### Leisure customers

NWL is one of the founding members of Kielder Water and Forest Park Development Trust, which will replace the Kielder Partnership, which seeks to promote sustainable development, recreation, access and leisure, education, infrastructure and a range of other charitable purposes at Kielder and in the surrounding area. The Trust is seeking registration as a charity and it will be chaired by NWL's Managing Director.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Quality**

NWL has maintained its certification to the international quality standard ISO 9001:2000 and to the international environmental standard ISO 14001:2004 across all areas of the business, including operational sites and office-based teams.

The company also achieved companywide accreditation to the international occupational health and safety management standard OHSAS 18001 in 2007 – the first water company to do so.

### **Research and development**

The company runs a programme of research and development linked to its operations. This includes the provision of technical solutions for water and waste water management and developing partnerships with academic and research organisations. During the year, the company invested £1.8m (2007: £2.1m) in research and development.

### **Political contributions**

The company does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party or other political organisations. However, the wide definition of donations in the Political Parties, Elections and Referendums Act 2000 (PPERA 2000) covers activities which form part of the necessary relationship between the company and political parties and political organisations. These activities include attending Party Conferences, as these provide the best opportunity to meet a range of stakeholders, both national and local, to explain the company's activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during the year were as follows (2007: £6,092):

<b>Organisation</b>	<b>Donations for the period (£)</b>
Labour	3,710
Liberal Democrat	618
Conservative	1,808
<b>Total</b>	<b>6,136</b>

NWG shareholder authority to permit the Group to continue with these activities until the 2009 AGM will be sought at this year's AGM.

### **Company payment policy**

The company's policy is to agree payment terms with suppliers and to pay on time according to those agreed terms. In the absence of alternative agreement, the policy is to make payment not more than 30 days after receipt of a valid invoice. The ratio, expressed in days, between the amount invoiced by its suppliers during the year and the amount owed to its trade creditors at 31 March 2008 was 18 days (2007: 19 days).

### **Fixed assets**

Freehold land and buildings are carried in the financial statements at historical cost with a net book value of £60.7m (2007: £61.8m). In the opinion of the directors, at 31 March 2008, there is no significant difference between the net book value and market value of property capable of disposal within the foreseeable future. Note 10 gives more details of the fixed asset movements during the year.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Pensions**

The Group operates a defined benefit pension scheme, of which the company is the principal member, providing benefits based on pensionable remuneration. After consultation with employees and the trade unions, NWG closed the final salary scheme to new entrants on 31 December 2007, raised the employee contribution for existing members by 2% in April 2008 and changed the benefit structure. This will reduce the risk associated with the scheme. In addition, on 1 January 2008, a defined contribution scheme was introduced which will be offered to new employees.

Further information about the pension schemes operated by the company is contained in note 26 to the financial statements.

### **Directors' remuneration**

Information about directors' remuneration is contained in note 5 to the financial statements.

### **Indemnification of directors**

The Group has in place directors' and officers' insurance and, on 28 November 2005, entered into a deed of indemnity to grant the directors of the Group and its subsidiaries further protection against liability to third parties, subject to the conditions set out in the Companies Act 1985. Such qualifying third party indemnity provision remains in force at the date of approving the directors' report.

### **Financial statements preparation and going concern**

The directors consider it is appropriate to prepare the financial statements for the financial year on the going concern basis. The directors have arrived at their decision based on consideration of the company's detailed budget for 2008/09 and the business plan for the period to 31 March 2010. Their analysis included a review of the capital expenditure and investment plans, the anticipated funding requirements and facilities available, and the reasonableness of the underlying assumptions of both the budget and the forecast.

### **Directors' declaration**

As required under Section 234ZA of the Companies Act 1985, so far as each director is aware, there is no relevant audit information of which the company's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

### **Auditors**

The company has appointed Ernst & Young LLP as its auditors and has, by elective resolution pursuant to section 386 of the Companies Act 1985, dispensed with the obligation to appoint auditors annually.

### **Statement of Directors' responsibilities**

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and regulations.

## **DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)**

### **Statement of Directors' responsibilities (continued)**

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The financial statements are required by law to give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and, hence, for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

BY ORDER OF THE BOARD

M Parker  
Company Secretary  
14 July 2008

## Appendix to the directors' report and operating and financial review

### DEFINITION OF KEY PERFORMANCE INDICATORS

#### Financial KPIs

##### Gearing to RCV

**Definition and calculation:** The ratio of net debt to Regulatory Capital Value (RCV). The RCV represents the total capital value of the appointed water and sewerage business on which Ofwat allows a rate of return at price reviews based on its view of the cost of capital.

**Purpose:** The RCV generates most of the revenue stream of the company and regulatory gearing is an important factor in credit ratings.

**Source of underlying data:** NWL's RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination.

##### Regulatory gearing

**Definition and calculation:** The ratio of NWL appointed business net debt to RCV. The RCV represents the total capital value of the appointed water and sewerage business on which Ofwat allows a rate of return at price reviews based on its view of the cost of capital.

**Purpose:** The RCV generates most of the revenue stream of the company and regulatory gearing is an important factor in credit ratings.

**Source of underlying data:** NWL's RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Net debt is disclosed in the audited regulatory accounts and Ofwat annual reports on financial performance.

##### Cash interest cover

**Definition and calculation:** Cash generated from operations less tax divided by net interest paid.

**Purpose:** Measures the ability of the company to service its debt.

**Source of underlying data:** Audited financial statements.

##### Cash flow to net debt

**Definition and calculation:** Cash generated from operations less tax paid divided by net debt.

**Purpose:** Indicates the company's ability to reduce debt in the absence of need for additional investment, without resorting to asset disposal.

**Source of underlying data:** Audited financial statements.

#### Non-financial KPIs

##### CUSTOMER

###### Customer satisfaction

**Definition and calculation:** Domestic customers' satisfaction with overall service and overall value for money, expressed as satisfaction averaged over the surveys carried out during the year.

**Purpose:** To enable tracking of perception of reputation, service and value for money over time.

**Source of underlying data:** Independent surveys of 500 customers (300 north, 200 south) chosen at random, but representative of the customer base, carried out each quarter – a total of 2,000 customers p.a.

###### Customer – levels of service

**Definition and calculation:** Customer service standards are established by Ofwat, the economic regulator, and calculated using source data in the company.

**Purpose:** To monitor customer service performance of the company.

**Source of underlying data:** Information collected by the company and submitted to Ofwat. It is independently certified.

## Appendix to the directors' report and operating and financial review

### DEFINITION OF KEY PERFORMANCE INDICATORS

#### WATER

##### Drinking water quality

**Definition and calculation:** Compliance with drinking water regulations as monitored by the Drinking Water Inspectorate (DWI).

**Purpose:** To monitor drinking water quality.

**Source of underlying data:** Samples recorded by NWL and audited by DWI.

##### Leakage

**Definition and calculation:** Total leakage from the water network (including customer pipes).

**Purpose:** To monitor compliance with Ofwat leakage targets.

**Source of underlying data:** Information recorded by NWL and audited by Ofwat.

#### ENVIRONMENT

##### Sewage treatment works

**Definition and calculation:** Percentage of population equivalent served by non-compliant works failing Look Up Tables' consents.

**Purpose:** To monitor the performance of NWL's sewage treatment works and their impact on the environment.

**Source of underlying data:** Information recorded by NWL and the Environment Agency (EA) and reported on by the latter.

##### Bathing waters Mandatory Standard

**Definition and calculation:** Percentage of bathing waters complying with Mandatory Standards.

**Purpose:** To monitor the impact of coastal treatment works on the environment.

**Source of underlying data:** Information recorded and reported by EA.

##### Pollution incidents

**Definition and calculation:** Number of category 1, 2 and 3 pollution incidents in the calendar year as defined by the EA.

**Purpose:** To monitor the performance of the sewerage system and its impact on the environment.

**Source of underlying data:** Information recorded and reported to Ofwat by the EA.

#### EMPLOYEE

##### Lost time reportable accidents

**Definition and calculation:** Injury accidents that are reported to the Health & Safety Executive as required by the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 1995. Calculated as the number of accidents reported in the financial year per 1,000 employees.

**Purpose:** To monitor the safety performance of NWL over time.

**Source of underlying data:** Completed NWL Accident / Incident report forms. Employee numbers provided by the human resources department.

##### Sickness absence

**Definition and calculation:** Sickness absence days as a percentage of total working days multiplied by the end of month headcount.

**Purpose:** To track and trend sickness absence levels across the organisation.

**Source of underlying data:** Sicknotes, return to work interviews and weekly returns by managers.

##### Employee turnover

**Definition and calculation:** Number of leavers within the year as a percentage of average headcount.

**Purpose:** To track the employee turnover within the business to ensure that it is within benchmark data.

**Source of underlying data:** Current employees' details are held within the human resources management system – reports show leavers against headcount.

**PROFIT AND LOSS ACCOUNT**  
**for the year ended 31 March 2008**

	Note	<u>2008</u>	<u>2007</u>
		£'m	£'m
Turnover	2	622.4	581.2
Operating costs	3(a)	(250.8)	(246.6)
Capital maintenance costs	3(b)	<u>(118.5)</u>	<u>(95.7)</u>
Total operating costs		<u>(369.3)</u>	<u>(342.3)</u>
<b>OPERATING PROFIT</b>		253.1	238.9
Net interest payable	4	<u>(75.9)</u>	<u>(82.0)</u>
<b>PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION</b>	3(c)	177.2	156.9
Taxation	8(a)	<u>(51.9)</u>	<u>(30.5)</u>
<b>PROFIT FOR THE FINANCIAL YEAR</b>	24	<u><u>125.3</u></u>	<u><u>126.4</u></u>

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**  
**for the year ended 31 March 2008**

	Note	<u>2008</u>	<u>2007</u>
		£'m	£'m
Profit for the financial year		125.3	126.4
Reversal of pension prepayment		(22.4)	-
Recognition of pension asset and actuarial gain in the year		70.1	-
Deferred tax related to pension adjustments	21	<u>(13.4)</u>	<u>-</u>
Total recognised gains and losses relating to the year		<u><u>159.6</u></u>	<u><u>126.4</u></u>



**BALANCE SHEET**  
**at 31 March 2008**

	Note	2008	2007
		£'m	£'m
<b>FIXED ASSETS</b>			
Tangible assets	10	3,135.0	3,008.0
Investments	11	160.8	160.7
		<u>3,295.8</u>	<u>3,168.7</u>
<b>CURRENT ASSETS</b>			
Stocks	12	2.7	2.9
Debtors due in less than one year	13	116.7	131.1
Debtors due in more than one year	14	3.4	3.5
Investments	15	183.1	253.9
Cash at bank and in hand		6.9	1.0
		<u>312.8</u>	<u>392.4</u>
<b>CREDITORS</b>			
Amounts falling due within one year	16	(255.4)	(186.0)
		<u>57.4</u>	<u>206.4</u>
<b>NET CURRENT ASSETS</b>			
		<u>57.4</u>	<u>206.4</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>			
		<u>3,353.2</u>	<u>3,375.1</u>
<b>CREDITORS: Amounts falling due after more than one year</b>			
	17	(1,781.1)	(1,832.3)
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>			
	21	(220.4)	(214.4)
<b>ACCRUALS AND DEFERRED INCOME</b>			
	22	(389.3)	(381.3)
		<u>(2,390.8)</u>	<u>(2,428.0)</u>
<b>NET ASSETS EXCLUDING PENSION ASSET</b>			
		<u>962.4</u>	<u>947.1</u>
Pension asset	26	65.1	-
<b>NET ASSETS INCLUDING PENSION ASSET</b>			
		<u>1,027.5</u>	<u>947.1</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	23	122.7	122.7
Profit and loss account	24	904.8	824.4
<b>EQUITY SHAREHOLDERS' FUNDS</b>			
	24	<u>1,027.5</u>	<u>947.1</u>

Approved on behalf of the board

J A Cuthbert

C M Green

14 July 2008

**NOTES TO THE STATUTORY FINANCIAL STATEMENTS  
for the year ended 31 March 2008**

**1. STATEMENT OF ACCOUNTING POLICIES**

These financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. A summary of the principal accounting policies is set out below. These have been applied consistently throughout the current and preceding periods.

**(a) Basis of accounting**

The financial statements have been prepared under the historical cost convention on a going concern basis. The company is exempt by virtue of section 228 of the Companies Act 1985 from the requirement to prepare group financial statements, as it is included in the group financial statements of Northumbrian Water Group plc. These financial statements therefore present information about the individual company and not about its group.

**(b) Turnover**

Turnover, which excludes Value Added Tax, represents the income receivable in the ordinary course of business for services provided within the United Kingdom.

**(c) Cash flow statement**

The directors have taken advantage of the exemption in FRS 1 (revised) and have not included a cash flow statement on the grounds that the company is wholly owned and its ultimate parent company publishes a consolidated cash flow statement.

**(d) Tangible fixed assets and depreciation**

Tangible fixed assets comprise:

**(i) Infrastructure assets**

Infrastructure assets comprise a network of systems which include water mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls.

Expenditure on infrastructure assets relating to increases in capacity, or enhancements of the network, and on maintaining the operational capability of the network, in accordance with defined standards of service, is treated as additions which are included at cost. Costs include external and internal costs to bring the asset into use.

The Section 19 quality programme addresses water discolouration problems caused by iron pipes, either through relining these pipes or replacing them where relining is not possible. “Overlap” expenditure represents the extra cost of replacing pipes, rather than relining them, where their structural condition is insufficient to withstand the relining process. Such expenditure is classified as capital in nature and is included under infrastructure assets in the fixed asset note.

The depreciation charge for infrastructure assets is based on the company’s independently certified asset management plan which has estimated the level of expenditure required over the next ten years to maintain the operating capability of the network. This is adjusted if the forecast expenditure is expected to differ significantly from the amounts included in the original plan.

**(ii) Non-infrastructure assets**

Other assets (including properties, overground plant and equipment) are included at cost less accumulated depreciation and, where required, provision for impairment. Additions are included at cost.

