

ANNUAL REPORT &  
FINANCIAL STATEMENTS

06/07



## Our mission

To be a national leader in the provision of sustainable water and waste water services.

## NWG at a glance

### Northumbrian Water Group plc

Northumbrian Water Group plc (NWG) owns a number of companies which, together with NWG, form the Group. The largest of these companies, Northumbrian Water Limited (NWL), is one of the ten regulated water and sewerage businesses in England and Wales. NWL operates 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. Northumbrian Water currently provides water and sewerage services to 2.6 million people and Essex & Suffolk Water provides water services to 1.7 million people.

### Water and waste water contracts

NWG owns a number of special purpose companies which hold water and waste water contracts in Scotland, Ireland and Gibraltar.

### Related services

Analytical & Environmental Services Limited (AES) provided environmental monitoring services, analysis and technical consultancy to major industrial groups, environmental regulators and local authorities throughout the UK and Ireland during the year. On 31 March 2007, the business of AES merged with NWL and continues to operate as a trading division of NWL.

SA Agrer NV (Agrer) carries out project work in developing countries through a number of overseas aid funded agencies.



NWL's Barry Hook working at Horsley water treatment works in Newcastle upon Tyne.

## Highlights – continuing operations

£633.5m

Revenue 2007  
(2006: £591.5m)

£258.2m

Profit before interest 2007  
(2006: £236.2m)

£147.8m

Profit before tax 2007  
(2006: £130.3m)

£111.2m

Profit after tax 2007  
(2006: £91.0m)

- Total regulated capital investment for the year of £225 million; cumulative investment of £436.9 million over last two years, on track to invest £1 billion by 2010
- Customers to benefit from price changes from April 2007 to March 2010: decision taken by NWL not to increase prices by the full amount allowed by Ofwat at the last price review
- Continuing high levels of customer service and satisfaction
- Financial position strengthened by the issue of two £100 million index linked Eurobonds to finance capital investment through to 2010
- Proposed final dividend of 7.52 pence per share to be paid on 14 September 2007, giving a full year ordinary dividend of 11.27 pence per share, an increase of 6.7%
- Delivering regulatory outputs for drinking water quality and environmental improvement
- Water supplies maintained without restriction; resource management initiatives implemented, including plans for a projected 60% increase in capacity at Abberton
- Leakage targets achieved for eighth consecutive year
- Best ever bathing water quality results

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## Chairman's statement



**"As the business goes forward, our priority is long term sustainability and we all know we must do everything we can to achieve this for the business, our investors, customers and the environment."**

Throughout my career I have been interested in the environment and public health, and have been in no doubt about the central importance of water: for our health, and for our social and environmental well-being. I was, therefore, delighted to join the NWG Board in 2003 and my very positive initial view of the Company has been confirmed as I deepen my understanding of its values, what it does and the way it operates.

I became Chairman of NWG and of its core water services business, NWL, in July 2006, and look forward to guiding the Group through the challenges ahead for the benefit of our three key groups of stakeholders: our customers, our employees and our shareholders.

The Group continues to have a strong reputation and the Board believes this is important to the Group's ability to conduct business. Maintaining that reputation is a critical part of sustaining the legitimacy of the business in the eyes of customers and other stakeholders. A strong reputation and a high standard of service to customers build trust in the organisation.

During the past year, we have performed well against a wide range of internal and external measures. These are significant achievements set against the background of higher energy prices, which affect all areas of the business. I am particularly pleased to report that in our southern operating area we did not need to introduce water restrictions last summer. I would like to thank all our customers, who responded positively to our appeals to use water wisely and enabled us to maintain their supplies.

Maintaining a high level of well directed investment is vital to our continuing success. In June 2006, we secured further funding to enable us to deliver the high levels of investment planned up to 2010. With funding in place

and its strong performance, NWL's board decided not to increase prices by the amount allowed by the regulator at the last price review. The benefit to customers from 2007 to 2010 will be around £22 million.

NWG's revenue was £633.5 million for the year to 31 March 2007 and represents a 7.1% increase on the year to 31 March 2006.

Profit on ordinary activities before interest for the year was £258.2 million (2006: £236.2 million).

These results could not have been achieved without the skills and effort of everyone within the Group and I would like to record my thanks to them all.

At the Annual General Meeting (AGM) on 2 August 2007, the Board will recommend a final dividend of 7.52 pence per share for the year ended 31 March 2007. Together with the interim dividend of 3.75 pence per share, the dividend for the year will be 11.27 pence per share. This represents an increase of 6.7% on the ordinary dividend for the previous year in line with the dividend policy we



Sir Derek and Managing Director John Cuthbert at the WaterAid Platinum Partners Thank You Lunch.



*NWL's Peter Clark operating a control board at Seahouses sewage treatment works in Northumberland.*

announced in June 2005, which is to grow the dividend by around 3% per annum, before inflation, in the current regulatory period.

The Group has a significant impact on the environment and we are determined to continue to improve our environmental performance, building on much good work already done.

We need to be mindful of the effects climate change is expected to have on the water cycle. Of course, those effects cannot be predicted with certainty so we must prepare for an uncertain future, finding even more ways to improve the way we retain, recycle and distribute water. Our customers need to be confident that we will continue to supply excellent drinking water, while managing safe and efficient waste water processes.

We have embarked on a new investment programme and we are confident that we can manage the risks and uncertainties faced by the water industry. Our strategy to reduce energy use and the risks from the effects of climate

change is underpinned by the work we have already done and sets a clear direction for the future. We will continue to use technology effectively to improve customer service, drive costs down and improve efficiency.

The Group has sustained its focus on core competencies and merged the business of AES with NWL on 31 March 2007. We have brought together expertise from the two companies and are building on existing strengths to deliver an improved service.

In September 2006 Alex Scott-Barrett, a non-executive director of NWL, joined the NWG Board. Dr Simon Lyster was appointed to the NWL board in October 2006. He is a lawyer by profession, and is Chief Executive of LEAD International (Leadership for Environment and Development). On leaving Ontario Teachers' Pension Plan Board (OTPP) for another post, Ron Lepin resigned from the NWG and NWL boards on 1 December 2006. He was replaced by Claude Lamoureux, who is President and CEO of OTPP.

As the business goes forward, our priority is long term sustainability and we all know we must do everything we can to achieve this for the business, our investors, customers and the environment.

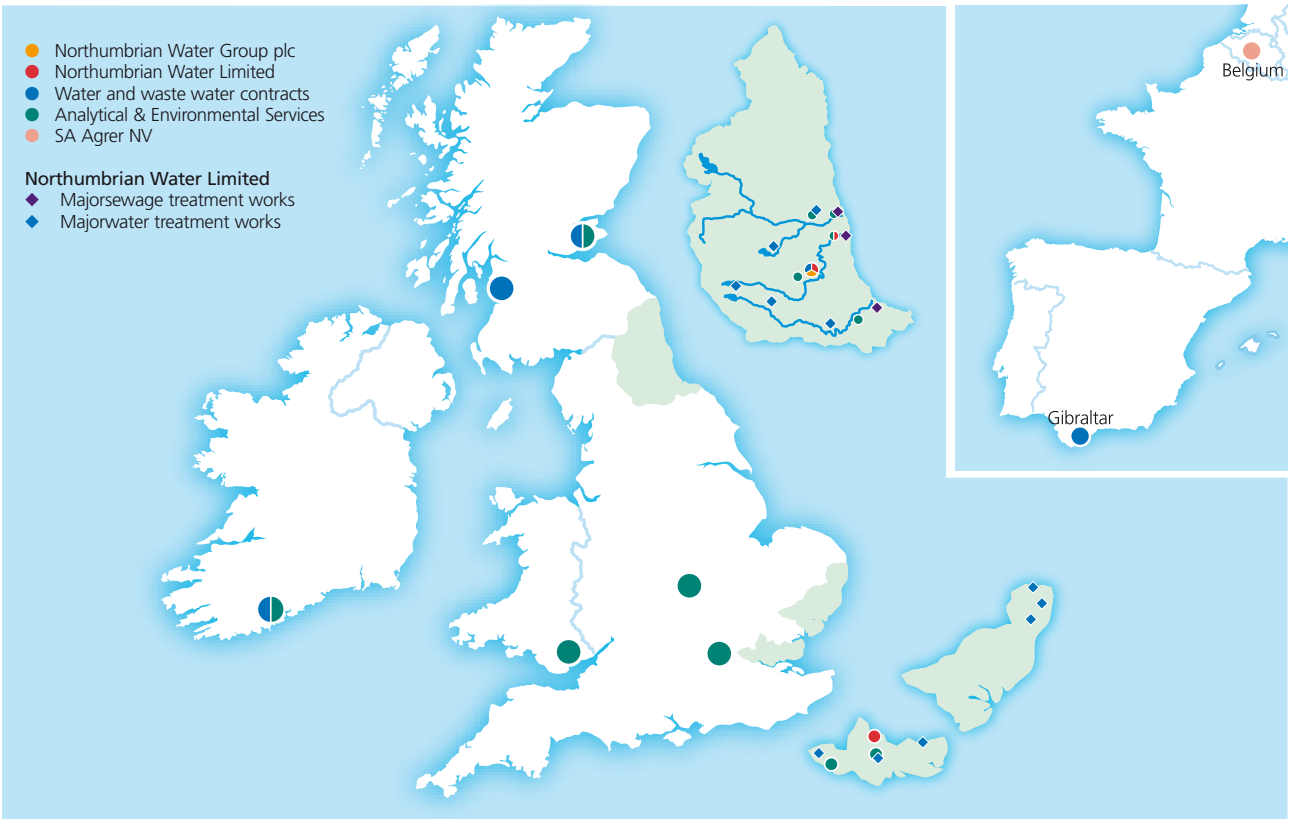
### **Sir Derek Wanless**

Chairman  
5 June 2007

# Directors' report and business review



Tunstall reservoir in County Durham.



The NWG directors are pleased to present their report on the affairs of the Company, along with the audited financial statements and the auditors' report for the year ended 31 March 2007.

**Directors**

The directors are Sir Derek Wanless, Sir Patrick Brown, John Cuthbert, Chris Green, Claude Lamoureux, Martin Nègre, Alex Scott-Barrett and Jenny Williams. All were directors of the Company as at 31 March 2007 and served throughout the year, apart from Alex Scott-Barrett, who was appointed on 26 September 2006, and Claude Lamoureux, who was appointed on 1 December 2006.

Sir Fred Holliday, who was Chairman of the Board on 1 April 2006, retired on 27 July 2006 and was succeeded as Chairman by Sir Derek Wanless. Ron Lepin was a director at the start of the year, but resigned from the Board on 1 December 2006.

In accordance with the Combined Code on Corporate Governance (the Combined Code) and the Company's Articles of Association (the Articles), two directors will retire by rotation and offer themselves for re-appointment at this year's AGM. Those directors are Sir Derek Wanless and Jenny Williams. In addition, Alex Scott-Barrett and Claude Lamoureux, having been appointed to the Board since the 2006 AGM, will offer themselves for appointment at this AGM. The directors' biographies are set out on pages 34 and 35.



*Hendon sewage treatment works in Sunderland.*

**Activities**

The principal activities of the Group during the year were the provision of water, waste water management and related services.



*NWL's Peter Winter using a thermal imaging camera which helps to detect faults.*

1 BUSINESS STRATEGY

2 OPERATING ENVIRONMENT

3 FINANCIAL PERFORMANCE

4 OPERATIONAL PERFORMANCE

5 RISKS AND RESOURCES

## Directors' report and business review *continued*



NWL's distribution technician Trevor Jobling using his PDA.

### Case study Work management

This programme is our flagship initiative to support the delivery of an even better service to our customers, while operating more efficiently and effectively.

For instance, through knowing the closest employee to an incident, and providing our office and field based employees with the right information at the right time, customers will be served better, the job completed sooner and the risk of a duplicate visit removed. In one area of the pilot, employees' mileage reduced by 34%, making a significant contribution to our efforts to respond to the challenges posed by climate change.

During the 'Work management' programme pilot, we fitted over 80 vehicles with Personal Digital Assistants (PDAs) combining satellite navigation and wireless links with the office. This simple device gives our customers a better service because:

- office employees see immediately where vehicles are and send the nearest one to a job;
- data is entered onto the corporate systems immediately so that both field and office based

employees have the most accurate and up to date information available to plan jobs and respond to emergencies; and

- data only needs to be entered once, freeing field employees from repetitive administration.

**"This is one of the best bits of kit I've had – apart from a flask! I have been working on creating the front sheets to make sure the essential information is keyed into the PDA. We used to have sheaves of paperwork to fill in, but now it is all done on the PDA, from tracking travel and arrival times, to risk assessment, carrying out the work and time sheets. I found the pilot a huge benefit – we could do more work in a day and it virtually did away with all paperwork. Now I'm looking forward to the next stage of the programme. I've seen the new PDA and it's even better!"**

Trevor Jobling is a distribution technician and has worked for NWL for 30 years.



# 1. Business strategy



Wear Valley water treatment works in County Durham.

Our mission is clear – to be a national leader in the provision of sustainable water and waste water services; our strategy reflects this and provides a clear direction for all of our activities.

NWG has a well developed strategy. It continues to focus on the Group's core competencies of water and waste water management, and aims to deliver value to all stakeholders by being a leading performer in the industry. All operations are geared to delivering efficient and effective outputs.

NWG is firmly rooted within the communities it serves. Our commitment to those communities is demonstrated by our leadership in initiatives such as 'Water for health' and in our approach to corporate responsibility.

To achieve the aspirations in our mission we focus on three strategic priorities:

To maintain our strong reputation and relationships by:

- creating shareholder value;
- delivering excellent service to customers;
- delivering regulatory outputs; and
- involving our 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:

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

Business planning is central to delivery of our long term objectives. It identifies how we will achieve our objectives and establishes the targets and principal actions against which business units are measured. Measurement focuses on key performance indicators (KPIs) set during the business planning process, which are linked to regulatory and business targets.

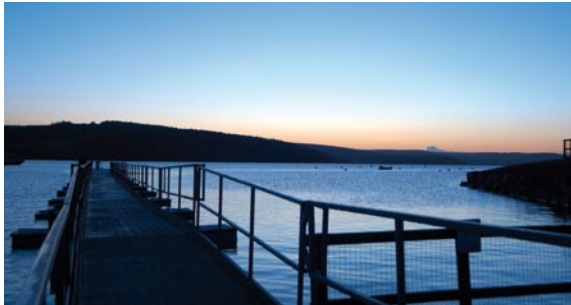
NWL is, by far, the largest of NWG's businesses and, like all UK water and sewerage companies, it is heavily regulated. Its success as a business depends on efficient delivery of its services and of quality improvements required by the Water Services Regulation Authority (Ofwat) in order to outperform the regulatory financial settlement.



Barkers Haugh sewage treatment works in Durham.

# Directors' report and business review *continued*

## 2. Operating environment



Dawn at Kielder Water in Northumberland.

### Geography

NWL operates in the north east and south east of England.

Its northern operating area is in a region of modest economic growth, which is considerably stronger now than in recent years. It has a declining industrial customer base and industrial demand for water, but a growing demand from domestic customers. It has well developed resources, such as Kielder Water, and these, coupled with above average rainfall in the region, enable it to meet expected demand. 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 contrast, NWL's southern operating area is in a region of rapid economic and population growth, although it too has seen a reduction in demand from heavy industry. This emphasises the importance of the company's well developed plans for resource development to meet additional water demand in a region where water resources are already constrained.

### Regulation

The UK water industry is highly regulated.

Ofwat, the economic regulator, has set NWL's price limits for the five years to 2010, using the following assumptions:

- annual average operating efficiency improvements of 1.2% for water and 2.0% for sewerage;
- overall capital maintenance efficiency improvements of 3.6% for water and 3.9% for sewerage (for the full five year period);
- overall capital enhancement improvements of 14.8% for water and 14.6% for sewerage (for the full five year period); and
- an industry cost of capital of 5.1% real, post tax.

For the second year of this five year period, NWL's operating costs were £7.2 million above Ofwat's

assumption, due to the increase in energy costs. Energy costs have since fallen by around 35% from their peak and, if this level is maintained, we expect to achieve Ofwat's efficiency targets in the remaining years to 2010. Prices in 2006/07 increased by 3.7% before inflation and for the next three years price limits will be:

Price limits per year	2007/08	2008/09	2009/10
% increase above inflation	2.8	nil	nil

This represents a reduction in the price limits set by Ofwat. Customers are to benefit from price changes in the period from April 2007 to March 2010 following confirmation from NWL that it will not increase prices by the amount allowed by Ofwat at the last price review. The cumulative benefit to customers from 2007 to 2010 will be around £22 million.