**1. STATEMENT OF ACCOUNTING POLICIES (continued)****(d) Tangible fixed assets and depreciation (continued)****(ii) Non-infrastructure assets (continued)**

Freehold land is not depreciated. Other assets are depreciated evenly to their estimated residual values over their estimated economic lives, which are principally as follows:

Freehold buildings	30 – 60 years
Operational structures, plant and machinery	4 – 92 years
Fixtures, fittings, tools and equipment	4 – 10 years

Where the remaining useful economic life of the asset is estimated to be greater than 50 years, an impairment review is performed at the end of each reporting period to ensure that the carrying amount can be supported.

**(iii) Assets in the course of construction**

Assets in the course of construction are not depreciated until commissioned, which is when the asset is available for use.

**(e) Grants and contributions**

Revenue grants are credited to the profit and loss account when received.

Capital grants and contributions are treated as deferred income and amortised to the profit and loss account over the expected useful economic lives of the qualifying assets. Specifically in the case of infrastructure assets, the expected useful economic lives have been determined by reference to the physical replacement cycle of these assets.

**(f) Hire purchase and leasing**

Where assets are financed by hire purchase or leasing arrangements which transfer substantially all the risks and rewards of ownership to the company, the assets are treated as if they had been purchased and the corresponding capital cost is treated as a liability. Rentals or leasing payments are treated as consisting of a capital element and finance costs, the capital element reducing the outstanding liability and the finance costs being charged to the profit and loss account over the period of the hire purchase contract or lease in proportion to the reducing outstanding liability.

Rental costs arising under operating leases are charged to the profit and loss account in the period in which they are incurred.

**(g) Stocks**

Raw materials and consumables are stated at cost less any provision necessary to recognise damage and obsolescence. Cost of work in progress includes labour, materials, transport and an element of overheads.

**(h) Pension costs**

The company is a member of the Northumbrian Water Pension Scheme, a defined benefit pension scheme providing benefits based on pensionable remuneration. In previous years NWL adopted the multi-employer exemption within FRS 17 and reported costs on a defined contribution basis. However, the transfer of staff from AES into the scientific services division within NWL has enabled the company to report costs on a defined benefit basis under FRS 17 in the current year.

The company also operates a defined contribution scheme. The costs are charged to the profit and loss account in the period they are incurred.

**1. STATEMENT OF ACCOUNTING POLICIES (continued)****(i) Taxation**

The charge for current UK corporation tax is based on the profit for the year as adjusted for taxation purposes using the rates of tax enacted or substantively enacted by the balance sheet date.

Provision is made for deferred tax in respect of all timing differences that have originated but not reversed at the balance sheet date that will result in an obligation to pay more, or a right to pay less, tax in future periods. Deferred tax is calculated at the tax rates that are expected to apply in the periods in which timing differences are expected to reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date.

Deferred tax assets are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

As permitted by FRS 19, the company has adopted a policy of discounting deferred tax assets and liabilities to reflect the time value of money over the period between the balance sheet date and the dates on which it is estimated that the underlying timing differences will reverse. The discount rates used reflect the post-tax yields to maturity that can be obtained at the balance sheet date on UK government bonds with similar maturity dates to those of the deferred tax assets or liabilities.

**(j) Foreign currency**

All transactions denominated in foreign currencies are translated into sterling at the actual rates of exchange ruling at the date of transaction. Foreign currency balances are translated into sterling at the rates of exchange ruling at the balance sheet date. Exchange gains or losses are recognised in the profit and loss account in the period incurred.

**(k) Research and development**

Research and development expenditure is charged to the profit and loss account in the period in which it is incurred.

**(l) Investments**

Fixed asset investments are stated at their purchase cost, less provision for diminution in value.

**(m) Derivative financial instruments**

The company utilises interest rate swaps, forward rate agreements and forward exchange contracts as derivative financial instruments.

A derivative instrument is considered to be used for hedging purposes when it alters the risk profile of an underlying exposure of the company in line with the company's risk management policies.

Interest rate swap agreements are used to manage interest rate exposures. Amounts payable or receivable in respect of these derivatives are recognised over the period of the contracts as adjustments to net interest payable in the profit and loss account.

Forward exchange contracts are valued at the period end rates of exchange. Resultant gains and losses are offset against foreign exchange gains or losses on the related borrowings or, where the instrument is used to hedge a committed future transaction, are deferred until the transaction occurs.

When interest rate swaps and underlying debt are terminated together, the net gain or loss is taken to the profit and loss account as interest payable. When interest rate swaps are terminated but the underlying debt is retained then the gain/loss is deferred and is amortised to interest payable over the remaining life of the underlying debt.

**(n) Liquid resources**

Liquid resources comprise external deposits.

**1. STATEMENT OF ACCOUNTING POLICIES (continued)****(o) Bad debt provisioning**

The bad debt provision is calculated by applying a range of percentages to debt of different ages. These percentages also vary between different categories of debt. Higher percentages are applied to those categories of debt which are considered to be of greater risk and also to debt of greater age. The value of the bad debt provision is sensitive to the specific percentages applied.

**(p) Share based payments**

The cost of equity-settled transactions with employees is measured by reference to the fair value at the date at which they are granted and is recognised as an expense over the vesting period, which ends on the date on which the relevant employees become fully entitled to the award. Fair value is determined by an external valuer using the Monte-Carlo simulation model. In valuing equity-settled transactions, no account is taken of any vesting conditions, other than conditions linked to the price of the shares of the company (market conditions).

No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

At each balance sheet date before vesting, the cumulative expense is calculated, representing the extent to which the vesting period has expired, management's best estimate of the achievement or otherwise of non-market conditions and the number of equity instruments that will ultimately vest or in the case of an instrument subject to a market condition, be treated as vesting as described above. The movement in cumulative expense since the previous balance sheet date is recognised in the income statement, with a corresponding entry in equity.

Where the terms of an equity-settled award are modified or a new award is designated as replacing a cancelled or settled award, the cost based on the original award terms continues to be recognised over the original vesting period. In addition, an expense is recognised over the remainder of the new vesting period for the incremental fair value of any modification, based on the difference between the fair value of the original award and the fair value of the modified award, both as measured on the date of the modification. No reduction is recognised if this difference is negative.

**2. TURNOVER, PROFIT BEFORE TAX AND NET ASSETS**

The directors consider that the company has one class of business and this is conducted wholly within the United Kingdom.

**3. OPERATING COSTS, CAPITAL MAINTENANCE COSTS AND PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION****(a) Operating costs comprise:**

	2008	2007
	£'m	£'m
Materials and consumables	17.7	14.9
Other external charges	74.7	69.2
Net manpower costs (note 7)	99.7	82.8
Other operating charges	84.9	103.8
Own work capitalised	(26.2)	(24.1)
	250.8	246.6

**3. OPERATING COSTS, CAPITAL MAINTENANCE COSTS AND PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION (continued)****(b) Capital maintenance costs comprise:**

	2008	2007
	£'m	£'m
Depreciation:		
Non-infrastructure assets	69.2	64.1
Non-infrastructure assets held under finance leases	3.6	3.3
Infrastructure assets	51.2	34.2
Amortisation of capital grants and contributions	(4.2)	(3.8)
Profit on disposal of fixed assets	(1.3)	(2.1)
	<u>118.5</u>	<u>95.7</u>

**(c) Profit on ordinary activities before taxation:**

	2008	2007
	£'m	£'m
Profit on ordinary activities before taxation is stated after charging:		
Operating leases: Plant and machinery	0.1	0.1
Other assets	1.0	0.9
Costs of research and development	1.8	2.1
Directors' emoluments (note 5)	<u>1.1</u>	<u>1.1</u>

Auditors' remuneration in respect of the statutory audit amounted to £98,897 (2007: £95,134). Auditors' remuneration for the regulatory audit amounted to £16,575 (2007: £15,944). Fees of £13,667 and £14,605 (2007: £13,147 and £14,049) were also incurred in the auditing of RAG 5 information and the June Return respectively. The remuneration to auditors for non-audit services is disclosed on a consolidated basis in the group financial statements of the ultimate parent company.

**4. NET INTEREST PAYABLE**

	2008	2007
	£'m	£'m
Net interest payable comprises:		
Interest payable:		
Bank loans and overdrafts	22.9	16.7
Group loans	86.4	81.6
Financing charges payable under finance leases	2.4	2.8
Interest cost on defined benefit pension schemes	35.2	-
Total interest payable	<u>146.9</u>	<u>101.1</u>
Interest receivable:		
Group interest	(22.2)	(9.2)
External interest	(0.4)	(9.9)
Finance income on defined benefit pension schemes	(48.4)	-
Net interest payable	<u>75.9</u>	<u>82.0</u>

**5. DIRECTORS' EMOLUMENTS****(a) Directors' remuneration**

The remuneration of the directors of the company was as follows:

	2008	2007
	£'000	£'000
Emoluments (including benefits in kind)	<u>1,100.4</u>	<u>1,127.1</u>

For those directors holding office with both NWL and NWG, costs are apportioned between the companies. This note reflects only the proportion of costs charged to NWL.

Four of the directors at 31 March 2008 were members of a defined benefit pension scheme where the company makes contributions towards the cost (2007: 4).

The directors who held office as at 31 March 2008 held the following conditional interests in Ordinary 10p shares of the Group, awarded in accordance with the terms of its Long Term Incentive Plan (LTIP):

Name of Director	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2008
J A Cuthbert	22.12.04 <sup>1</sup>	67,001	-	18,649	48,352 <sup>2</sup>	-
	9.12.05 <sup>3</sup>	75,903	-	-	-	<b>75,903</b>
	21.12.06 <sup>4</sup>	66,721	-	-	-	<b>66,721</b>
	13.12.07 <sup>5</sup>	-	79,230	-	-	<b>79,230</b>
Totals		209,625	79,230	18,649	48,352	<b>221,854</b>
C M Green	22.12.04 <sup>1</sup>	44,221	-	12,308	31,913 <sup>2</sup>	-
	9.12.05 <sup>3</sup>	50,602	-	-	-	<b>50,602</b>
	21.12.06 <sup>4</sup>	49,423	-	-	-	<b>49,423</b>
	13.12.07 <sup>5</sup>	-	61,620	-	-	<b>61,620</b>
Totals		144,246	61,620	12,308	31,913	<b>161,645</b>
A C Jones	22.12.04 <sup>1</sup>	20,100	-	5,594	14,506 <sup>6</sup>	-
	9.12.05 <sup>3</sup>	26,506	-	-	-	<b>26,506</b>
	21.12.06 <sup>4</sup>	25,899	-	-	-	<b>25,899</b>
	13.12.07 <sup>5</sup>	-	22,450	-	-	<b>22,450</b>
Totals		72,505	22,450	5,594	14,506	<b>74,855</b>
G Neave	22.12.04 <sup>1</sup>	25,125	-	6,993	18,132 <sup>7</sup>	-
	9.12.05 <sup>3</sup>	32,530	-	-	-	<b>32,530</b>
	21.12.06 <sup>4</sup>	32,374	-	-	-	<b>32,374</b>
	13.12.07 <sup>5</sup>	-	27,470	-	-	<b>27,470</b>
Totals		90,029	27,470	6,993	18,132	<b>92,374</b>

**5. DIRECTORS' EMOLUMENTS (continued)****(a) Directors' remuneration (continued)****Notes:**

1. The market value of the shares on the date of the award was 174.50 pence per share. The three year performance period ran from 1 October 2004 to 30 September 2007 and shares became available to vest on 22 December 2007.
2. Shares vested on 27 December 2007 and the closing price on that date was 345.75 pence per share.
3. The market value of the shares on the date of the award was 252.00 pence per share. The three year performance period runs from 1 October 2005 to 30 September 2008.
4. The market value of the shares on the date of the award was 302.75 pence per share. The three year performance period runs from 1 October 2006 to 30 September 2009.
5. The market value of the shares on the date of the award was 334.00 pence per share. The three year performance period runs from 1 October 2007 to 30 September 2010.
6. The cost of conditional awards is charged to the income statement over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.4m was charged to equity (2007: £0.3m).
7. Details of the performance conditions are shown at note 11 to the Regulatory Financial Statements on page 64.
8. The market price of the shares on 31 March 2008 was 349.25 pence per share. During the year, the highest market price was 376.00 pence per share and the lowest market price was 288.25 pence per share.
9. Aggregate gross gains made by directors on exercise of awards at date of vesting was £390,362 (2007: £434,738).
10. Some or all of the shares will vest only if specified performance targets are achieved during the three year performance period. For further information, please refer to the Directors' Remuneration Report in the NWG accounts and to note 11 to the Regulatory Financial Statements.

The directors who held office as at 31 March 2008 held the following interests in the Ordinary 10p shares of NWG, purchased and held in accordance with the terms of the Share Incentive Plan:

Name of Director	Number of shares held as at 1 April 2007	Number of shares held as at 31 March 2008
J A Cuthbert	3,565	4,176
C M Green	3,565	4,176
A C Jones	3,565	4,176
G Neave	-	590

**(b) Highest paid director**

The amounts for remuneration shown in note 5(a) include the following in respect of the highest paid director:

	2008	2007
	£'000	£'000
Emoluments (including benefits in kind)	282.4	310.0

The accrued pension entitlement under the company's defined benefit scheme of the highest paid director at 31 March 2008 was £141,700 (2007: £133,800).

**6. TRANSACTIONS WITH DIRECTORS AND OFFICERS**

No transactions or arrangements with Directors and Officers which are disclosable under the provisions of the Companies Act 1985 have occurred during the year.



**7. EMPLOYEE INFORMATION**

The total employment costs of all employees (including directors) were as follows:

	2008	2007
	£'m	£'m
Gross costs charged to the profit and loss account:		
Wages and salaries	58.0	48.2
Social security costs	4.9	4.2
Other pension costs	12.4	7.9
	<u>75.3</u>	<u>60.3</u>
Costs recharged to other group companies:		
Wages and salaries	1.2	1.1
Social security costs	0.1	0.1
Other pension costs	0.2	0.2
	<u>1.5</u>	<u>1.4</u>
Net costs charged to the profit and loss account:		
Wages and salaries	56.8	47.1
Social security costs	4.8	4.1
Other pension costs	12.2	7.7
	<u>73.8</u>	<u>58.9</u>
Costs charged to capital schemes:		
Wages and salaries	19.9	19.1
Social security costs	1.7	1.7
Other pension costs	4.3	3.1
	<u>25.9</u>	<u>23.9</u>
Total net employee costs	<u><u>99.7</u></u>	<u><u>82.8</u></u>

The average monthly number of employees on the payroll during the financial year was 2,890 (2007: 2,554) and the total at the year end was 2,917 (2007: 2,862).