Market conditions have been favourable over the last 18 months and NWL has taken advantage of this and secured funding on attractive terms for the capital programme through to 2010. The benefit of this, together with the strong performance to date, informed the decision of the NWL board to limit increases in bills in 2008/09 and 2009/10 to RPI.

The price limit for 2007/08 of 3.2% has already been reduced to 2.8% and this is reflected in current bills. The price limits for 2008/09 and 2009/10, of 1.0% and 0.6% respectively, include financeability adjustments introduced to ensure companies could finance their functions with adequate financial ratios throughout the 2005 to 2010 period. These adjustments were to assist financing and were not available for distribution.

This has no impact on dividend policy and shareholders will continue to benefit from any outperformance.

NWL's Regulatory Capital Value (RCV), as advised by Ofwat, at 31 March 2007 was £2,817 million and for the next three years will be:

RCV at 31 March	2007/08	2008/09	2009/10
Outturn prices, assuming inflation of 2.5% per year (£ million)	2,940	3,047	3,127

Over the five years to 2010, NWL will invest around £1 billion.



*NWL's Jeff Robinson inspecting the hydro generator at Wear Valley water treatment works in County Durham (Richard Dove in the background).*

## Case study Climate change

Energy is vital to clean water, to deliver it to wherever it is needed and to treat it again after it has been used, and the water industry is the third largest user of energy in the UK. We have been working hard to reduce our carbon footprint as part of our normal business, with a particular focus on:

- work management system reducing mileage and creating efficient working (see case study on page 6);
- reducing tertiary ultra violet disinfection out of season;
- developing and implementing a sludge strategy: to introduce a sludge digestion process which would help power the plant at three smaller sites, initially, and then two larger sites, increasing our renewable energy by 20%; and
- generating renewable energy; hydroelectricity at Kielder Water, Derwent, Lartington and Wear Valley and biogas combined heat and power (CHP) at Stressholme, Hexham and Aycliffe.

We are working with independent experts to identify and understand the impact climate change will have on our business:

- Weather Intelligence has undertaken a Climate Change Readiness Assessment and found that NWL has a good understanding of the issues it faces as a result of climate change and has carried out a detailed impact assessment;
- working with Royal Haskoning and Newcastle University to understand the potential impact on our assets; and
- taking part in the DEFRA 'Making Space for Water' initiative and working with developers to find sustainable drainage solutions.

Our multi-faceted 'Water is precious' campaign encourages customers to use water wisely and to recognise that if they waste water, they also waste energy.

# Directors' report and business review *continued*

## 2. Operating environment *continued*



Hanningfield reservoir in Essex.

Ofwat also monitors levels of customer service, whilst the Environment Agency (EA) deals with environmental protection and the Drinking Water Inspectorate (DWI) monitors drinking water quality. NWL has good working relationships with them and with other regional organisations, such as local authorities, which have an interest in the services it provides and have regulatory powers that affect the company.

We are working with the EA to consider the drivers for investment beyond 2010, including the Water Framework Directive (WFD). The quality of rivers and bathing waters in the north east is among the best in the country and our initial view is that the investment required to comply with the WFD will be less than in many other regions. Nutrient removal, particularly phosphates, is likely to be an important factor, with ammonia also requiring attention in some cases. In order to achieve a cost effective programme and meet the 'polluter pays' principle, other sources of these pollutants must also be addressed. Removing the source of the problem, for example by changing farming or land management practice, may be cheaper but could take longer to deliver. We need to ensure that 'end of pipe' solutions are not viewed as an easy option. The Consumer Council for Water (CCWater), the independent body which represents customer interests, is also fully engaged in work with the EA and other stakeholders to develop a sustainable, coordinated approach to achieving environmental objectives.

It will be increasingly important to ensure an appropriate balance between marginal improvements in river quality and the energy, concrete and chemicals required to achieve this. In some cases the increased carbon footprint may outweigh the environmental benefit.

Through Water UK, we have worked closely with the EA in developing 'Together Towards Sustainable Water – a sector plan for water' which sets out a long term environmental vision for the water sector. This is due to be published later this year.

We are participating in the Northumbria River Basin Liaison Panel which is developing the plan to meet the WFD in the north east. This panel is currently considering the Significant Water Management Issues (SWMIs) for the region. Action plans to address the SWMIs will be a key element of the programme of measures to be agreed by 2008.

We have applied to the EA to have the consents for six coastal sewage treatment works (STWs) amended. These works discharge highly treated effluent through long sea outfalls. The final stage of treatment, ultraviolet (UV) disinfection, is energy intensive, contributing to significant CO<sub>2</sub> emissions. Our modelling concludes that bathing waters in the vicinity would meet not only EU Mandatory but also the stricter Guideline Standard, without UV treatment. We have applied to restrict UV application to summer months. This application raises important issues about achieving the right environmental balance and we await a decision.

NWL welcomes Ofwat's new duty to contribute to sustainable development. Many of the key challenges for the water industry have sustainable development at their core: implementing the WFD, developing long term maintenance strategies, balancing supply and demand, ensuring that bills remain affordable, and managing the effects of climate change. NWL will evaluate these issues in the context of wider social and economic considerations and as part of its corporate responsibility programme.

Regulators can play an important role in the water industry by incentivising sustainable approaches, but water companies must take the lead in promoting sustainable development both in their planning and operations. NWL will continue to make these responsibilities a high priority.

An important step leading up to the next price review in 2009 is NWL's Strategic Direction Statement. This is now being prepared and will outline a 25 year vision for the company, as well as key objectives for the next five years. The Statement will be published in the autumn and will be used as the basis for a stakeholder consultation exercise in each of our operating areas, which will in turn help inform the periodic review of prices in 2009.

The Water Supply Licensing regime has been slow to develop. NWL has agreed Wholesale Master Agreements with two new entrants but to date no customers have transferred.

In April 2007, Ofwat published the findings of its internal review of the current state of competition in the water industry. It is currently consulting on proposals that may help the current system to work more effectively. We will be responding to these proposals and will continue to make a full contribution to the debate on the role of competition in water and waste water services.

We welcome Ofwat's decision to launch a wider review of the opportunities for extending the scope for competition including the possibility of new legislation and more radical structural measures. We think it is right to engage in a full public debate on these issues.

In our view, any decisions on the role of competition need to be based on the best interest of customers. We regard competition as a means to an end rather than an end in itself. The essential characteristics of water supply make the process something of a natural monopoly so the scope for competition is likely to be less than in other utilities. However, there may be opportunities to expand competition beyond its current very limited level.

**Relationships**

The Group as a whole has a code of conduct covering its relationships with its customers, employees, suppliers, local communities, shareholders, other investors and regulators. NWG communicates regularly with its stakeholders in face-to-face meetings, by printed and electronic forms of communication and through the media.

**National**

NWL is an active member of Water UK, the industry association that represents all UK water and waste water service suppliers at national and European level. It provides a positive 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.

We also meet regularly with national, regional and local authorities and other appropriate organisations to explain NWL's activities and related issues.

**Political**

We do not support any political party and we do not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. 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 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 our activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during 2006/07 were as follows:

Organisation	£
Labour	7,585
Liberal Democrats	2,293
Conservative	2,303
<b>Total</b>	<b>12,181</b>

The expenditure reflects the representation of political parties in NWL's areas of supply. Shareholder authority to permit the Company to continue with these activities until the 2008 AGM will be sought at this year's AGM.

During the year, the Group's work with senior politicians of all parties, officials and opinion formers included making representations on issues that NWG feels are important to our customers and communities such as abstraction charges, Water for health, climate change, the WFD and legislative issues which could detrimentally affect our customers.

**Investors**

Communication with shareholders during the year is mainly through the annual and half yearly reports, and through information on the Company's website. The executive directors maintain regular contact with the Company's large institutional investors, as well as giving regular presentations to analysts and stockbrokers. During the year, the executive directors met 59 times with institutional investors, including a visit in March by institutional investors and analysts to some of our southern operational sites. Further information on NWG's shareholder relations is contained in the corporate governance report on page 40.