Costs in 2008 include 308 staff who transferred from AES on 31 March 2007.

**8. TAXATION****(a) Analysis of tax charge for the financial year:**

	2008	2007
	£'m	£'m
Current tax:		
UK corporation tax on profits for the year at 30% (2007:30%)	28.2	21.1
Adjustments in respect of prior years	(2.7)	(12.5)
Payable in respect of group relief for the current year at 30% (2007:30%)	8.1	6.6
Adjustments in respect of prior years	0.3	5.5
Total current tax charge (note 8b)	33.9	20.7
Deferred tax:		
Reduction due to opening tax rate change	(32.9)	-
Decrease in discount arising from above rate change	15.4	-
Net reduction in opening deferred tax (note 21)	(17.5)	-
Movement in the year at 28% (2007: 30%):		
Change in tax law re industrial buildings allowances	(37.2)	-
Origination and reversal of timing differences in the year	11.6	18.3
Adjustments in respect of prior periods	1.0	4.9
	(24.6)	23.2
Decrease/(increase) in discount arising from current year movements	60.1	(13.4)
Movement in the year (note 21)	35.5	9.8
Total deferred tax	18.0	9.8
Tax on profit on ordinary activities	51.9	30.5

Tax losses have provisionally been claimed from other group companies in the current year of £25.7m (2007: £20.7m) for which payment will be made at the rate of 30% (2007:30%).

The Finance Act 2007 provides that the rate of UK corporation tax is reduced from 30% to 28% with effect from 1 April 2008. As a result, the opening balance of deferred tax has been restated at the new rate at which timing differences are expected to reverse.

The Finance Act 2007 also contains provisions which prevent any clawback of industrial buildings allowances arising on a disposal of relevant assets. In accordance with FRS 19 deferred tax in respect of timing differences relating to those assets has been released in the year and industrial building allowances claimed and related depreciation have been dealt with in the reconciliation of the current tax charge as permanent differences (see note 8b).

The discount has decreased due to the removal of timing differences relating to industrial buildings as well as falls in the post-tax yields on UK government gilts during the year.

**8. TAXATION (continued)****(b) Reconciliation of the current tax charge:**

	2008	2007
	£'m	£'m
Profit on ordinary activities before tax	177.2	156.9
Profit on ordinary activities multiplied by standard rate of UK corporation tax 30% (2007: 30%)	53.2	47.1
Effects at 30% (2007: 30%) of:		
Expenses not deductible for tax purposes	(0.2)	0.3
Non-taxable income	(2.4)	(2.5)
Depreciation in respect of non-qualifying items	5.0	1.1
Industrial buildings allowances claimed in the year	(6.9)	-
Capital allowances in excess of depreciation	(10.7)	(17.5)
FRS17 pension surplus	(6.1)	-
Other timing differences	4.4	(0.8)
Adjustments in respect of prior years	(2.4)	(7.0)
Transfer pricing adjustments	(0.4)	(0.4)
Balancing payment payable	0.4	0.4
Total current tax charge (note 8a)	33.9	20.7

**(c) Factors that may affect future tax charges:**

The company expects to continue to incur high levels of capital expenditure and, accordingly, it expects to be able to claim capital allowances in excess of depreciation for the remainder of the current regulatory review period.

Deferred tax is provided on a discounted basis using post-tax yields on UK government gilts. The charge for deferred tax will, therefore, be influenced by future fluctuations in gilt rates.

**9. DIVIDENDS**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Equity:		
Dividends paid:		
Final paid for the year ended 31 March 2007 of 31.62p (year ended 31 March 2006: 30.07p) per share on an aggregated basis	38.8	36.9
Interim paid of 33.25p (2007: 31.54p) per share on an aggregated basis	<u>40.8</u>	<u>38.7</u>
Total dividends paid in the year	<u><u>79.6</u></u>	<u><u>75.6</u></u>
Dividends proposed:		
Final proposed for year ended 31 March 2008 of 33.41p (year ended 31 March 2007: 31.62p) per share on an aggregated basis	<u><u>41.0</u></u>	<u><u>38.8</u></u>

The directors have a policy which, unless circumstances dictate otherwise, aims to grow dividends on a slow but regular basis and which takes into account the principle of incentive based price cap regulation, including operating and investment performance.

The company has maintained its policy of steady real growth per annum for the appointed business dividend and also re-based the dividend in line with Ofwat's assumptions for dividends in the 2004 final determination. Dividends from the non-appointed business are determined by the directors and are based on performance.

Accordingly, the level of dividend has been declared by reference to:

- the company's ability to finance its functions;
- the company's cumulative financial performance; and
- the directors' judgement as to a fair reward for shareholders in the context of market conditions.

**10. TANGIBLE FIXED ASSETS**

	Freehold land and buildings	Infra- structure assets	Operational structures, plant and machinery	Fixtures, fittings, tools and equipment	Assets in the course of construction	Total
	£'m	£'m	£'m	£'m	£'m	£'m
Cost:						
At 1 April 2007	91.7	1,681.4	1,864.2	129.9	105.7	3,872.9
Additions	-	-	-	-	251.6	251.6
Schemes commissioned	0.4	100.0	96.8	7.9	(205.1)	-
Reclassifications	0.9	(0.1)	(0.8)	-	-	-
Disposals	(0.4)	-	(2.5)	-	-	(2.9)
At 31 March 2008	92.6	1,781.3	1,957.7	137.8	152.2	4,121.6
Depreciation:						
At 1 April 2007	29.9	223.9	514.0	97.1	-	864.9
Charge for year	2.0	51.2	62.2	8.6	-	124.0
Disposals	-	-	(2.3)	-	-	(2.3)
At 31 March 2008	31.9	275.1	573.9	105.7	-	986.6
Net book value:						
At 31 March 2008	60.7	1,506.2	1,383.8	32.1	152.2	3,135.0
At 31 March 2007	61.8	1,457.5	1,350.2	32.8	105.7	3,008.0
Leased assets included above:						
Net book value:						
At 31 March 2008	-	28.4	23.7	-	-	52.1
At 31 March 2007	-	-	23.2	-	-	23.2

**11. FIXED ASSET INVESTMENTS**

	Loans to Group Companies
	£'m
At 1 April 2007	160.7
Capitalised interest	0.1
At 31 March 2008	160.8

In May 2004 NWL made a loan of £159.0m to Northumbrian Services Limited (NSL), maturing in January 2034.

The company has a wholly owned subsidiary undertaking, Northumbrian Water Finance plc (NWF), whose principal activity is to hold certain finance instruments on behalf of the company.

The company has a wholly owned subsidiary undertaking, Reiver Holdings Limited, which in turn has a wholly owned subsidiary, Reiver Finance Limited, whose principal activity is as a sole special purpose financing vehicle.

**12. STOCKS**

	2008	2007
	£'m	£'m
Raw materials and consumables	2.7	2.9

There is no material difference between the balance sheet value of stocks and their replacement cost.

**13. DEBTORS DUE IN LESS THAN ONE YEAR**

	2008	2007
	£'m	£'m
Trade debtors	61.7	54.3
Amounts owed by other group companies	8.2	5.9
Other debtors	1.8	8.4
Prepayments and accrued income	45.0	62.5
	116.7	131.1

Trade debtors are shown net of bills raised in advance.

**14. DEBTORS DUE IN MORE THAN ONE YEAR**

	2008	2007
	£'m	£'m
Interest rate hedge	3.4	3.5

**15. INVESTMENTS**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Short term deposits with group company	183.1	253.9

**16. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Obligations under finance leases (note 19)	6.1	4.8
Loans (note 18)	94.6	20.0
Trade creditors	5.8	5.4
Amounts owed to other group companies	15.4	46.5
Taxation and social security	2.0	1.9
Corporation tax	3.7	4.4
Other creditors	10.8	10.5
Receipts in advance	18.2	19.2
Accruals and deferred income	98.8	73.3
	<u>255.4</u>	<u>186.0</u>

Accruals and deferred income includes accruals related to capital projects of £41.2m (2007: £46.3m).

Included in amounts owed to other group companies is £11.2m (2007: £10.2m) payable in respect of tax losses surrendered from fellow group companies.

**17. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Obligations under hire purchase contracts and finance leases (note 19)	83.6	56.4
Loans (note 18)	261.4	356.0
Amounts owed to other group companies (note 20)	1,435.8	1,419.4
Other creditors	0.3	0.5
	<u>1,781.1</u>	<u>1,832.3</u>

**18. LOANS**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Loans are repayable as follows:		
Within one year (note 16)	94.6	20.0
Between one and two years	19.1	94.6
Between two and five years	98.0	51.4
After five years	144.3	210.0
	<u>356.0</u>	<u>376.0</u>

Loans wholly repayable within 5 years amount to £152.5m (2007: £117.6m).

Loans not wholly repayable within 5 years amount to £203.5m (2007: £258.4m) and bear interest rates in the range 5.16% to 7.27%.

**19. OBLIGATIONS UNDER FINANCE LEASES**

Obligations under hire purchase contracts and finance leases are as follows:

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Amounts due:		
Within one year	6.1	4.8
Between one and two years	5.4	5.1
Between two and five years	13.7	16.1
After five years	123.8	53.5
	<u>149.0</u>	<u>79.5</u>
Less:		
Finance charge allocated to future periods	(59.3)	(18.3)
	<u>89.7</u>	<u>61.2</u>
Disclosed as due:		
Within one year (note 16)	6.1	4.8
After more than one year (note 17)	83.6	56.4
	<u>89.7</u>	<u>61.2</u>

The aggregate gross amount of obligations under hire purchase contracts and finance leases, any part of which falls due for repayment in five years or more, is £149.0m (2007: £79.5m).



**20. AMOUNTS DUE TO OTHER GROUP COMPANIES**

Amounts due to other group companies include loans repayable as follows:

	<u>2008</u>	<u>2007</u>
	£'m	£'m
After five years	<u>1,435.8</u>	<u>1,419.4</u>

NWF issued £200.0m and £150.0m Guaranteed Eurobonds in February 1998 and September 2001 respectively, maturing February 2023, with an annual coupon of 6.875%. The issues were guaranteed by the company who received the issue proceeds by way of inter-company loans of £194.2m and £163.2m respectively. Finance costs allocated during the year amounted to £0.2m (2007: £0.2m). Amortisation of loan issue receipts during the year amounted to £0.3m (2007: £0.3m).

NWF issued £300.0m Guaranteed Eurobonds in December 2001, maturing October 2017, with an annual coupon of 6.0%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan of £301.0m. Amortisation of loan receipts during the year amounted to £0.1m (2007: £0.1m).

NWF issued £250.0m and £100.0m Guaranteed Eurobonds in December 2002 and December 2004, maturing April 2033 with an annual coupon of 5.625%. Both issues were guaranteed by the company who received the issue proceeds by way of inter-company loans of £246.6m and £100.8m respectively. Finance costs allocated during the year amounted to £0.2m (2007: £0.2m).

NWF issued £150.0m Guaranteed Index Linked Eurobonds in September 2005, maturing July 2036, with a real coupon of 2.033%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan of £150.0m. Indexation accretion during the year amounted to £6.0m (2007: £5.0m).

NWF issued £60.0m Guaranteed Index Linked Eurobonds in January 2006, maturing January 2041, with a real coupon of 1.6274%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan of £60.0m. Indexation accretion during the year amounted to £2.4m (2007: £2.0m).

NWF issued two £100.0m Guaranteed Index Linked Eurobonds in June 2006 with real coupons of 1.7118% and 1.7484% and with maturities of 2049 and 2053 respectively. Both issues were guaranteed by the company who received the issue proceeds by way of two inter-company loans of £100.0m. Indexation accretion during the year amounted to £7.9m (2007: £5.4m).

**21. PROVISIONS FOR LIABILITIES AND CHARGES**

	£'m
Pension provision for former directors:	
At 1 April 2007	3.1
Transferred from profit and loss account	0.1
Utilised during the year	<u>(0.2)</u>
At 31 March 2008	<u>3.0</u>
Deferred tax :	
At 1 April 2007	211.3
Opening rate change (note 8a)	<u>(17.5)</u>
	193.8
Movement in the year (note 8a)	35.5
Dealt with via STRGL	<u>13.4</u>
	242.7
Transferred to pension asset (note 26)	<u>(25.3)</u>
At 31 March 2008	<u>217.4</u>
Provisions for liabilities and charges	<u><u>220.4</u></u>

The pension provision for former directors relates to pensions payable to former directors of water-only companies which have since merged with the company. The provision of £3.0m represents the full future amounts payable, based on an actuarial assessment, for which the company is directly liable.

The provision for deferred tax comprises:

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Accelerated capital allowances	483.8	546.2
Other timing differences	<u>(59.5)</u>	<u>(52.5)</u>
Undiscounted provision for deferred tax	424.3	493.7
Discount	<u>(206.9)</u>	<u>(282.4)</u>
Discounted provision for deferred tax	<u><u>217.4</u></u>	<u><u>211.3</u></u>

**22. ACCRUALS AND DEFERRED INCOME**

	<u>Gilt lock</u>	<u>Capital grants and contributions</u>	<u>Proceeds from Kielder Securitisation</u>	<u>Total</u>
	£'m	£'m	£'m	£'m
At 1 April 2007	0.5	189.3	191.5	381.3
Additions	-	19.6	-	19.6
Amortised / transferred during the year	-	(4.5)	(7.1)	(11.6)
At 31 March 2008	<u>0.5</u>	<u>204.4</u>	<u>184.4</u>	<u>389.3</u>

The Kielder securitisation involved the assignment of the right to the future income stream associated with the Kielder operating contract to Reiver Finance Limited, a subsidiary company, up to 2034 in return for consideration of £212.1m. This income is amortised to the profit and loss account of the company over the life of the assignment.

In 2006/07, the company entered into a hedging instrument in order to protect the company against movement in real interest rates prior to the launch of the two £100 million index linked bonds issued in June 2006. The bonds were priced on 24 May 2006 and the hedging instrument was liquidated on the same day resulting in a gain of £0.5m. This income is amortised to the profit and loss account of the company over the life of the bonds.