As at 5 June 2007, the Company had been notified of the following interests in 3% or more in the voting rights of its issued share capital:

	Number of shares	Percentage of share capital
Ontario Teachers' Pension Plan Board	129,655,961	25.00
Amvescap PLC	72,165,166	13.92
Pictet Asset Management SA	37,040,370	7.14

# Directors' report and business review *continued*

## 2. Operating environment *continued*



NWL's Paul Fairrie working in the northern customer centre.

### Domestic customers

Our relationship with our customers is central to the success of our services. Our reputation for providing value for money and working to maintain high levels of customer satisfaction has helped us achieve a positive response to our appeals to use water carefully. As a result, we did not have to impose restrictions on using water, even in the driest parts of our operating areas.

NWL tries to keep customers informed about its activities via direct communications sent with bills and an annual magazine called 'Source'. Customers directly affected by our works receive a note detailing the work, when it will be complete and the benefits of the work. Customers also have access to a range of information relating to the company's services, which is available on our websites at [www.nwl.co.uk](http://www.nwl.co.uk) and [www.eswater.co.uk](http://www.eswater.co.uk). These were re-launched in January and provide a more flexible source of information for customers, including details of activities in their area.

NWL also communicates with local communities through public meetings and written material when we need to explain the impact of work we are due to carry out.

### Business customers

We have regular meetings with the business community and its representative groups such as the CBI and Chambers of Commerce.

The north east has a strong industrial base and NWL has well-established relationships with its key industrial and commercial customers. The availability of both high quality potable and raw water together with access to reliable effluent treatment services is valued by existing customers and is also attractive to prospective investors in the region.

### Employees and employee policies

Each company within the Group has developed its own

employee policies reflecting the framework set out in NWG's Our Code of Conduct, which is available on the Company's website. These policies are tailored to specific business objectives and operating environments. Each company aims to recruit and retain the best people, with a diverse range of skills, experience and backgrounds, who are committed to making the company successful. In return, companies aim to provide opportunities and training for employees to develop their skills and capabilities to equip them to meet the challenges of their roles, while rewarding the contributions of both teams and individuals.

### Equal opportunities

The Group operates an equal opportunity policy and promotes equality of opportunity in recruitment, employment continuity and 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.

We give 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 our 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

Each company engages with its employees through formal consultation processes. These ensure that all employees understand and have the opportunity to discuss issues which affect the company.

### Training and development

All Group companies train and develop their employees to benefit both the company and the individual.

One of our aims is to develop leadership skills in current and potential managers, and NWL has introduced a Management Development Framework with the Newcastle Business School, part of Northumbria University. The five programmes will give potential leaders a path from a diploma to an Honours degree in leadership and management and ultimately, where appropriate, to a Masters degree.

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 Group's goals and policies.

NWL is recruiting for its new apprentice programme for electrical and mechanical apprentices. The four year partially funded programme will guarantee permanent jobs for apprentices who have successfully completed the scheme.

**Communication**

'Unplugged', the new Group magazine, was launched during the year and includes articles on activities and news from across the business, giving an increased focus on the people who work in the business and their achievements. The Group also uses a range of communication methods, including team briefing, magazines, newsletters, intranet, noticeboards and regular team meetings.



The new Group magazine 'Unplugged'.

**Whistleblowing**

The Group encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be unethical. The Audit Committee monitors the effectiveness of our Disclosure Policy and receives reports on any incidents.

**Health and safety**

A safe working environment is given a high priority across the Group. The health and safety policy is maintained and implemented through each subsidiary's individual health and safety team. The Group's medical advisor, Grosvenor Health, provides occupational health services.

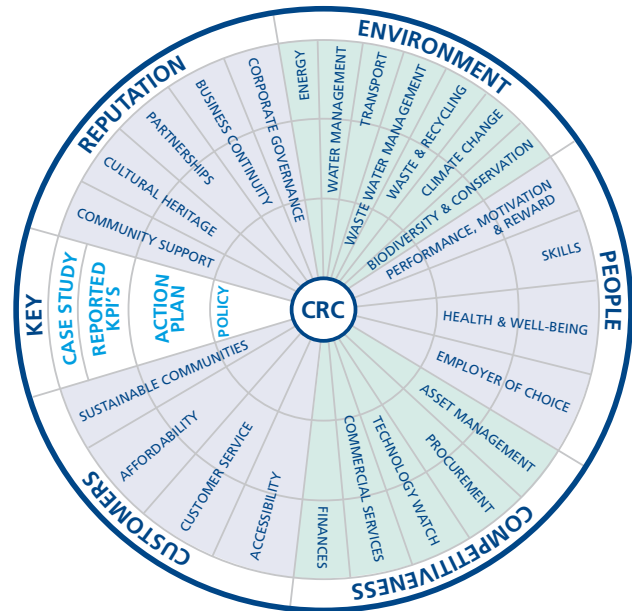
**Employee Share Incentive Plan (SIP)**

The directors believe that employee investment strengthens the ties between the Company and the Group's employees. More than a third participate in the SIP, with an interest in 0.34% of issued share capital. 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.

**Corporate responsibility**

NWG takes its corporate responsibilities seriously, aiming to balance social and environmental priorities. This approach underpins all our activities and is integral to the way we do business.

The Group has significant resources in its assets, land and employees and we believe we have a responsibility to use these resources for the benefit of customers and shareholders and the wider communities we serve.



During the year, we developed a model to help the business to focus on corporate responsibility as part of normal business practice.

NWG also replaced the Sustainable Development Committee with a new Corporate Responsibility Committee (CRC) with a wider remit. The new committee comprises directors, management team members and senior managers and will review policies, agree targets and the framework for activity in the model. Specialist working groups are responsible for investigating and advising on specific environmental, workplace, marketplace and community projects, such as climate change, energy use, transport and waste. The Managing Director is accountable to the NWL and NWG boards for the environment and sustainable development policies.

## Directors' report and business review *continued*

### 2. Operating environment *continued*

We are expected to provide a secure supply of water – a basic necessity for health – and to protect or enhance the environment when we return waste to it. However, our stakeholders also expect us to:

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

NWG helps its communities in a number of different ways and these are covered in different parts of the model shown on page 13. As well as financial support, employees are encouraged to volunteer and we provide facilities to help the communities in which we operate. These activities are mainly targeted to support projects that make the areas we serve better places in which to live, work or invest. The programme focuses on key themes throughout our communities but, increasingly, we are developing initiatives which promote lasting change in specific areas. Much of the programme is covered under the following titles in the model:

- community support;
- partnerships; and
- sustainable communities.

Examples include:

#### **Community support**

##### *Employees and volunteering*

Currently 35% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 3,300 hours to the community. The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments totalling £72,270 for our nominated charities: Great North Air Ambulance, Mencap's Dilston College, RNLI, St. Theresa's Hospice and the East Anglian Children's Hospice.

##### *Education*

Educational support materials have been developed during the year with the introduction of an interactive CD ROM 'Water made clearer' for schools which won a prestigious silver award from IVCA (International Visual Communications Awards).

We have also supported schools awards, which recognise excellence in schools in both operating areas.

#### **Partnerships**

##### *Water for health*

NWL is playing a leading role in the 'Water for Health Alliance' which is encouraging people to drink more tap water for their health. Over £200,000 has been provided to date for water coolers in schools and over 410 have

been supplied to date in nearly 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 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.



Dean Lawson from NWL's health and safety team presenting a cheque to the RNLI Sunderland as part of the 'Care for safety' scheme.



Sheryl Jones and Bruce Gardiner from NWL's southern area on a 'Just an hour' challenge to build a pergola at Sunnymede Junior School, Meadoway, Billericay.





FTSE4Good

**Environmental**

NWL has developed key partnerships to help the conservation of biodiversity on our sites. These involve agreed action plans and objectives for biodiversity and catchment management for individual sites. NWL's contribution to the partnerships includes funding of project officers. Current partnerships include:

- Northumberland Wildlife Trust – (Kielder and Bakethin);
- Durham Wildlife Trust;
- Essex Wildlife Trust – (Hanningfield);
- Broads Authority – (Lound and Trinity Broads); and
- Davy Down Trust.

**Sustainable communities**

NWG supports a number of programmes which are long term initiatives to bring about lasting change in the community and make them more sustainable.

**Community Foundations**

Endowment funds contributed by NWL over the last 15 years, totalling nearly £1 million, are held with the Community Foundations covering our areas of supply. These are long term investments with the income from the funds used to support community initiatives.