**23. CALLED UP SHARE CAPITAL**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Authorised:		
122,650,000 Ordinary Shares of £1 each (2007: 122,650,000)	<u>122.7</u>	<u>122.7</u>
	<u>2008</u>	<u>2007</u>
	£'m	£'m
Allotted, called-up and fully paid:		
122,650,000 Ordinary Shares of £1 each (2007: 122,650,000)	<u>122.7</u>	<u>122.7</u>

**24. RECONCILIATION OF MOVEMENTS IN EQUITY SHAREHOLDERS' FUNDS AND MOVEMENT ON RESERVES**

	<u>Profit and loss account</u>	<u>Total shareholders' funds</u>
	£'m	£'m
At 31 March 2007	824.4	947.1
Profit for the year	125.3	125.3
Share based payment	0.4	0.4
Recognition of pension asset and actuarial gain	34.3	34.3
Dividends paid (note 9)	(79.6)	(79.6)
At 31 March 2008	<u>904.8</u>	<u>1,027.5</u>

**25. COMMITMENTS****(a) Capital expenditure:**

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Expenditure contracted for but not provided for	<u>166.8</u>	<u>109.0</u>

**(b) Lease commitments:**

The company has entered into non-cancellable operating leases in respect of land and buildings, plant, machinery and motor vehicles. The total amount payable under these leases in the next year is as follows:

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Land and buildings:		
Leases which expire:		
After one year but not more than five	0.1	-
In five years or more	<u>0.6</u>	<u>0.6</u>
	<u>0.7</u>	<u>0.6</u>
	<u>2008</u>	<u>2007</u>
	£'m	£'m
Other:		
Leases which expire:		
Within one year	0.1	0.1
Between two and five years	<u>-</u>	<u>0.1</u>
	<u>0.1</u>	<u>0.2</u>

**26. PENSIONS**

The Group operates a defined benefit pension scheme providing benefits based on final pensionable remuneration to 2,391 active members at 31 March 2008 (2007: 2,310). The Scheme, the Northumbrian Water Pension Scheme (NWPS), of which the company is the principal member, comprises four unitised sub-funds - WPS, Northumbrian Water (North), Northumbrian Water (South) and MIS.

The assets of the NWPS are held separately from those of the Group in independently administered funds.

The most recent actuarial valuation of the NWPS was at 31 December 2004. At that date the market value of assets amounted to £520m. The valuation also took account of debt on the employer payments in respect of the withdrawal of two participating employers and added £10m to the asset value. The 2004 valuation disclosed that the combined value of the assets represented 97.6% of the value of the accrued liabilities.

The following table sets out the contribution rates recommended in the NWPS actuary's draft valuation summary:

Section	WPS	North	South	MIS
Members' contributions	6%	5%	5%	5%/6%
Employer's contributions	29.1%	23.1%	2.6%	73%

The recommended employer contribution rate was assessed using the Projected Unit Method and the following actuarial assumptions:

Investment Return	
- Pre Retirement	6.2%
- Post Retirement	5.3%
Pay Increases	3.75%
Pension Increases	3.0%
Price Inflation	3.0%

The Group responded to the recommendations with an alternative proposal to make capital injections of £36.1m by April 2006 and £23.3m in April 2007. The capital injections would cover:

- employers' contributions, and the strain on the fund arising from ill-health retirements, for the 5 years commencing 1 January 2006, and
- employee contributions for members electing to participate in a salary sacrifice arrangement effective for the period from 1 April 2006 to 31 December 2010.

For the period 1 January 2006 to 31 March 2006, all members continued to pay contributions to the NWPS. Members electing not to join the salary sacrifice arrangement continue to pay contributions to the NWPS from 1 April 2006. In addition, the employers have agreed to pay any savings in employer national insurance contributions arising from this arrangement into the NWPS and this amounts to £0.3m p.a.

The employers' proposals were accepted by the NWPS Trustee.

The Group made changes to the NWPS during the year after consultation with employees and trade unions, and discussions with the NWPS Trustee. The main changes (effective 1 January 2008 unless stated otherwise) were:

- defined benefit scheme closed to new entrants on 31 December 2007;
- member contributions increased with effect from 1 April 2008;
- normal retirement date set as the day before age 65 for future service;
- rule of 85 removed for future service; and
- the introduction of a defined contribution section of NWPS for new entrants.

The contributions paid to the NWPS in the year by the company totalled £22.9m (2007: £25.9m).

**26. PENSIONS (continued)**

The Group contributed to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP), until 31 December 2007. Members and employers contributed 3% and 6% of salary respectively. The NWGPPP was provided by an insurance company and members had their own individual policy. The contributions paid to NWGPPP in the year by the company totalled £0.2m (2007: £0.1m).

The defined contribution section of NWPS commenced on 1 January 2008 and had 219 active members at 31 March 2008. Members can choose to contribute either 3%, 4% or 5% of salary, with employers contributing at either 6%, 7% or 8% depending on the member contributions rate. The contributions paid to the defined contribution section of NWPS in the year by the company totalled £0.1m (2007: £nil).

In respect of the NWPS, in previous years NWL adopted the multi-employer exemption within FRS 17 and reported costs on a defined contribution basis. However, the transfer of staff from AES into the scientific services division within NWL has enabled the company to report costs on a defined benefit basis under FRS 17 in the current year.

The disclosures regarding the Group's defined benefit scheme, as required under FRS 17 'Retirement benefits', and the relevant impact on the Group's financial statements are set out below. A qualified actuary, using revised assumptions consistent with the requirements of FRS 17, has updated the actuarial valuation described above at 31 December 2004. Investments have been valued, for this purpose, at fair value.

FRS 17 actuarial assumptions :

	Group	
	2008 %	2007 %
Pay increases <sup>1</sup>	4.5	4.1
Pension increases	3.5	3.1
Price inflation	3.5	3.1
Discount rate	6.8	5.3
Mortality assumptions <sup>2,3</sup>	PMA/PFA00	PMA/PFA92
- Life expectancy for an active member – female aged 60 (years)	28.0	27.6
- Life expectancy for an active member – male aged 60 (years)	25.2	24.6

1. including promotional salary scale

2. 115% of PMA/PFA00

3. PMA/PFA92 (year of birth), PMA/PFA00 (year of birth with medium cohort improvements).

The fair value of the assets, and the present value of the liabilities, in the NWPS and the long term expected rate of return at 31 March were:

	Long term expected rate of return 2008	2008	Long term expected rate of return 2007	2007
	%	£'m	%	£'m
Equities	7.5	457.1	7.5	498.5
Corporate bonds	6.8	51.6	5.3	50.3
Government bonds	4.5	66.1	4.5	65.9
Property	6.0	76.3	6.0	86.7
Cash	5.3	15.6	5.3	9.4
Total fair value of assets		666.7		710.8
Present value of liabilities		(576.3)		(668.1)
Surplus		90.4		42.7
Related deferred tax		(25.3)		(12.8)
Net pension asset		65.1		29.9

**26. PENSIONS (continued)**

The comparative details for 2007, including the net pension asset of £29.9m, are shown for information only and were not included on the balance sheet for that year.

Analysis of the amount that has been charged to operating profit under FRS 17 (2007 for information only):

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Current service cost	15.3	15.6
Past service cost	<u>0.4</u>	<u>0.4</u>
Total operating charge	<u><u>15.7</u></u>	<u><u>16.0</u></u>

Analysis of the amount that has been charged to net finance payable under FRS 17 (2007 for information only):

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Expected return on assets	48.4	42.9
Interest on liabilities	<u>(35.2)</u>	<u>(32.4)</u>
Net credit	<u><u>13.2</u></u>	<u><u>10.5</u></u>

The actuarial gain that has been recognised in the statement of total recognised gains and losses (2007 for information only):

	<u>2008</u>	<u>2007</u>
	£'m	£'m
Net actuarial gains recognised in the statement of total recognised gains and losses	<u><u>27.2</u></u>	<u><u>25.0</u></u>

History of experience gains and losses:

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Fair value of assets	666.7	710.8	659.8	523.8
Present value of defined benefit obligation	<u>(576.3)</u>	<u>(668.1)</u>	<u>(663.5)</u>	<u>(600.2)</u>
Surplus / (deficit)	90.4	42.7	(3.7)	(76.4)
Experience adjustments arising on plan assets	(93.4)	0.6	87.1	25.6
Experience adjustments arising on plan liabilities	0.6	1.7	34.0	(4.4)

Changes in the present value of the defined benefit pension obligations are analysed as follows:

	<u>2008</u>	<u>2007</u>
	£'m	£'m
At 1 April	668.1	663.5
Current service cost	15.3	15.6
Past service cost	0.4	0.4
Interest cost	35.2	32.4
Contributions by plan participants	0.1	0.3
Actuarial gains on obligations	(120.6)	(24.4)
Benefits paid	<u>(22.2)</u>	<u>(19.7)</u>
At 31 March	<u><u>576.3</u></u>	<u><u>668.1</u></u>

**26. PENSIONS (continued)**

Changes in the fair value plan assets are analysed as follows:

	2008	2007
	£'m	£'m
At 1 April	710.8	659.8
Expected return on plan assets	48.4	42.9
Actuarial (losses)/gains on plan assets	(93.4)	0.6
Contributions by employer	23.0	26.9
Contributions by plan participants	0.1	0.3
Benefits paid	(22.2)	(19.7)
At 31 March	<u>666.7</u>	<u>710.8</u>

**27. SHARE INCENTIVE PLANS****(a) Long Term Incentive Plan (LTIP)**

Under the Group LTIP, executive directors and senior managers of the company may receive, at the discretion of NWG's Remuneration Committee, annual conditional awards of shares in the Group. Further details of the LTIP can be found in note 5.

The following table illustrates the movements in conditional share awards during the year for the Group scheme. The costs of the scheme are apportioned to the employing companies and the company reports only the relevant proportion of scheme cost.

	March 2008	March 2007
	Number	Number
Outstanding at 1 April	1,114,715	1,216,320
Granted during the year	364,370	360,022
Forfeited/lapsed during the year	(102,606)	(131,876)
Exercised	(273,410)	(329,751)
Outstanding at 31 March	<u>1,103,069</u>	<u>1,114,715</u>
Exercisable at 31 March	<u>4,062</u>	<u>11,418</u>

The weighted average exercise price throughout the year was £nil (2007: £nil). The fair value of conditional share awards granted during the year was £0.1m (2007: £0.1m).

The weighted average share price at the date of exercise for the conditional share awards was 343.34 pence (2007: 296.92 pence).

For the conditional awards outstanding as at 31 March 2008, the weighted average remaining contractual life is 1.7 years (2007: 1.7 years).

The fair value of conditional share awards granted was estimated using the Monte-Carlo model. The significant inputs to the model were as follows:

	March 2008	March 2007
Dividend yield	3.5%	4.0%
Expected share price volatility	24%	22%
Share price at award	334.00p	302.75p
Expected FTSE 250 index volatility	13%	12%
Risk free interest rate %	4.6%	5.01%
Expected life of option (years)	3	3

The expected life of these options is based on historical data and is not necessarily indicative of exercise patterns that may occur. The expected volatility reflects the assumption that the historical volatility is indicative of future trends, which may also not necessarily be the actual outcome.



**27. SHARE INCENTIVE PLANS (continued)****(b) Share Incentive Plan (SIP)**

The Group SIP scheme provides one free matching share for every three shares purchased by an employee of the company. Shares for the SIP are purchased at market price by the Trustee, and dividends are paid in cash directly to participants.

The following table illustrates the movements in conditional share awards during the year for the Group scheme. The costs of the scheme are apportioned to the participating subsidiary companies and the company reports only the relevant proportion of scheme cost.

	March 2008	March 2007
	Number	Number
Outstanding at 1 April	115,219	136,168
Granted during the year	100,721	118,625
Forfeited during the year	(3,647)	(3,358)
Exercised	(114,417)	(136,216)
Outstanding at 31 March	97,876	115,219

**28. RELATED PARTY DISCLOSURES**

The company is a wholly owned subsidiary of Northumbrian Water Group plc which produces publicly available financial statements which include the company. Consequently the company is exempt under the terms of FRS 8 “Related Party Disclosures” from disclosing transactions with other members of the group headed by NWG.

**29. ULTIMATE PARENT COMPANY**

Northumbrian Water Group plc, incorporated in the UK, is regarded by the directors of the company as the company’s ultimate parent company and controlling party.

The only group in which the results of the company are consolidated is that of which NWG is the parent company. The consolidated financial statements of NWG may be obtained from Northumbria House, Abbey Road, Pity Me, Durham, DH1 5FJ.

**INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF NORTHUMBRIAN WATER LIMITED**

We have audited the company's financial statements for the year ended 31 March 2008 which comprise the Profit and Loss Account, Statement of Total Recognised Gains and Losses, Balance Sheet and the related notes 1 to 29. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities. Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report and Operating and Financial Review is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only the Directors' Report and Operating and Financial Review and the Appendix to the Directors' Report and Operating and Financial Review. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

**Opinion**

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 March 2008 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report and Operating and Financial Review is consistent with the financial statements.