NWG has been a member of the Per Cent Club of Business in the Community (BITC) for a number of years. We maintain this membership by donating at least 1% of pre-tax profits to community investment projects through cash, employee time, and work in kind or use of facilities. NWG continues to be a member of the FTSE4Good Index and NWL was again ranked as one of the top 100 'Companies for corporate responsibility' based on an assessment of the widely recognised BITC indices. It achieved the highest possible award, platinum, for its community activities. These indices enable NWL to measure, manage and report its responsible business practice underpinned by a rigorous external review process. NWL has a 'Big Tick' Award for Excellence from BITC for integrating responsible business practice into mainstream operations for our 'Just an hour' scheme (Healthy Communities).

The Group made charitable donations totalling £128,555 during the year.



NWL's Claire Burn and Dave Lye after completing a 'Just an hour' challenge to repair the fountain at The Bowes Museum in County Durham.

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- 2 OPERATING ENVIRONMENT
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## Directors' report and business review *continued*

### Case study Corporate responsibility

NWG has a continuing commitment to support projects and organisations within the geographic areas in which we work and to contribute to the long term sustainability not only of our business, but also of the environment, society and communities we serve.

Corporate responsibility is integral to how we do business and as part of this commitment we are looking at different ways to work within our communities to promote lasting change on key issues.

We are 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 our chosen charity WaterAid.

#### Health

Census records show that Easington has one of the worst health records in the country.

In 2006, NWL reached an agreement with County Durham Primary Care Trust (PCT) giving them a 99 year lease on a redundant building at our Easington waterworks. We are working in partnership with the PCT, the District of Easington Council, the Neighbourhood Management Pathfinder and other stakeholders to refurbish the building which will re-open as a Healthy Living Centre in October 2007.

However, our commitment goes beyond providing the building.

There is a natural synergy between our own 'Water for health' campaign and the Healthy Living agenda, so we are devising new ways for NWL to work at a strategic level with the partners of the Healthy Living Centre.

We have already contributed research, marketing and communications support to create awareness of the Centre and understand local needs and have been involved in three events to promote healthy living, targeted at primary and secondary schools and day centres. This activity is supported by sponsorship of an innovative swimming programme run by the Amateur Swimming Association to promote physical exercise and an arts programme run by Creative Partnerships to use arts-based activities to change children's attitudes to eating and drinking, supported by research by the Centre for Arts and Humanities in Health and Medicine at Durham University.

Our contribution to the work of the Healthy Living Centre is a unique approach to tackling the poor long term health of the residents in Easington.



*Artist's impression (for illustrative purposes only) of the new academy at Castle View, Sunderland.*

#### Education

Sunderland City Council is pioneering its own model for academies as part of its wider Building Schools for the Future programme.

The 'Sunderland model' has been designed to meet the needs of Sunderland pupils and has evolved through successful partnership working in the city. In the 'Sunderland model', Northumbrian Water and two other leading north east based businesses will be lead sponsors, in partnership with Sunderland City Council and other co-sponsors. Each business will take the lead for one academy, which will specialise in a particular area of the curriculum.

The funding from sponsors and donors will go into a trust fund for 'educational disadvantage' and will not be used for capital costs as is the normal practice for academies. 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.

We are the lead sponsors for Castle View school in north Sunderland, which will have a business and enterprise specialism. We will be able to bring our expertise and network of contacts across the region to complement the curriculum and we will be able to guide, mentor and support staff and pupils to increase their understanding of business and enterprise. We can provide role models and an introduction to a wide range of employment opportunities because of the size and nature of our business; we can use our own employees and networks to provide help and support to meet the needs identified by staff or pupils. Our aim is to use our expertise to support academic and vocational attainment and help bring lasting improvement to this community.

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.

**Affordable housing**

The nature of our business means that we own large areas of land, often in rural areas. As part of our stewardship of that land we are exploring ways it can be used for the benefit of rural communities.

If we own land that can be developed, without affecting our core activity of maintaining and delivering a clean, safe, water supply, then we will give priority to providing affordable rural housing. This will contribute to the sustainability and vitality of rural communities and reduce the need for people to move to towns and cities for both housing and employment. If jobs can be retained in rural communities, then there is the complementary environmental benefit of reducing the use of transport and the associated carbon emissions.

NWL has supported HRH The Prince of Wales' Affordable Rural Housing Initiative since it was launched in 2003. The initiative is a partnership between BITC and key strategic organisations including The Housing Corporation, The Countryside Alliance and the Department for Communities and Local Government. We are leading the industry in this initiative and, together with BITC, have produced a guide to affordable rural housing which was launched by HRH The Prince of Wales.

As part of this commitment, we are now embarking on a housing scheme at Hanningfield in Essex and are identifying other opportunities for affordable rural housing in our supply areas.

We believe that any development should be based on sustainable principles, not least because of the effects housing can have on the water table, and are currently working with specialist environmental developers to create a best practice model for future developments.

**Economy**

**North East Enterprise Bond**

Our investment to the Bond is a five year loan, which will help fund the purchase and running of a number of 'Launch Pads' – dynamic, state of the art mobile vehicles that will tour the region to help trigger and encourage enterprise start-ups to make real, long term change. The Bond works in partnership with creative enterprise promoters such as Big Ideas, People into Enterprise and Newcastle Education

Business Partnership and they serve as a catalyst to help educate and inspire people to consider setting up their own business or social enterprise.

**NEL Growth Fund**

NWG has supported this investment fund to help smaller north east companies since its launch last year. The fund offers targeted loans and equity to companies struggling to raise finance from traditional sources, helping them grow and plan ahead with greater certainty for the future. It is a fast-track funding stream of between £50,000 and £350,000 into companies with high growth potential, with a maximum of £500,000 being invested in any one business.



NWL's John Mowbray meets HRH Prince Charles at WaterAid's 25th Anniversary Celebration.

**WaterAid**

NWL set itself the target of raising awareness of the overwhelming benefits the work of WaterAid brings to people in Africa. We wanted to raise awareness not just in this region but also at government level.

In 2006, we took a team of leading journalists and photographers from BBC NE and the north east daily paper, The Journal, accompanied by Kevan Jones MP, to Malawi to see the impact of WaterAid's work.

Malawi is the world's tenth poorest country. The average life expectancy is 39, daily income is £1 and inflation is 11%. The group were shown areas where WaterAid has been working and areas where there has been no intervention.

The subsequent media coverage kickstarted a fundraising campaign that has already raised over £60,000 and our aim is to develop our involvement beyond raising awareness and funds to increase our volunteering base from the regions we serve in the UK, to take some expertise overseas and bring lasting health benefits to other parts of the world.

## Directors' report and business review *continued*



### Case study NVQs

One of NWL's customer advisers Sonia Hewitson working in the northern customer centre.

The NWL People Plan 2006/10 was launched in 2006 and sets out clear objectives and actions over that period.

Three of the seven objectives of the plan are to:

- equip our people with the right skills for their current job and the next job;
- achieve and maintain high levels of performance and motivation; and
- recognise and reward our people for their achievement and contribution.

During the year, we introduced a pilot NVQ scheme in the Customer section of the business. In addition to the training they receive to meet our own standards, employees were able to work towards an NVQ level 2 or 3. The qualification was not essential for employees to carry out their role, but it provides them with a national qualification in recognition of the very high standards of work they carry out.

By March 2007, 70 employees had achieved their NVQ. This scheme is now being extended throughout Customer and in other areas of the business including,

for example, the introduction of the new Competent Operator standard in water production.

**"I did enjoy doing the NVQ. When I first saw what was involved it looked a bit scary. But once it was broken down into the different units I realised it was just about what I do every day. It made you stop and reflect on what you are doing. Getting away from the phones gave you time to think about the way you do things and why. It shows you just how much service you are giving the customer – and that's what it's all about.**

**It's good to achieve something and have a qualification to show that I can do my job. It's there if I want to do more."**

Sonia Hewitson has been a customer adviser since 2002 and completed her NVQ in November 2006.

## 3. Financial performance

### Key performance indicators (KPIs)

NWG uses many performance indicators to monitor its progress. For NWG, the KPIs are all financial and the non-financial KPIs relating to NWL are shown on page 22.

The definition, purpose and source of each KPI are shown on pages 32 and 33.

A summary of the Group's performance against the KPIs is set out below:

### Performance against financial KPIs

The financial performance of NWG and NWL is monitored against the same KPIs.