Ernst & Young LLP  
Registered Auditor  
Newcastle upon Tyne  
14 July 2008

**HISTORICAL COST PROFIT AND LOSS ACCOUNT**  
**For the year ended 31 March 2008**

	Note	2008			2007		
		Appointe d business	Non- appointed business	Aggregate d basis	Appointe d business	Non- appointed business	Aggregate d basis
		£'m	£'m	£'m	£'m	£'m	£'m
Turnover	2	595.3	27.1	622.4	560.7	20.5	581.2
Operating costs		(291.7)	(13.5)	(305.2)	(276.0)	(7.9)	(283.9)
Historical cost depreciation		(69.2)	(0.7)	(69.9)	(64.5)	(0.4)	(64.9)
Operating income		1.3	-	1.3	2.0	0.1	2.1
OPERATING PROFIT	a	235.7	12.9	248.6	222.2	12.3	234.5
Net interest (payable) / receivable	a	(86.6)	10.6	(76.0)	(92.1)	10.0	(82.1)
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		149.1	23.5	172.6	130.1	22.3	152.4
Taxation – current		(29.5)	(4.3)	(33.8)	(15.9)	(4.8)	(20.7)
– deferred	a	(17.5)	6.0	(11.5)	(5.3)	(0.2)	(5.5)
PROFIT FOR THE FINANCIAL YEAR		102.1	25.2	127.3	108.9	17.3	126.2
Dividends		(72.6)	(7.0)	(79.6)	(68.6)	(7.0)	(75.6)
RETAINED PROFIT FOR THE YEAR		29.5	18.2	47.7	40.3	10.3	50.6

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**  
**for the year ended 31 March 2008**

	Note	2008			2007		
		Appointe d business	Non- appointed business	Aggregate d basis	Appointe d business	Non- appointed business	Aggregate d basis
		£'m	£'m	£'m	£'m	£'m	£'m
Profit for the financial year		102.1	25.2	127.3	108.9	17.3	126.2
Pension prepayment reclassification		(21.9)	(0.6)	(22.5)	-	-	-
Recognition of pension asset and actuarial gain in the year		68.2	1.2	69.4	-	-	-
Deferred tax related to pension adjustments		(12.9)	(0.2)	(13.1)	-	-	-
Total recognised gains and losses relating to the year		135.5	25.6	161.1	108.9	17.3	126.2

**HISTORICAL COST BALANCE SHEET****At 31 March 2008**

Note	2008			2007			
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis	
	£'m	£'m	£'m	£'m	£'m	£'m	
<b>FIXED ASSETS</b>							
Tangible assets	a	2,858.9	100.0	2,958.9	2,730.4	99.8	2,830.2
Investments – loans to group companies		-	160.8	160.8	-	160.7	160.7
<b>TOTAL FIXED ASSETS</b>		<b>2,858.9</b>	<b>260.8</b>	<b>3,119.7</b>	<b>2,730.4</b>	<b>260.5</b>	<b>2,990.9</b>
<b>CURRENT ASSETS</b>							
Stocks		2.5	0.3	2.8	2.7	0.2	2.9
Debtors		118.3	1.7	120.0	129.4	5.2	134.6
Cash		-	18.6	18.6	-	6.4	6.4
Short term deposits		183.1	-	183.1	253.9	-	253.9
<b>TOTAL CURRENT ASSETS</b>		<b>303.9</b>	<b>20.6</b>	<b>324.5</b>	<b>386.0</b>	<b>11.8</b>	<b>397.8</b>
<b>CREDITORS: Amounts falling due within one year</b>							
Overdrafts		(11.7)	-	(11.7)	(5.4)	-	(5.4)
Infrastructure renewals accrual		(20.2)	(1.8)	(22.0)	(0.7)	(1.7)	(2.4)
Creditors		(142.5)	(8.6)	(151.1)	(153.0)	(3.7)	(156.7)
Borrowings		(100.7)	-	(100.7)	(24.8)	-	(24.8)
Corporation tax payable		(3.6)	-	(3.6)	(4.4)	-	(4.4)
<b>TOTAL CREDITORS</b>		<b>(278.7)</b>	<b>(10.4)</b>	<b>(289.1)</b>	<b>(188.3)</b>	<b>(5.4)</b>	<b>(193.7)</b>
<b>NET CURRENT ASSETS</b>		<b>25.2</b>	<b>10.2</b>	<b>35.4</b>	<b>197.7</b>	<b>6.4</b>	<b>204.1</b>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		<b>2,884.1</b>	<b>271.0</b>	<b>3,155.1</b>	<b>2,928.1</b>	<b>266.9</b>	<b>3,195.0</b>
<b>CREDITORS: Amounts falling due after more than one year</b>							
Borrowings		(1,780.8)	-	(1,780.8)	(1,831.8)	-	(1,831.8)
Other creditors		(0.3)	-	(0.3)	(0.5)	-	(0.5)
<b>TOTAL CREDITORS</b>		<b>(1,781.1)</b>	<b>-</b>	<b>(1,781.1)</b>	<b>(1,832.3)</b>	<b>-</b>	<b>(1,832.3)</b>
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>							
Deferred tax provision	a	(194.3)	(1.7)	(196.0)	(188.6)	(8.0)	(196.6)
Deferred income – grants and contributions	a	(56.7)	(0.5)	(57.2)	(54.9)	(0.5)	(55.4)
Post employment asset	a	63.4	1.1	64.5	-	-	-
Other provisions		(3.0)	-	(3.0)	(3.1)	-	(3.1)
Other deferred income		(0.5)	(184.4)	(184.9)	(0.5)	(191.5)	(192.0)
<b>NET ASSETS EMPLOYED</b>		<b>911.9</b>	<b>85.5</b>	<b>997.4</b>	<b>848.7</b>	<b>66.9</b>	<b>915.6</b>
<b>CAPITAL AND RESERVES</b>							
Called up share capital		92.1	30.6	122.7	92.1	30.6	122.7
Profit and loss account		819.8	54.9	874.7	756.6	36.3	792.9
<b>CAPITAL AND RESERVES</b>		<b>911.9</b>	<b>85.5</b>	<b>997.4</b>	<b>848.7</b>	<b>66.9</b>	<b>915.6</b>

Approved on behalf of the board  
J A Cuthbert  
14 July 2008

C M Green

**(a) RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST  
REGULATORY ACCOUNTS  
For the year ended 31 March 2008**

	Statutory UK GAAP £'m	Regulatory £'m	Explanation of difference
<b>PROFIT AND LOSS ACCOUNT</b>			
Operating Profit	253.1	248.6	Adjustment relating to Section 19 “overlap” (£3.3m) (see note 1(a)(i)) and amortisation of infrastructure income (£1.4m)(see note 1(a)(ii)). Additional charge in statutory accounts for VLS pension scheme element (£0.2m).
Net interest payable	75.9	76.0	Additional credit of £0.1m in statutory accounts for VLS pension scheme element.
Deferred tax charge	18.0	11.5	Adjustment relating to amortisation of infrastructure income (£0.1m), Section 19 “overlap” (£0.4m) and discount (£6.0m).
<b>BALANCE SHEET</b>			
Tangible fixed assets (net book value)	3,135.0	2,958.9	Adjustments relating to – infrastructure grants and contributions netted off (£164.0m), Section 19 “overlap” (£34.1m) and infrastructure renewals provision (£22.0m).
Provisions for liabilities and charges – deferred tax	217.4	196.0	Adjustment relating to amortisation of infrastructure income (£4.7m), Section 19 “overlap” (£9.6m) and discount (£7.1m).
Deferred income – grants and contributions	204.4	57.2	Adjustment relating to gross up (£164.0m) and amortisation (£16.8m) of infrastructure grants and contributions.
Post employment asset	65.1	64.5	Adjustment relating to additional charge in statutory accounts for VLS pension scheme (£0.6m).

**CURRENT COST PROFIT AND LOSS ACCOUNT**  
**For the year ended 31 March 2008**

		<u>2008</u>	<u>2007</u>
	Note	£'m	£'m
Turnover	2	595.3	560.7
Current cost operating costs	3	(416.6)	(387.8)
Operating income	2	1.6	2.0
Working capital adjustment	2	<u>(0.5)</u>	<u>(0.2)</u>
<b>CURRENT COST OPERATING PROFIT</b>		179.8	174.7
Net interest payable		(86.6)	(92.0)
Financing adjustment		<u>46.2</u>	<u>65.5</u>
<b>CURRENT COST PROFIT BEFORE TAXATION</b>		139.4	148.2
Taxation:			
Current tax		(29.5)	(15.9)
Deferred tax		<u>(17.5)</u>	<u>(5.3)</u>
<b>CURRENT COST PROFIT ATTRIBUTABLE TO SHAREHOLDERS</b>		92.4	127.0
Dividends		<u>(72.6)</u>	<u>(68.6)</u>
<b>CURRENT COST PROFIT RETAINED</b>		<u><u>19.8</u></u>	<u><u>58.4</u></u>

All note references to the summary current cost financial statements on pages 55 to 69 refer to the notes to the current cost accounts.

**CURRENT COST BALANCE SHEET**  
**At 31 March 2008**

	Note	2008	2007
		£'m	£'m
<b>FIXED ASSETS</b>			
Tangible assets	4	13,360.7	12,723.2
Third party contributions since 1989/90		(96.7)	(91.5)
		<u>13,264.0</u>	<u>12,631.7</u>
Working capital	5	12.1	12.3
Short term deposits		183.1	253.9
Overdraft		(11.7)	(5.4)
Infrastructure renewals accrual		(20.2)	(0.7)
<b>NET OPERATING ASSETS</b>		<u>13,427.3</u>	<u>12,891.8</u>
<b>NON OPERATING ASSETS AND LIABILITES</b>			
Borrowings		(100.7)	(24.8)
Non-trade debtors		3.8	5.2
Non-trade creditors due within one year		(37.6)	(38.4)
Corporation tax payable		(3.6)	(4.4)
<b>Total non-operating liabilities</b>		<u>(138.1)</u>	<u>(62.4)</u>
<b>CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR</b>			
Borrowings		(1,780.8)	(1,831.8)
Other creditors		(0.3)	(0.5)
<b>Total creditors due after more than one year</b>		<u>(1,781.1)</u>	<u>(1,832.3)</u>
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>			
Deferred tax provision		(194.3)	(188.6)
Post employment asset		63.4	-
Other provisions		(3.0)	(3.1)
<b>Total provisions</b>		<u>(133.9)</u>	<u>(191.7)</u>
<b>NET ASSETS</b>		<u>11,374.2</u>	<u>10,805.4</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital		92.1	92.1
Profit and loss account		545.1	491.5
Current cost reserve	6	10,737.0	10,221.8
<b>TOTAL CAPITAL AND RESERVES</b>		<u>11,374.2</u>	<u>10,805.4</u>

**CURRENT COST CASH FLOW STATEMENT****For the year ended 31 March 2008**

Note	2008			2007			
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis	
	£'m	£'m	£'m	£'m	£'m	£'m	
NET CASH FLOW FROM OPERATING ACTIVITIES	7	333.0	14.6	347.6	301.3	1.3	302.6
<b>Returns on investments and servicing of finance</b>							
Interest received		14.0	10.1	24.1	8.0	10.0	18.0
Interest paid		(94.1)	-	(94.1)	(83.3)	-	(83.3)
Interest in finance lease rentals		(3.6)	-	(3.6)	(2.8)	-	(2.8)
Net cash flow from returns on investments and servicing of finance		(83.7)	10.1	(73.6)	(78.1)	10.0	(68.1)
<b>Taxation paid</b>		(29.0)	(4.6)	(33.6)	(21.6)	(4.0)	(25.6)
<b>Capital expenditure and financial investment</b>							
Gross cost of purchase of fixed assets		(222.2)	(1.2)	(223.4)	(185.2)	(1.2)	(186.4)
Receipt of grants and contributions		24.8	-	24.8	18.6	-	18.6
Infrastructure renewals expenditure		(34.9)	-	(34.9)	(40.7)	-	(40.7)
Disposal of fixed assets		1.6	0.3	1.9	2.0	0.2	2.2
Net cash outflow from investing activities		(230.7)	(0.9)	(231.6)	(205.3)	(1.0)	(206.3)
<b>Equity dividend paid</b>		(72.6)	(7.0)	(79.6)	(68.6)	(7.0)	(75.6)
<b>Management of liquid resources</b>							
Net cash flow from management of liquid resources		70.8	-	70.8	(196.2)	-	(196.2)
NET CASH FLOW BEFORE FINANCING		(12.2)	12.2	-	(268.5)	(0.7)	(269.2)
<b>Financing</b>							
Capital element in finance lease rentals		(3.2)	-	(3.2)	(2.5)	-	(2.5)
New bank loans		29.1	-	29.1	300.0	-	300.0
Repayment of bank loans & debentures		(20.0)	-	(20.0)	(29.2)	-	(29.2)
Net cash inflow from financing		5.9	-	5.9	268.3	-	268.3
(DECREASE)/INCREASE IN CASH		(6.3)	12.2	5.9	(0.2)	(0.7)	(0.9)



**NOTES TO THE REGULATORY FINANCIAL STATEMENTS**  
**For the year ended 31 March 2008**

**1. STATEMENT OF REGULATORY ACCOUNTING POLICIES**

**(a) Historical cost information**

The financial statements have been prepared in accordance with regulatory accounting guidelines (RAGs) published by Ofwat.

The accounting policies set out on pages 24 to 27 apply to the historical cost regulatory financial information, with the exception of:

- capital grants and contributions to infrastructure assets which is not in accordance with the Companies Act 1985 (as described in (ii) below).
- infrastructure renewals accounting which, in accordance with RAG 3.06, has been accounted for in accordance with RAG 2.03, “Classification of Infrastructure Expenditure”. RAG 2.03 is not in accordance with FRS 12, “Provisions, Contingent Liabilities and Contingent Assets” and FRS 15, “Tangible Fixed Assets” as described in section (i) below.

**(i) Infrastructure assets**

Infrastructure assets comprise a network of systems which include water mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls.

Expenditure on infrastructure assets relating to increases in capacity or enhancements of the network is treated as additions which are included at cost after deducting grants and contributions.

Expenditure on maintaining the operating capability of the network in accordance with defined standards of service is charged as an operating cost. No depreciation is charged on infrastructure assets because the network of systems is required to be maintained in perpetuity and, therefore, has no finite economic life.

In accordance with RAG 3.06 the company has not applied FRS 12, “Provisions, Contingent Liabilities and Contingent Assets” and FRS 15, in respect of infrastructure renewals accounting and has continued to charge infrastructure renewal costs (calculated in accordance with their Asset Management Plan) to the profit and loss account. Expenditure during the year is charged to the provision.

Under FRS 12 it is not permitted to recognise a provision for the costs of renewals expenditure. Adoption of FRS 12, taken together with FRS 15, would require:

- restatement of the cost and accumulated depreciation of infrastructure fixed assets to reflect infrastructure renewals expenditure, depreciation and retirement of assets since renewals accounting was first adopted. Accordingly, infrastructure renewals provisions and prepayments at years ended 31 March 2007 and 31 March 2008 would have been included within infrastructure fixed assets.
- the depreciation of infrastructure assets and the inclusion of the infrastructure renewals charge as a component of the depreciation charge for the year.
- restatement of the cost of infrastructure fixed assets to reflect the treatment of Section 19 “overlap” expenditure. The objective of the Section 19 quality programme is to address water discolouration problems caused by iron pipes, either through relining those pipes or replacing them where relining is not possible. The “overlap” represents the extra cost of replacing pipes rather than relining them where their structural condition is insufficient to withstand the relining process. Such expenditure is included in the infrastructure renewals charge in the regulatory financial statements. The statutory financial statements classify such expenditure as capital in nature and include this under infrastructure assets in the fixed asset note, resulting in a higher profit in the statutory financial statements.