Bran Sands effluent treatment works in Teesside.

KPI	Target		Performance			
	NWG	NWL	Current year		Previous year	
			NWG	NWL	NWG	NWL
Gearing to RCV	<80%	<70%*	74%	65%	77%	66%
Cash interest cover	>2.5x	>3.0x	2.9x	3.6x	2.7x	3.3x
Cash flow to net debt	>13%	>13%	15%	16%	15%	17%

\* Less than 65% for the regulated business of NWL.

The increase in cash interest cover for the year reflects the positive cash effects of the index linked bond issuance since September 2005. More details are given in the capital structure section on page 21.

For the regulated business within NWL, gearing decreased from 58% to 57%.

The focus at NWL continues to be improving efficiency levels and driving down operating costs. Continuous improvement will be necessary to ensure the company is successful in meeting the targets set by Ofwat in its final determination of price limits for 2005 to 2010.

### Other measures and evidence

The Group prepares detailed medium term business plans and annual budgets, which are 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. On a monthly basis, management compares the actual operational and financial performance of each business with plan and budget and this is reported to the Board.

### Financial results and dividends

The Group's results and dividends are as follows:

	Year to 31.3.2007 £m
Profit for the year from continuing operations	111.2
Interim dividend paid (ordinary – 3.75 pence per share)	19.4
Final dividend proposed (ordinary – 7.52 pence per share)	39.0

Revenue was £633.5 million for the year to 31 March 2007 and represents a 7.1% increase on the year to 31 March 2006. This increase is mainly due to the uplift in water and sewerage charges to support continuing high capital investment as part of the regulatory price review in 2004.

Profit on ordinary activities before interest for the year was £258.2 million (2006: £236.2 million). Operating costs increased by £20.0 million (5.6%) to £375.3 million. At NWL, operating costs have increased from £320.9 million to £343.9 million, principally reflecting a significant increase in energy market prices and the full year impact of increased pension costs following an actuarial review of the pension scheme, in addition to the impact of inflation.

# Directors' report and business review *continued*

## 3. Financial performance *continued*



NWL's Alan Dixon and Mark McClean carrying out a mains repair.

Operating costs for the appointed business in 2006/07 are £7.2 million higher than those estimated in the 2004 final determination for the year due to energy costs. Within water and waste water contracts, the results include a credit of £3 million in respect of gas indexation on tariffs which is not expected to be repeated in 2007/08.

The net interest charge was £111.2 million (2006: £106.0 million). This charge includes a credit of £7.7 million (2006: £13.0 million) in respect of the amortisation of the debt fair value and a gain of £2.9 million (2006: nil) in respect of the cancellation of a financial instrument.

Profit on ordinary activities before tax for the year was £147.8 million, 13.4% higher than the previous year (2006: £130.3 million). The tax charge of £36.6 million (2006: £39.3 million) reflects increased profitability, adjustments in respect of prior periods arising from changes in claims for capital allowances, a revision to retirement benefits and a reduction in the amortisation of financing items. The effective tax rate for the year to 31 March 2007 was 25% (2006: 30%).

The Group's gearing has decreased from 77% to 74% of NWL's RCV, net debt increasing by £69.2 million to £2,079.6 million over the year. The decrease in the Group's gearing is principally due to the growth in RCV over the year from £2,624 million to £2,817 million at 31 March 2007. For the regulated business within NWL, gearing decreased from 58% to 57%.

Cash interest cover for the Group has improved from 2.7x to 2.9x in the year reflecting the positive cash effects of the index linked bond issuance since September 2005 (see page 19 for further analysis).

### Earnings per share and dividend cover

Basic and diluted earnings per share were 21.42 pence (2006: 20.45 pence) and 21.38 pence (2006: 20.42 pence) respectively. Earnings per share from continuing operations, adjusted for IAS 39, deferred tax and the amortisation of debt fair value, were 24.95 pence (2006: 19.52 pence).

The dividend cover for the year is 1.9x, and 2.3x (2006: 1.5x and 1.7x, including the special dividend) excluding deferred tax and the amortisation of debt fair value.

A final dividend of 7.52 pence per share for the year ended 31 March 2007 will be recommended by the Board to shareholders at the AGM on 2 August 2007 and, if approved, will be paid on 14 September 2007 to shareholders on the Company's Register of Members at the close of business on 17 August 2007. Together with the ordinary interim dividend of 3.75 pence per share, the ordinary dividends paid and proposed for the year will be 11.27 pence per share (2006: 10.56 pence per share). This represents an increase of 6.7% on the ordinary dividend for the previous year and is consistent with the Board's decision to maintain a progressive dividend policy with real increases of around 3% per annum. The board of our main subsidiary, NWL, has proposed a dividend policy consistent with the underlying assumptions adopted by Ofwat at its price review in 2004.

Northumbrian Water Share Scheme Trustees Limited, which at the date of this report held 716,917 shares to be used in the future to satisfy the vesting and exercise of awards under the Company's Long Term Incentive Plan (LTIP), has waived the right to all dividends on the shares it holds. Further details of the LTIP can be found in the directors' remuneration report on pages 43 and 44.

### Accounting policies

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS). This is consistent with IFRS as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2007.

### Purchase of the Company's own shares

During the year, and up to 5 June 2007, no market purchases have been made. The directors' authority to make market purchases of the Company's own shares expired at the 2006 AGM. The directors are not seeking to renew this authority.

### Capital structure

In June 2006, Northumbrian Water Finance plc (NWF), the finance subsidiary of NWL, issued two further £100 million index linked Eurobonds with real coupons of 1.7118% and 1.7484% and with maturities of 2049 and 2053, respectively. Index linked debt now comprises 18% of the gross debt portfolio, whilst fixed rate debt amounts to 65%.

On 28 June 2006, the Group redeemed the remaining £172 million 8.625% Eurobonds. The redemption was financed by the drawdown of £125 million of five year committed bank facilities with the balance coming from cash resources. The loans were taken on a variable basis with interest rates linked to LIBOR.

In March 2007, the latest £100 million EIB facility was drawn by NWL. The loan was advanced on a variable interest rate basis, with a 15 year maturity and an amortising principal repayment profile.

### Credit rating

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

### Treasury policies and objectives

The main purposes of the Group's treasury function are to assess the Group's ongoing capital requirement, to maintain short term liquidity and to raise funding, taking advantage of any favourable market opportunities. It ensures access to medium term committed back up facilities on a five year basis.

It also invests any surplus funds the Group may have, based on its forecast requirements and in accordance with the Group's treasury policy. On occasions, derivatives are used as part of this process, but the Group's policies prohibit their use for speculation. Full details are provided in note 21 to the financial statements. The Group is operating in compliance with its policies.

### Cash flows/liquidity

As noted previously, the Group has available substantial cash resources and undrawn committed bank facilities in order to maintain general liquidity.

### Pensions

The Group operates a defined benefit pension scheme providing benefits based on pensionable remuneration. As at 31 March 2007, there were 2,310 (2006: 2,351) active members. The surplus under IAS 19, at 31 March 2007, was £42.7 million (2006: deficit £3.7 million).

The Group is currently reviewing pension provision with the aim of introducing revised arrangements from 1 January 2008. Members as at 30 November 2007 would be eligible to participate in a revised defined benefit section and entrants would be eligible for a new occupational trust-based defined contribution scheme, with a choice of contribution rates.

The most recent triennial actuarial valuation, as at 31 December 2004, reported that the scheme was 97.6% funded and new employer contributions were recommended by the scheme actuary. The Group agreed an alternative proposal to make advanced payments of £36.1 million by April 2006 and £23.3 million by April 2007, covering both employee and employer contributions to 31 December 2010. In addition, the Group launched a salary sacrifice arrangement, on 1 April 2006, under which savings in employer national insurance contributions are also paid into the scheme.

The Group also operates an existing defined contribution scheme and, as at 31 March 2007, there were 248 (2006: 258) contributing members.

Further details of both schemes are disclosed in note 26 to the financial statements.

### Creditors

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 to the Company by its suppliers during the year and the amount owed to its trade creditors at 31 March 2007, was five days.



Selsset reservoir in Teesdale.

# Directors' report and business review *continued*

## 4. Operational performance

### KPIs

NWL use performance indicators to monitor progress. As well as the financial indicators shown on page 19, NWL use non-financial indicators throughout the business, which are reviewed by the management team each month.