**1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)****(a) Historical cost information (continued)****(ii) Grants and contributions**

Revenue grants are credited to the profit and loss account when received.

Grants and contributions relating to infrastructure assets have been deducted from the cost of those assets, in accordance with RAG 3.06. This is not in accordance with the Companies Act 1985 which requires fixed assets to be stated at their purchase price or production cost without deduction of grants and contributions which are accordingly accounted for as deferred income. The effect of the departure on the value of tangible fixed assets is disclosed in note (a). The statutory financial statements reflect grants and contributions as deferred income and amortise them to profit and loss account over the expected useful economic lives of the assets, resulting in a higher operating profit in the statutory financial statements.

Capital grants and contributions relating to other assets are treated as deferred income and amortised in the profit and loss account over the expected useful economic lives of the qualifying assets.

**(b) Current cost information**

The accounting policies used are the same as those adopted in the historical cost financial statements, except as set out below. This financial information has been prepared for the appointed business of Northumbrian Water Limited in accordance with guidance issued by Ofwat for modified real time financial statements suitable for regulation in the water industry. They measure profitability on the basis of real financial capital maintenance in the context of assets which are valued at their current cost value to the business.

**(i) Tangible fixed assets**

Assets in operational use are valued at the replacement cost of their operating capability. To the extent that the regulatory regime does not allow such assets to earn a return high enough to justify that value, no adjustment is made in arriving at the replacement cost. No provision is made for the possible funding of future replacements of assets by contributions from third parties and, to the extent that some of those assets would on replacement be so funded, replacement cost again differs from value to the business. Redundant assets are valued at their recoverable amounts.

A process of continuing refinement of the Asset Management Plan (AMP), based on serviceability, will result in adjustments to the existing valuation of assets at the end of the regulatory review period. In intervening years, values are restated to take account of changes in the general level of inflation as measured by changes in the Retail Price Index (RPI) over the year.

- **Land and Buildings**

Non-specialised operational properties are valued on the basis of open market value for existing use. Specialised operational properties are valued at the lower of depreciated replacement cost and recoverable amount.

- **Infrastructure assets**

Mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls are valued at replacement cost determined principally on the basis of data provided by the AMP.

- **Other fixed assets**

All other fixed assets are valued periodically at depreciated replacement cost.

- **Surplus land**

Surplus land is valued at recoverable amount taking into account that part of any proceeds to be passed on to customers under Condition B of the Licence.

- **Grants and contributions**

Grants and contributions are revalued to take account of changes in the general level of inflation as measured by changes in the RPI over the year.

**1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)****(b) Current cost information (continued)****(ii) Real financial capital maintenance adjustments**

The real financial capital maintenance adjustments are calculated by applying depreciation to the current cost value of fixed assets.

**(iii) Working capital adjustment**

The working capital adjustment is calculated by applying the change in the RPI over the year to the opening balance of working capital.

**(iv) Financing adjustment**

The financing adjustment is calculated by applying the RPI change over the year to the opening balance of net finance which comprises all monetary assets and liabilities in the balance sheet except those included in working capital.

**2. ANALYSIS OF TURNOVER AND OPERATING INCOME FOR THE APPOINTED BUSINESS**

	2008			2007		
	Water services	Sewerage services	Appointed business	Water services	Sewerage services	Appointed business
	£'m	£'m	£'m	£'m	£'m	£'m
Unmeasured	186.3	148.8	335.1	178.9	141.9	320.8
Measured	111.1	79.2	190.3	98.6	74.3	172.9
Trade effluent	-	2.7	2.7	-	2.5	2.5
Large user and special agreement	25.2	25.7	50.9	24.2	24.7	48.9
Non-potable large user and special agreement	10.6	-	10.6	9.7	-	9.7
Rechargeable works	0.6	-	0.6	0.6	0.1	0.7
Bulk supplies/inter company payments	0.7	-	0.7	0.4	-	0.4
Other appointed business (third party)	2.8	0.3	3.1	2.7	0.3	3.0
Other sources	0.6	0.7	1.3	0.8	1.0	1.8
<b>Total turnover</b>	<b>337.9</b>	<b>257.4</b>	<b>595.3</b>	<b>315.9</b>	<b>244.8</b>	<b>560.7</b>
Operating income:						
Current cost profit on disposal of fixed assets	1.2	0.4	1.6	1.9	0.1	2.0
Working capital adjustment	(0.3)	(0.2)	(0.5)	(0.1)	(0.1)	(0.2)

**3. OPERATING COSTS**

	<b>Water services</b>			<b>Sewerage services</b>			
	Resources & treatment	Distribution	Water services subtotal	Sewerage	Sewage treatment	Sludge treatment & disposal	Sewerage service subtotal
	£'m	£'m	£'m	£'m	£'m	£'m	£'m
<b>Direct Costs</b>							
Employment costs	8.5	8.5	<b>17.0</b>	3.5	4.3	2.7	<b>10.5</b>
Power	5.5	5.4	<b>10.9</b>	2.3	5.8	2.5	<b>10.6</b>
Hired & contracted services	1.6	5.7	<b>7.3</b>	1.4	0.9	7.5	<b>9.8</b>
Materials and consumables	6.6	1.0	<b>7.6</b>	0.2	0.5	1.8	<b>2.5</b>
Service charges (EA)	18.6	-	<b>18.6</b>	1.0	1.4	-	<b>2.4</b>
Bulk supply imports	2.0	-	<b>2.0</b>	-	-	-	<b>-</b>
Other direct costs	0.2	2.9	<b>3.1</b>	0.7	0.2	-	<b>0.9</b>
<b>Total direct costs</b>	<b>43.0</b>	<b>23.5</b>	<b>66.5</b>	<b>9.1</b>	<b>13.1</b>	<b>14.5</b>	<b>36.7</b>
General and support expenditure	11.6	14.5	<b>26.1</b>	4.5	9.6	4.7	<b>18.8</b>
<b>Total functional expenditure</b>	<b>54.6</b>	<b>38.0</b>	<b>92.6</b>	<b>13.6</b>	<b>22.7</b>	<b>19.2</b>	<b>55.5</b>
<b>Business analysis</b>							
Customer services			<b>15.3</b>				<b>7.4</b>
Scientific services			<b>7.3</b>				<b>3.5</b>
Other business activities			<b>1.6</b>				<b>0.8</b>
Business activities sub total			<b>24.2</b>				<b>11.7</b>
Local authority rates			<b>16.2</b>				<b>5.5</b>
Doubtful debts			<b>7.9</b>				<b>5.8</b>
Total opex less third party services			<b>140.9</b>				<b>78.5</b>
Third party services – opex			<b>11.8</b>				<b>6.1</b>
<b>Total operating expenditure</b>			<b>152.7</b>				<b>84.6</b>
<b>Capital maintenance</b>							
Infrastructure renewals charge	1.5	32.5	<b>34.0</b>	20.4	-	-	<b>20.4</b>
Current cost depreciation – service activities	29.7	17.5	<b>47.2</b>	6.8	43.9	12.8	<b>63.5</b>
- business activities			<b>11.0</b>				<b>5.9</b>
Amortisation of grants			<b>(1.0)</b>				<b>(1.7)</b>
<b>Total capital maintenance</b>			<b>91.2</b>				<b>88.1</b>
<b>Total operating costs</b>			<b>243.9</b>				<b>172.7</b>
<b>CCA (MEA) Values</b>							
Service activities			<b>6,584.4</b>				<b>6,626.3</b>
Business activities			<b>104.4</b>				<b>45.6</b>
<b>Total</b>			<b>6,688.8</b>				<b>6,671.9</b>

**4. TANGIBLE FIXED ASSETS**

<b>Water services</b>	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
<b>Gross Replacement Cost:</b>					
At 1 April 2007	1,520.1	55.6	5,422.3	168.1	7,166.1
AMP adjustment	0.8	-	1.3	0.2	2.3
RPI adjustment	59.2	1.8	207.4	4.0	272.4
Disposals	-	-	-	(4.7)	(4.7)
Additions	50.0	0.2	48.1	17.0	115.3
At 31 March 2008	1,630.1	57.6	5,679.1	184.6	7,551.4
<b>Depreciation:</b>					
At 1 April 2007	719.1	29.2	-	73.6	821.9
AMP adjustment	(41.1)	(1.4)	-	(1.5)	(44.0)
RPI adjustment	28.3	1.1	-	1.8	31.2
Disposals	-	-	-	(4.7)	(4.7)
Charge for year	46.2	1.0	-	11.0	58.2
At 31 March 2008	752.5	29.9	-	80.2	862.6
Net book value at 31 March 2008	877.6	27.7	5,679.1	104.4	6,688.8
Net book value at 31 March 2007	801.0	26.4	5,422.3	94.5	6,344.2
<b>Sewerage services</b>					
	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
<b>Gross Replacement Cost:</b>					
At 1 April 2007	1,733.2	46.0	5,268.7	66.1	7,114.0
AMP adjustment	(2.2)	-	(0.9)	0.3	(2.8)
RPI adjustment	65.3	1.7	201.5	2.2	270.7
Disposals	-	-	-	(2.6)	(2.6)
Additions	51.7	0.1	24.1	9.6	85.5
At 31 March 2008	1,848.0	47.8	5,493.4	75.6	7,464.8
<b>Depreciation:</b>					
At 1 April 2007	686.7	22.0	-	26.3	735.0
AMP adjustment	(35.5)	(0.7)	-	(0.6)	(36.8)
RPI adjustment	26.1	0.8	-	1.0	27.9
Disposals	-	-	-	(2.6)	(2.6)
Charge for year	61.8	1.7	-	5.9	69.4
At 31 March 2008	739.1	23.8	-	30.0	792.9
Net book value at 31 March 2008	1,108.9	24.0	5,493.4	45.6	6,671.9
Net book value at 31 March 2007	1,046.5	24.0	5,268.7	39.8	6,379.0

**4. TANGIBLE FIXED ASSETS (continued)**

Total	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
Gross Replacement Cost:					
At 1 April 2007	3,253.3	101.6	10,691.0	234.2	14,280.1
AMP adjustment	(1.4)	-	0.4	0.5	(0.5)
RPI adjustment	124.5	3.5	408.9	6.2	543.1
Disposals	-	-	-	(7.3)	(7.3)
Additions	101.7	0.3	72.2	26.6	200.8
At 31 March 2008	3,478.1	105.4	11,172.5	260.2	15,016.2
Depreciation:					
At 1 April 2007	1,405.8	51.2	-	99.9	1,556.9
AMP adjustment	(76.6)	(2.1)	-	(2.1)	(80.8)
RPI adjustment	54.4	1.9	-	2.8	59.1
Disposals	-	-	-	(7.3)	(7.3)
Charge for year	108.0	2.7	-	16.9	127.6
At 31 March 2008	1,491.6	53.7	-	110.2	1,655.5
Net book value at 31 March 2008	1,986.5	51.7	11,172.5	150.0	13,360.7
Net book value at 31 March 2007	1,847.5	50.4	10,691.0	134.3	12,723.2

Additions in the current cost fixed asset statements are shown net of infrastructure grants.

**5. WORKING CAPITAL**

	2008 £'m	2007 £'m
Stocks	2.5	2.7
Trade debtors:		
- measured household	11.1	12.7
- unmeasured household	29.5	22.6
- measured non-household	10.1	11.2
- unmeasured non-household	0.3	0.5
- other	7.8	5.6
Measured income accrual	36.4	32.4
Prepayments and other debtors	19.3	39.2
Trade creditors	(5.6)	(5.3)
Deferred income – customer advance receipts	(13.9)	(19.2)
Capital creditors	(41.0)	(46.1)
Accruals and other creditors	(44.4)	(44.0)
Total working capital	12.1	12.3

**6. MOVEMENT ON CURRENT COST RESERVE**

	2008	2007
	£'m	£'m
At 1 April	10,221.8	9,714.6
AMP adjustment	80.3	8.1
RPI adjustments:		
- fixed assets	484.0	568.6
- working capital	0.5	0.2
- financing	(46.2)	(65.5)
- grants and third party contributions	(3.4)	(4.2)
At 31 March	<u>10,737.0</u>	<u>10,221.8</u>

**7. RECONCILIATION OF CURRENT COST OPERATING PROFIT TO NET CASH FLOW FROM OPERATING ACTIVITIES FOR THE APPOINTED BUSINESS**

	2008	2007
	£'m	£'m
Current cost operating profit	179.8	174.7
Working capital adjustment	0.5	0.2
Movement in working capital	5.3	(8.0)
Current cost depreciation	124.9	111.8
Current cost profit on sale of fixed assets	(1.6)	(2.0)
Infrastructure renewals charge	54.4	37.2
Other non-cash profit and loss items	(30.3)	(12.6)
Net cash flow from operating activities	<u>333.0</u>	<u>301.3</u>

**8. ANALYSIS OF NET DEBT FOR THE APPOINTED BUSINESS**

	Interest rate risk profile			Total
	Fixed rate	Floating rate	Index linked	
	£'m	£'m	£'m	£'m
Maturity profile:				
Less than one year	19.5	80.1	1.1	100.7
Between one and two years	18.5	4.9	1.1	24.5
Between two and five years	41.7	66.4	3.6	111.7
Between five and twenty years	795.9	41.7	24.3	861.9
In more than twenty years	344.6	-	438.1	782.7
Total borrowings	<u>1,220.2</u>	<u>193.1</u>	<u>468.2</u>	<u>1,881.5</u>
Overdraft				11.7
Short term deposits				(183.1)
Net debt at 31 March 2008				<u>1,710.1</u>

**9. DISCLOSURE OF TRANSACTIONS WITH ASSOCIATES****Services supplied by the appointee to associated companies:**

Associate	Service	December 2007 or March 2008		Terms of Supply	2007/08 Value
		Turnover	£'m		
Vehicle Lease and Service Limited	Rental of garage and service charges	11.5		Negotiated	0.1

**Services supplied to the appointee by associated companies:**

Associate	Service	December 2007 or March 2008		Terms of Supply	2007/08 Value
		Turnover	£'m		
Northumbrian Water Group plc	Holding company charges	5.4		No market	0.6
Three Rivers Insurance Company Limited	Public liability insurance (deductible infill policy)	0.4		No market	0.4
Vehicle Lease and Service Limited	Vehicle maintenance and capital finance charge	11.5		Competitive letting	6.7

**Information in relation to allocations and apportionments**

The appointed and non-appointed businesses operate separate accounting ledgers including sales and purchase ledgers. Turnover, operating costs, assets and liabilities are taken directly from these ledgers.