The definition, purpose and source of the main KPIs are shown on pages 32 and 33.

### NWL performance against non-financial KPIs (unaudited)

	North (N) South (S)	Target 2007/08	Target 2006/07	Performance Current year	Performance Previous year
<b>Water</b>					
Water quality (%)	N/S	Maintain >99.9	Maintain >99.9	99.9	99.9
Leakage (Ml/d)	N	≤154.5	≤156.0	145.92	157.1
(Ml/d)	S	≤67.5	≤68.3	67.99	66.64
<b>Environment</b>					
Sewage treatment works (%)	N	100	100	99.8	100
Bathing waters Mandatory Standard (%)	N	100	100	100	97
Pollution incidents	N	116	181	142	201
<b>Customer – levels of service</b>					
Properties at risk of low pressure	N	274	274	298	312
	S	126	126	130	136
Properties subject to unplanned interruption of 6 hours or more (%)	N	0.14	0.14	4.57 <sup>1</sup>	0.39
	S	0.14	0.14	0.57	0.17
Properties subject to hosepipe bans at any time during the year	N/S	0	0	0	0
Population subject to sewer flooding incidents (overloaded sewers and other causes)	N	260	260	313	1,077
Properties at risk of sewer flooding incidents (once in ten years)	N	78	95	116	142
Properties at risk of sewer flooding incidents (twice in ten years)	N	51	60	229	162
Billing contacts responded to (within five working days) (%)	N	99.0	99.0	99.3	99.2
	S	99.0	99.0	99.2	99.1
Written complaints responded to (within ten working days) (%)	N	99.8	99.8	99.9	99.9
	S	99.8	99.8	99.9	99.9
Bills based on meter readings (%)	N	99.95	99.95	99.84	99.95
	S	99.95	99.95	99.94	99.97
All telephone lines busy (%)	N	2.0	5.0	0.2	0.8
	S	2.0	5.0	0.0	0.0
Abandoned telephone calls (%)	N	2.5	1.5	3.2	2.3
	S	2.5	1.5	2.3	1.2
<b>Customer satisfaction</b>					
Overall service (%)	N/S	Maintain	Maintain	91.75	93.00
Value for money (%)	N/S	Maintain	Maintain	87.00	88.50
<b>Employees</b>					
Lost time reportable accidents (per 1,000 employees)	N/S	6	8	8	7
Sickness absence (%)	N/S	2.95	3.00	3.01	3.12
Employee turnover (rolling %) <sup>2</sup>	N/S	–	Industry average 10.3	8.2	6.7

#### Notes:

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.



**Water**

NWL achieved its best ever drinking water quality results in 2006 and the quality of drinking water supplied in both operating areas remains among the best in the country. One of the DWI's key measures is Mean Zonal Compliance and NWL achieved 99.97% in the south and 99.96% in the north. Additionally, its Operational Performance Index was 99.99% in the south and 99.84% in the north.

During 2006/07, we completed significant improvements to water treatment works (WTWs) at Whittle Dene and Horsley, on Tyneside, and Chigwell in Essex. These works now have an additional treatment process to remove pesticides from raw water. Similar work at Warkworth in Northumberland will be completed in summer 2007. We also completed a major refurbishment of our Ormesby WTW in Suffolk.

One of NWL's key priorities is to reduce the amount of water lost from the networks. We agreed leakage targets with Ofwat of 156 MI/d in the northern operating area and 68.3 MI/d in the south, and both have been met. This means that leakage targets have been met consistently since 1998/99. The leakage in our southern operating area has been among the lowest in the country for many years. NWL aims to set best practice standards to reduce leakage and is playing a leading role in a review of leakage methodologies with the EA and Ofwat.

NWL has achieved national recognition for its work on water efficiency. This year Essex & Suffolk Water again won the Economic Research and Innovation prize at the EA National Water Efficiency Awards and also received a commendation for a project on domestic audits.



Construction work at Warkworth water treatment works in Northumberland.



John Cuthbert presenting at one of the 'Building our future' employee roadshows.



Clare Ridgewell and Tom Andrewartha from NWL's southern demand planning team with their water efficiency awards.

NWL's success in this area over the past ten years was recognised by the judges who presented the company with a special award. They commended the company for showing that water efficiency is not just a one-off project, but a constantly evolving organisational challenge. They praised the team's enthusiasm and tenacity in making water efficiency a core part of their company philosophy saying 'This is a unique record and really sets a standard for all other companies'.

Comprehensive repairs to the two water mains supplying Hexham in Northumberland, which had been washed away during the severe weather in 2005, are now complete. The solution involved building a tunnel several metres below the riverbed.

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## Directors' report and business review *continued*

### 4. Operational performance *continued*

In Essex, we laid 10.5km of pipeline to triplicate the strategic mains taking water from our Layer-de-la-Haye WTW and to improve the overall infrastructure. In addition, 477km of mains was renewed or relined. The current rehabilitation programme in the south is now complete and the work in the north is due to be finished in 2008. This work will help reduce incidents of discoloured water and also help further reduce leakage.

Over the years, NWL has carefully designed its systems to secure water supplies for its customers. This is particularly challenging in Essex, where there is limited water in the summer months. The Langford Recycling Scheme has improved the security of supply and can provide up to 30 ML/d of water during the summer months.

In the medium term, we plan to further improve the security of supply and augment resources in the Essex area by increasing the capacity of the Abberton reservoir, as outlined on page 30.

#### Environment

All 33 bathing waters passed the EU Mandatory Standard and, of these, 29 (88%) passed the more demanding Guideline Standard. Those passing the Guideline Standard are predicted to achieve good or excellent ratings under the new Bathing Water Directive, which is expected to take effect from the 2015 bathing water season. To maintain this high performance we are working with the EA to identify the impact of other stakeholders including local authorities, highway authorities, farmers and land holders on the quality of bathing waters.

The performance of the 425 STWs operated by NWL continued to be high with 99.8% of the population being served by works which met their consent standards.

We had one category 1 pollution incident in 2006 and the EA has commended NWL for achieving above average compliance with standards. The number of minor incidents, such as blockages, continued to fall significantly (by nearly 30%) compared to last year as a result of more proactive maintenance and our investment in remote monitors. We currently have around 450 monitors installed to warn of high or unusual flows, so that we can take action to prevent spillages and flooding.

NWL is working with other stakeholders in the region to reduce flooding and improve the way flooding incidents are managed. Regular meetings with CCWater, local authorities and local residents groups have helped to improve communication with affected communities.

In 2006/07, the number of properties flooded from sewers was 314, about the long term average. As a result of investment in improving the sewerage system, 129 properties were removed from the register of properties at risk of flooding during 2006/07. This takes the total to 228 properties, effectively delivering three years' outputs in two years.

During the year, 98 sewage overflows have been improved. This will improve local water courses, enhance their visual appearance and reduce pollution incidents.

#### Domestic customers

NWL is committed to providing a high standard of customer service that meets the expectations of both customers and regulators.

Based on information provided to Ofwat for 2006/07, NWL should remain in the top category for each Ofwat level of service indicator, with the exception of DG3, which covers unplanned interruptions to supply.



Abberton reservoir in Essex.



Langford water treatment works in Essex.

Performance here was affected by two major bursts, one in Middlesbrough on Teesside and one in Bedlington in Northumberland.

Although there has been a rise in written and telephone contacts, partly due to these bursts, the Customer Centre still responded to 99.9% of written complaints within ten working days. During 2006/07, the total number of written complaints received was 11,496. The increase, when compared to 2005/06, can be attributed to heightened national media interest in water shortages and leakage levels along with the large operational incidents in our northern operating area. Greater levels of debt recovery activity have also generated more responses from our customers regarding billing arrears.

CCWater formally reviews the quality of complaints handling. During this process they audit procedures, track samples of complaints correspondence through our systems and assess the quality of our responses. In 2006/07, all northern complaints and 80% of southern complaints were rated as 'good'.

Despite regional socio-economic characteristics, and increases in levels of water and sewerage charges during the year, NWL has maintained its collection rates, supported by its successful initiative to encourage as many customers as possible to use direct debit. This still proves to be the most efficient way to collect payment for bills.

### Business customers

NWL has continued to develop its commercial business with major companies in the region. Solvent Resource Management Ltd at its site in Sunderland, is recovering and recycling used solvents. Effluent from this process is now being delivered for treatment at Hendon STW.