Turnover is separately recorded between water services and sewerage services and no apportionment has been necessary. Operating costs have been allocated between water and sewerage services in accordance with the guidance set out in Regulatory Accounting Guideline No 4.03.

Overhead costs incurred in the appointed business which relate to the non-appointed business have been allocated using an activity based approach to comply with Regulatory Accounting Guideline No 5.04.

Interest has been allocated between the appointed and non-appointed businesses on the basis of actual cash balances held by these businesses during the year at market rates. Capital costs and the related depreciation charges are specifically identifiable to the appropriate business and service.

**Amounts borrowed by the appointee from associated companies**

The company has loans amounting to £1,435.8m due to NWF, a subsidiary company. Details of these loans and the associated guarantees are provided in note 20 of the statutory financial statements.

The company acquires vehicles from VLS, an associated company, on a finance lease basis. During the year, new finance leases of £3.8m were entered into and capital repayments of £2.7m were made. The year end finance lease creditor was £7.3m. All leases are at a fixed interest rate of 7%.

**Amounts lent by the appointee to associated companies**

NWL had short-term deposits amounting to £183.1m with NSL at the year end, representing surplus cash invested via the Group's treasury function.



**9. DISCLOSURE OF TRANSACTIONS WITH ASSOCIATES (continued)****Guarantees or other forms of security**

There were no guarantees or other forms of security provided by the appointee to any associate during the year, other than those relating to amounts borrowed from NWF, outlined above.

**Dividends paid and proposed**

During the year, the appointed business paid and proposed dividends to its immediate parent company, NSL, as follows;

	£'m
Dividends paid:	
Final paid for the year ended 31 March 2007	35.3
Interim paid for the year ended 31 March 2008	37.3
Total dividends paid in the year	<u>72.6</u>
Dividends proposed:	
Final proposed for year ended 31 March 2008	<u>37.5</u>

The dividends for the year, comprising the interim dividend of £35.3m and the final dividend of £37.3m, total £72.6m (2007: £70.5m). This continues the stated dividend policy of 1.9% real annual growth.

**Omission of right**

There were no omissions by the appointee to exercise any rights which would cause the net assets to decrease.

**Waivers**

There were no waivers by the appointee of any consideration, remuneration or other payment owed to it by any associated company.

The information in this note has been produced to comply with the requirements of RAG 5.04, "Transfer Pricing in the Water Industry" and the disclosures required by paragraph 6 of Condition F of the company's operating licence.

The directors confirm that, to the best of their knowledge, all appropriate transactions with associated companies have been disclosed.

**10. REGULATORY CAPITAL VALUE AT 2007/08 PRICES**

	<u>2007/08</u>
	£'m
Opening regulatory capital value	2,923.9
Infrastructure renewals expenditure (IRE)	35.8
Capital expenditure (excluding IRE)	188.6
Infrastructure renewals charge	(39.3)
Grants and contributions	(11.8)
Current cost depreciation	(118.8)
Out performance adjustment	(2.0)
Closing regulatory capital value	<u><u>2,976.4</u></u>
Average year regulatory capital value	<u><u>2,901.4</u></u>

Note the average year regulatory capital value is in the average year price base, all other figures are in the year end price base.

The numbers included above are taken from the Ofwat publication “Future Water and Sewerage Charges 2005-10 Final Determinations” published in December 2004 and are consistent with the publication RD07/08.

Differences between the above figures and actual capital expenditure, infrastructure renewals expenditure, infrastructure renewals charge, grants and contributions and current cost depreciation will not affect the price limits set for the period 2005-10. They will be taken into account in the calculation of out performance adjustments at the next Periodic Review in 2009.

**11. STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE**

The following statement on Directors’ remuneration is a requirement for the regulatory accounts in accordance with the Water Act 2003. This information is not required for statutory reporting purposes.

The directors’ remuneration policy is set by NWL’s Remuneration Committee (the Remuneration Committee) in conjunction with the Remuneration Committee of the Company’s ultimate parent company, Northumbrian Water Group plc (the Committee) and NWG’s appointed recruitment consultants, Hewitt New Bridge Street (HNBS). The remuneration policy is as follows:

- that the setting of base salaries is largely influenced by individual contributions and internal relativities rather than external comparators;
- the annual bonus plan recognises the interests of all of NWG’s stakeholders (shareholders, customers and employees) rather than being focused solely on profit; and
- management shares in the longer term value created for NWG’s investors, but equity incentives schemes should only reward if there is clear out performance of the market and other relevant companies.

During the year the Committee:

- agreed bonuses for 2006/07;
- agreed salaries for 2008/09;
- decided the vesting percentage to be applied to the LTIP awards made on 22 December 2004, which vested on 22 December 2007;
- granted LTIP awards on 13 December 2007 (to vest in December 2010); and
- set performance targets for executive directors and senior managers.

## 11.STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE (continued)

### Elements of remuneration

The remuneration of the executive directors comprises basic salary and benefits, including pension and participation in the SIP, all of which are fixed pay, and a performance related annual bonus and LTIP awards. The relative importance of the fixed and variable performance related elements is monitored and while the Committee recognises the importance of the performance related elements, it has not created a scenario where high levels of incentive pay promote risk taking in order to secure personal reward. For executive directors in 2008/09, on-target annual bonus is 35% of salary and the expected value of longer term incentives is 55% of salary. This is not a small sum, but is less than the executive directors’ total fixed pay.

The table below shows the remuneration paid by NWL to directors during the year. For those directors holding office with both NWL and NWG, costs are apportioned between the companies. This note reflects only the proportion of costs charged to NWL.

	Basic pay	Bonus	Other benefits	Fees	Total remuneration
	£’000	£’000	£’000	£’000	£’000
Sir D Wanless	-	-	-	75.0	75.0
J A Cuthbert	189.0	88.8	4.6	-	282.4
C M Green	147.0	69.1	5.5	-	221.6
G Neave	156.0	71.8	6.0	-	233.8
A C Jones	127.5	62.5	7.5	-	197.5
A G Balls	-	-	-	30.0	30.0
A M Frew	-	-	-	30.0	30.0
Dr S Lyster	-	-	-	30.0	30.0
Total remuneration	619.5	292.2	23.6	165.0	1,100.3

#### (i) Executive directors: basic salary and benefits

Basic salary is the only pensionable element of the executive directors’ remuneration package. The basic salaries payable to directors of NWL are not directly linked to standards of performance in connection with the carrying out of functions of a “relevant undertaker”. However, executive directors’ basic salaries and benefits are reviewed annually by the Remuneration Committee, taking into account the overall performance of the Company, advice from HNBS on market comparators and individual performance. Data received from HNBS over the years has consistently indicated that the Managing Director’s basic salary is significantly less than the market rate paid to his counterparts at other quoted water companies. When defining the market rate, the Committee has regard to the comparator group’s market capitalisation, turnover and complexity and adjustments are made to ensure that an appropriate comparison is made. However, John Cuthbert declined the Committee’s proposed salary increase in 2006 and 2007. This year he has accepted an increase and, as from 1 April 2008, his annual basic salary is £295,000 (previously £270,000). Chris Green’s salary, from 1 April, was increased to £225,000 (from £210,000) and, again, it was noted by the Committee that this is still below the market rate. Benefits provided to the executive directors include membership of a defined benefit pension scheme, car allowance and healthcare.

#### (ii) Annual bonus

The bonus arrangements for executive directors of NWL for 2007/08 were linked to NWL’s predicted performance in the Overall Performance Assessment (OPA), as well as the other measures described below.

The directors were entitled to bonuses of up to 70% of salary, relating to four components, as follows:

- up to 40% related to the profit before tax performance of NWG;
- up to 5% related to NWL’s predicted current year performance against industry performance taken from the latest published OPA results. The scale for calculating the 2007/08 bonus was 342-413 points, which was the reported industry performance for 2006/07;
- up to 5% related to time lost through sickness, calculated on a linear scale around the published target for the Company of 2.95%; and
- up to 20% related to personal targets.

**11.STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE (continued)****(ii) Annual bonus (continued)**

The potential 5% bonus in respect of predicted OPA performance is considered to be linked to NWL’s performance as a “relevant undertaker”. The Remuneration Committee confirmed on 28 May that no bonus would be payable against this measure reflecting the forecast score of 345 against a range between 342 and 413 points. The Remuneration Committee also confirmed that no bonus would be payable in respect of time lost through sickness, as the target was not met.

Of the personal targets, only those of Mr Neave and Mr Jones included targets directly linked to NWL’s performance as a “relevant undertaker”. Mr Neave’s targets related to the continued development of employee relations to improve performance and to ensuring that NWL is a high performer in the industry for levels of service, reputation and efficiency. Of the 20% available in respect of personal targets, Mr Neave was awarded 17%.

Mr Jones’ personal targets included ensuring the 2007 June Return process meets Ofwat’s expectation, in respect of data quality and corporate governance and developing a focused and coherent Strategic Direction Statement. Taking account of overall performance against his personal targets, the Remuneration Committee awarded Mr Jones the full 20% available in respect of personal targets.

Mr Cuthbert’s personal targets related principally to maintaining key financial ratios and measures, ensuring that good relationships are maintained with major investors, ensuring proper implementation of reporting under the Transparency Directive, implementing pension scheme changes and succession planning. Mr Green’s personal targets were focused mainly on the maintenance of key financial ratios and measures, relationships with major investors and analysts, disposal of surplus properties and upgrading financial systems. Of the 20% available in respect of personal targets, Mr Cuthbert and Mr Green were each awarded 18%.

Taking account of performance against personal targets and the OPA, PBT and lost time performance, bonuses equal to the percentages of basic salary indicated were approved for payment to Mr Cuthbert of 47%, Mr Green of 47%, Mr Neave of 46% and Mr Jones of 49%.

The purpose of linking the relevant standards of performance to remuneration is to encourage directors to ensure that achievement of the standards was given appropriate priority during the year.

The Remuneration Committee considered whether or not any portion of annual bonus should be deferred but its conclusion was that this was not appropriate at this time.

**(iii) Pension**

Directors participate in a defined benefit pension scheme which is not linked to NWL’s performance as a “relevant undertaker”. The executive directors’ pensions were modified with effect from 1 January 2008, in line with the changes proposed for the pension scheme as a whole, and the executive pension arrangements were closed to new entrants on that date.

## 11.STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE (continued)

### (iv) Long Term Incentive Plan

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Committee, annual conditional awards of shares in NWG. Details of the levels of award and performance conditions are shown in the table below.

#### Summary of LTIP awards and performance conditions

LTIP AWARD MADE 22 DECEMBER 2004	
Maximum award	75% of salary permitted. Actual grants to executive directors related to shares worth up to 40% of salary.
Performance conditions	Comparison of TSR with two comparator groups over three years: (1) 70% of award depends on the Company’s TSR performance against other listed water companies: AWG plc, Bristol Water Group plc, East Surrey Holdings plc, Kelda Group plc, Pennon Group plc, Severn Trent plc and United Utilities plc; and (2) 30% of award depends on the Company’s TSR performance against the FTSE 250 Index, excluding investment trusts. East Surrey Holdings plc de-listed on 28 October 2005 and Bristol Water Group plc de-listed on 18 May 2006. AWG plc de-listed on 21 December 2006. These companies have been left in the comparator group for the purpose of the awards and their performance was frozen on the date each company de-listed. This means that a constant TSR has been applied at each date after the de-listing.
Vesting schedules	(1) 30% vests at median performance with sliding scale based on ranking to 100% if the Company tops the group. Where the Company’s TSR performance is below the median performance of the comparator group, none of that element of the award will vest. (2) 30% vests if the Company's TSR equals the FTSE 250 Index, increasing to 100% if the Company's TSR outperforms the Index by at least 6%. Where the Company’s TSR performance is less than that of the Index, none of that element of the award will vest.
LTIP AWARD MADE 9 DECEMBER 2005	
Maximum award	75% of salary permitted. Actual grants to executive directors related to shares worth 70% of salary.
Performance conditions	As above, except Kelda Group plc de-listed on 12 February 2008. This also remained in the comparator group as described above.
Vesting schedules	(1) as above, but between median and upper quartile, the vesting will be calculated on a straight line basis comparing the Company’s TSR to that of the median and upper quartile positions, rather than ranking. (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance. Where the Company’s TSR performance is below the median, none of that element of the award will vest.
LTIP AWARD MADE 21 DECEMBER 2006	
Maximum award	75% of salary permitted. Actual grants to executive directors related to shares worth up to 70% of salary.
Performance conditions	(1) 50% of award depends on NWL’s return on capital employed relative to that of the other water and sewerage companies of England and Wales. (2) 50% of award depends on the Company’s TSR performance against the FTSE 250 Index, excluding investment trusts.
Vesting schedules	(1) 30% vests at median performance. At upper quartile or above return on capital employed, all of that half of the award will vest. Between median and upper quartile straight line pro-rating will apply. Where the Group’s return on capital employed performance is below the median, none of this element of the award will vest. (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance. Where the Company’s TSR performance is below the median, none of this element of the award will vest.

**11.STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE  
(continued)****Summary of LTIP awards and performance conditions (continued)**

LTIP award made 13 December 2007 and future awards	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth 100% of salary.
Performance conditions and vesting schedules	As per LTIP award made 21 December 2006.

The Committee, with advice from HNBS, has reviewed the LTIP and is still of the view that it remains the most appropriate equity incentive plan, particularly in the light of NWG’s dividend policy. Total shareholder return (TSR) remains an appropriate measure because it ensures that executives are rewarded fairly for value created for NWG’s investors.

For the awards granted on 13 December 2007 the three years to be reviewed are 2007/08, 2008/09 and 2009/10. Over the three year performance period, the return on capital employed will be calculated on a compounded annualised return basis.

In addition, awards will only vest if the Committee is satisfied that NWG’s TSR performance is consistent with the underlying business performance of NWG. An independent firm is engaged by the Committee to calculate the TSRs and to assess the extent to which the performance conditions have been met, so that the process is rigorous and transparent.

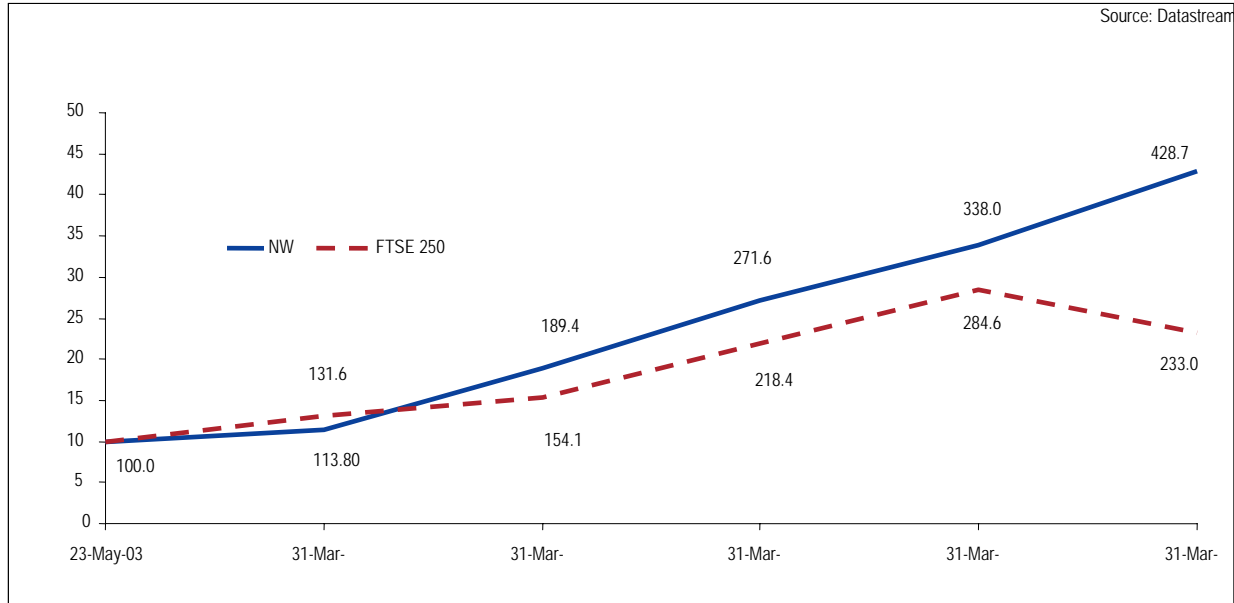
In the event of a change of control, the Committee would determine the extent to which the performance conditions had been met and the proportion of the performance period that had elapsed in deciding whether or not any vesting of awards would take place.

The LTIP award, granted on 22 December 2004, became available to vest on 22 December 2007. The Committee instructed PricewaterhouseCoopers (PWC) to assess the level of vesting of this award. PWC reported that 73% of the award was available to vest (being 100% of the award relating to NWG’s TSR performance against the FTSE 250 Index and 60% of the award relating to NWG’s TSR performance against the other listed water companies). Prior to vesting, the Committee satisfied itself that the recorded TSR performance was a genuine reflection of NWG’s underlying performance. Details of the number of awards which lapsed and those which were exercised by the directors of the Company are shown in the table on page 29.

## 11.STATEMENT ON DIRECTORS’ PAY AND STANDARDS OF PERFORMANCE (continued)

### Performance graph

The graph below shows a comparison between the TSR for NWG’s shares for the period 23 May 2003 (the date NWG’s shares were listed on AIM) to 31 March 2008, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as NWG is a constituent of the FTSE 250.



Note:

This graph shows the value, by 31 March 2008, of £100 invested in Northumbrian Water Group plc on 23 May 2003 (the date NWG’s shares were listed on AIM) compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

At its meeting on 21 November 2007, the Committee agreed to make conditional awards to Mr Cuthbert and Mr Green with a value equal to 100% of base salaries, and to Mr Neave and Mr Jones with a value equal to 60% of base salaries. The level of the awards was previously agreed in principle by the Committee, following detailed advice from HNBS. The awards were made on 13 December 2007. The higher level of awards to Mr Cuthbert and Mr Green recognises their additional roles as executive directors of NWG.

#### (v) Contribution to Remuneration by NWG

NWG contributes 30% of the cost of the basic salaries, benefits, bonus and pension of Mr Cuthbert and Mr Green. NWG also contributes 50% of the cost of basic salary and benefits of the Chairman. All costs of the LTIP and SIP arrangements, for directors and all employees, are borne by NWG.

#### (vi) Consideration of Ofwat Reports by Remuneration Committee

In assessing overall performance, the Remuneration Committee take into account the Company’s position in the Ofwat reports. The relevant performance data published by Ofwat is also used by Mr Cuthbert to assess Mr Neave’s and Mr Jones’ performance and this informs the bonus recommendation put to the Remuneration Committee.

#### (vii) Future Targets

For 2008/09, all four executive directors have personal targets which relate to NWL’s performance as a “relevant undertaker”. Mr Cuthbert and Mr Green both have personal targets which relate to the delivery of the agreed investment programme, delivery of regulatory outputs and improving efficiency. Mr Green also has a target relating to ensuring that NWL is positioned to respond to Ofwat’s proposals on accounting separation. Mr Neave’s targets relate to the management of the PR09 process, continued development of employee relations and ensuring NWL achieves high performance in the industry for levels of service, reputation and efficiency, reflected in OPA performance. Mr Jones’s relevant targets relate to the management of the PR09 process, production of the Water Safety Plan, health and safety and business continuity.

**DIRECTORS' RESPONSIBILITIES AND DECLARATIONS**  
**For the year ended 31 March 2008**

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The directors are responsible under Condition F of the Instrument of Appointment by the Secretary of State for the Environment of the company as a water and sewerage undertaker under the Water Industry Act 1991 for:

- (a) ensuring that proper accounting records are maintained by the Appointee to enable compliance with the requirements of Condition F and having regard also to the terms of guidelines notified by the Water Services Regulation Authority ("the Authority") to the Appointee from time to time;
- (b) preparing on a consistent basis for each financial year regulatory financial statements in accordance with Condition F, having regard also to the terms of guidelines notified by the Authority from time to time, which so far as is reasonably practicable have the same content as the annual financial statements of the Appointee prepared under the Companies Act 1985 and which are prepared in accordance with the formats, accounting policies and principles which apply to those financial statements;
- (c) preparing financial statements on a current cost basis in respect of the same accounting period in accordance with guidelines issued by the Authority from time to time;
- (d) preparing such other financial and related information as is required by Condition F having regard also to the terms of guidelines issued by the Authority from time to time.

**RING FENCING**

The directors confirm that, as at 31 March 2008, the company was in compliance with paragraph 3.1 of Condition K of the Instrument of Appointment by which the Appointee had available to it sufficient rights and assets to enable a special administrator to manage the affairs, business and property of the Appointee, should a special administrative order be made.

**OFWAT INSTRUMENT OF APPOINTMENT – CONDITION F6A.2A CERTIFICATE  
(FINANCIAL & MANAGEMENT RESOURCES TO CARRY OUT THE APPOINTED BUSINESS)**

The directors of Northumbrian Water Limited confirm that, in their opinion, the Appointee will:

- have sufficient financial resources and facilities to enable it to carry out for at least the next 12 months the Regulated Activities (including the investment programme necessary to fulfil the Appointee's obligations under the Appointment); and
- for at least the next 12 months, have available to it management resources which are sufficient to enable it to carry out those functions.

The directors of Northumbrian Water Limited confirm that, in their opinion, all contracts entered into with any Associated Company include all necessary provisions and requirements concerning the standard of service to be supplied to the Appointee, to ensure that it is able to meet all its obligations as a water and sewerage undertaker.

In providing this certificate, the Directors have taken into account the 2004 Final Determination, company performance during 2007/08, prospects for the period up to 2010, with particular reference to the next 12 months, and the fact that substantial pre-funding has been put in place in order to meet the capital investment programme in the period to 31 March 2010.

ON BEHALF OF THE BOARD

M Parker  
Company Secretary

14 July 2008



**INDEPENDENT AUDITORS' REPORT TO  
THE WATER SERVICES REGULATION AUTHORITY AND DIRECTORS OF  
NORTHUMBRIAN WATER LIMITED**

We have audited the regulatory financial statements of Northumbrian Water Limited (the company) for the year ended 31 March 2008 which comprise

- the regulatory historical cost financial information, itself comprising the regulatory historical cost profit and loss account, the regulatory historical cost statement of total recognised gains and losses, the regulatory historical cost balance sheet, the reconciliation between statutory accounts and historical cost regulatory accounts and the related note to the regulatory historical cost financial information numbered 1(a), and
- the regulatory current cost financial information, itself comprising the regulatory current cost profit and loss account for appointed business, the regulatory current cost balance sheet for appointed business, the regulatory current cost cash flow statement and the related notes to the current cost financial information numbered 1(b) to 11.

This report is made, on terms that have been agreed, solely to the company and the Water Services Regulation Authority (“the WSRA”) in order to meet the requirements of Condition F of the company’s Instrument of Appointment granted by the Secretary of State for the Environment to the company as a water and sewerage undertaker under the Water Industry Act 1991 (“the Regulatory Licence”). Our audit work has been undertaken so that we might state to the company and the WSRA those matters that we have agreed to state to them in our report, in order (a) to assist the company to meet its obligations under the company’s Instrument of Appointment to procure such a report and (b) to facilitate the carrying out by the WSRA of its regulatory functions and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the WSRA, for our audit work, for our report, or for the opinions we have formed.

**Basis of preparation**

The regulatory financial statements have been prepared in accordance with Condition F of the company’s Instrument of Appointment as a water undertaker, the Regulatory Accounting Guidelines 1.04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 2.03 (Guideline for the classification of expenditure), Regulatory Accounting Guideline 3.06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4.03 (Guideline for the analysis of operating costs and assets), and the accounting policies set out in note 1(a) to the historical cost financial information and note 1(b) to the current cost financial information and in the case of the historical cost financial information under the historical cost convention.

The regulatory financial statements are separate from the statutory financial statements of the company. There are differences between United Kingdom Generally Accepted Accounting Principles (UK GAAP) and the basis of preparation of information provided in the regulatory financial statements because the Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03 specify alternative treatment or disclosure in certain respects. Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, then they require UK GAAP to be followed. Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.

**Respective responsibilities of the WSRA, the directors and auditors**

The nature, form and content of the regulatory financial statements are determined by the WSRA. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the WSRA’s purposes. Accordingly, we make no assessment.

The directors’ responsibilities for preparing the regulatory financial statements in accordance with the Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03 are set out in the Statements of Directors’ Responsibilities. Our responsibility is to audit the regulatory financial statements in accordance with International Standards on Auditing (UK and Ireland), except as stated in the ‘Basis of audit opinion’ below and having regard to the guidance contained in Audit 05/03 ‘Reporting to Regulators of Regulated Entities’.

**INDEPENDENT AUDITORS' REPORT TO  
THE WATER SERVICES REGULATION AUTHORITY AND DIRECTORS OF  
NORTHUMBRIAN WATER LIMITED (continued)**

We report our opinion as to whether the regulatory historical cost financial information present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the company's Instrument of Appointment and Regulatory Accounting Guideline 2.03 (Guideline for the classification of expenditure), Regulatory Accounting Guideline 3.06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4.03 (Guideline for the analysis of operating costs and assets); and whether the regulatory current cost financial information has been properly prepared in accordance with Regulatory Accounting Guidelines 1.04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03. We also report to you if, in our opinion, the company has not kept proper accounting records as required by paragraph 3 of Condition F and whether the information is in agreement with the appointees' accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03.

We read the other information contained in the Regulatory Financial Statements, including any supplementary schedules on which we do not express an audit opinion, and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Regulatory Financial Statements. The other information comprises the Directors' Report and Operating and Financial Review and the Appendix to the Directors' Report and Operating and Financial Review.

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except as noted below. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the regulatory financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the regulatory financial statements and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the regulatory financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of regulatory financial statements are determined by the WSRA, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under Auditing Standards.

Our opinion on the regulatory financial statements is separate from our opinion on the statutory financial statements of the company on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory financial statements of the company (our Statutory audit) was made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our Statutory audit work was undertaken so that we might state to the company's members those matters that we are required to state to them in a Statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the company and the company's members as a body, for our Statutory audit work, for our Statutory audit report, or for the opinions we have formed in respect of that Statutory audit.

The regulatory historical cost financial statements have been drawn up in accordance with Regulatory Accounting Guideline 3.06 in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly that the relevant sections of Financial Reporting Standards 12 and 15 be disappplied. The effect of this departure from Generally Accepted Accounting Principles and a reconciliation of the balance sheet drawn up on this basis with that drawn up under Companies Act 1985 is given in the reconciliation between the statutory financial statements and the regulatory historical cost financial statements.

**INDEPENDENT AUDITORS' REPORT TO  
THE WATER SERVICES REGULATION AUTHORITY AND DIRECTORS OF  
NORTHUMBRIAN WATER LIMITED (continued)**

**Opinion**

In our opinion, the regulatory financial statements of the company for the year ended 31 March 2008 fairly present in accordance with Condition F of the company's Instrument of Appointment granted by the Secretary of State for the Environment to the company as a water and sewerage undertaker under the Water Industry Act 1991, the Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03 issued by the WSRA, and the accounting policies set out in note 1(a) to the historical cost financial information and note 1(b) to the current cost financial information, the state of the company's affairs at 31 March 2008 on a regulatory historical cost and regulatory current cost basis, the regulatory historical cost and regulatory current cost profit for the year then ended and the regulatory current cost cash flow for the year the ended, and have been properly prepared in accordance with those conditions, guidelines and accounting policies.

In respect of this information, we report that in our opinion:

- a) proper accounting records have been kept by the Appointee as required by paragraph 3 of Condition F of the Instrument of Appointment;
- b) the information is in agreement with the Appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA;
- c) the regulatory historical cost financial information present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the company's Instrument of Appointment and Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA;
- d) the regulatory current cost financial information has been properly prepared in accordance with Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA.

Ernst & Young LLP  
Registered auditors  
Newcastle upon Tyne

14 July, 2008