Biofuels Corporation, the developer of Europe's largest biodiesel plant at Seal Sands on Teesside, is now transferring effluent to Bran Sands effluent treatment works. Biofuels Corporation produces 250,000 tonnes of biodiesel a year at Seal Sands from renewable vegetable crops. NWL also supplies the company with water services.

Corus has benefited from these effluent treatment services since 1998. NWL has successfully completed modifications to Bran Sands so that it can undertake additional effluent treatment for Corus. This has extended the long term relationship between the two companies.

### Leisure customers

There has been an increase in the number of visitor days as NWL has continued to develop its leisure facilities at strategic sites.

Events included:

- over 13,000 customers visited Kielder Winter Wonderland during November and December; and
- BBC Springwatch in May with over 6,000 visitors to Kielder.

NWL is the lead member of the Kielder Partnership, which consists of organisations committed to the economic development of the Kielder area through tourism, chaired by John Cuthbert. This year saw the launch of 'The Big Picture', a concept for the development of the area as a major visitor attraction which will further contribute to the economy of the Tyne Valley.

### Customer satisfaction

NWL carries out regular quarterly tracking surveys and during the year customer satisfaction levels remained very high, with 91.75% of our customers satisfied or very satisfied with the service NWL provides and 87% feeling it provides value for money.

Research with commercial and industrial customers showed that 91% are satisfied with the services provided and 85% believe that they are receiving value for money. In the case of managed account customers, these results increased to 97% and 90% respectively.

In our regular surveys, 93% of our leisure customers rated our services as good or excellent.

Customers have always been central to NWL's strategy and will continue to be so as we prepare for the next price review in 2009. NWL began customer consultation at the start of 2007, building on the results of its regular tracking surveys.

### 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. In addition, during 2007, we will seek certification to the international health and safety standard, OHSAS 18001:1999.

# Directors' report and business review *continued*

## 4. Operational performance *continued*

### Employees

Throughout the Group we have 3,040 employees, as set out below:

Group business unit	Average number of employees	%
Northumbrian Water Limited	2,554	84
Water and waste water contracts	153	5
Related services	333	11
<b>Total employees</b>	<b>3,040</b>	<b>100</b>

One of the strengths of NWL is employee loyalty, evidenced by the fact that employee turnover is relatively low at 8.2%, well below the UK water industry average of 10.3%.

Employees have access to the *mybenefits* scheme which provides a range of money saving benefits including tax efficient child care vouchers and discounted store vouchers. This year also saw the launch of a Christmas Savings Scheme. Currently 20% of employees participate in the *mybenefits* scheme, up from 17% last year.

NWL continues to seek the views of employees. This year's survey was completed by 56%, an increase of 7%, 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 72% of respondents stating they are proud to work for the company.

The Group currently has a final salary pension scheme with 2,310 active members at 31 March 2007. In 2006 the Board announced a review of the scheme and a Pensions Working Group was formed, comprising employee representatives, management representatives, and full-time union officers to discuss options.

The views from the Pensions Working Group were presented to the Board in January 2007 and at the end of March 2007, the Company proposed pension scheme changes for current members and a defined contribution scheme for new entrants from 1 January 2008.



Kriss Akabusi at the NWL Skills Awards which celebrates employees' academic achievements.



NWL's Alistair Baker (right) receives the Chartered Institute of Public Relations (CIPR) award for the best charity campaign in the UK 2006/07 for 'WaterAid in Malawi'.

### Training and development

During the year, NWL introduced a pilot award scheme in the Customer Centre to enable employees trained to NWL standards to achieve an NVQ level 2 or 3. By March 2007, 70 employees had attained their NVQ. See case study on page 18.

### Health and safety

The emphasis on health and safety within NWL has resulted in major improvements to our safety record in recent years. This year lost time reportable accidents equalled our best performance of eight per 1,000 employees. This has been accompanied by a further reduction in days lost through accidents.



Louise McCormack from AES performing settled solids analysis.

We continue to develop programmes to promote healthy eating and discourage smoking in our workforce and offer excellent health screening and medical insurance schemes. Around 1,700 employees have been through our health screening and fitness standards programmes, both of which now include lifestyle advice elements. The success of these programmes has helped reduce NWL's total sickness absence rate to 3.01%, which is well below the sector norm.

**Research and development**

We run a programme of research and development linked to UK business 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 Group invested £2.1 million (2006: £2.3 million) in research and development.

**Water and waste water companies**

The Group is a member of two consortiums delivering private finance initiative contracts with Scottish Water for waste water treatment. At Levenmouth, where the Group has a 75% shareholding in both project and operating companies, the effluent treatment plant is delivering against discharge consent conditions. Practical completion of the odour treatment and sludge drying facilities has been achieved and commissioning and performance testing has been completed.

At Ayrshire, the Group has a 75% shareholding in the project company and a 100% shareholding in the operating company. The three effluent treatment plants that make up this contract continue to perform satisfactorily.

In Ireland, the Group is part of a contractual consortium that designed and built a waste water treatment plant for Cork City Council. Under the consortium agreement, the Group has responsibility for the operation and maintenance of the plant.

AquaGib Limited, two thirds owned by the Group in joint venture with the Government of Gibraltar, operates Gibraltar's dual drinking water and sea water distribution systems under its long term contract with the Government of Gibraltar.

**Related services companies**

UKAS gave AES its best ever audit results in 2006. It achieved multi-site UKAS Accreditation for all laboratory related activities and UKAS Accreditation for the Acoustics Section.

During the year, AES won new contracts with blue chip clients including Marks & Spencer, the Ministry of Defence, Northern Ireland Water Service, Anglian Water (Hartlepool) and Newcastle University, and won new clients in the growing incineration industry. AES is one of four laboratories authorised to work for Secondsite Properties (British Gas).

AES has refurbished its laboratories at Horsley and Howdon and the occupational hygiene and acoustic consultancy sections opened an office in Huddersfield to service customers in the West Yorkshire and North West regions.

On 31 March 2007, the AES business combined with the NWL water and waste water compliance teams to form a new Scientific Services division within NWL.

During the year, Agrer signed contracts for 29 new projects across a diverse range of sectors around the world.



Inverclyde waste water treatment works, part of the Ayrshire consortium.

## Directors' report and business review *continued*

### 5. Risks and resources

All subsidiaries within the Group identify and assess the impact of risks to their business. The Group uses a model that identifies risks under five headings – environment, external, operations, finance and reputation. For each risk the unmanaged and managed likelihood and consequence are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed.

NWL has set measures to enable it to determine whether the risks are significant to the business. The NWL management team reviews the model in detail every year to ensure that the inclusion and assessment of each risk is still appropriate. The NWG and NWL audit committees consider the outcome of this review. In addition, the NWL board considers the management of significant risks at each of its meetings.



NWL's John Fielding at Howdon sewage treatment works in Tyne and Wear.



NWL's senior ranger Dave Rounce on patrol at Hanningfield reservoir in Essex.

Apart from NWL, none of the subsidiaries has risks considered to be significant to the Group's short and long term value. The NWG Board considers social, environmental and ethical risks as outlined in the corporate governance report on pages 39 and 40. Details of the Group's treasury risks are contained in note 21 to the financial statements.

#### Changes to the regulatory environment and to legislation

Significant changes are occurring in economic, environmental and quality regulation.

The EA, as part of its Modern Regulation agenda, is moving to a more risk-based regulatory approach. While we support the principle, we expressed some concerns about the proposed timing and some of the detailed changes proposed in the EA consultation papers. We are pleased to note that the EA has responded positively to consultation responses.

The DWI, too, has adopted a risk-based approach. Our response to its consultation on the revisions to the Drinking Water Regulations noted that much depends on the guidance supporting the Regulations, which are yet to be issued.

We believe Ofwat should also adopt a risk-based approach. We recognise that Ofwat had to respond to misreporting issues in the sector and fully accept that all companies must give top priority to ensuring the regulatory data is of the highest quality and credibility. We believe the industry and Ofwat should now explore how regulatory data can be streamlined and simplified to improve regulatory processes.

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

- Traffic Management Act to be implemented (April 2008); and
- transfer of private sewers which will increase the sewers owned and maintained by the company by about 50% (out to consultation).

#### Changes to weather patterns and their impact

The Group's main business, the provision of water and sewerage services, is closely linked to the water cycle and is, therefore, influenced by the vagaries of the British weather. NWL is skilled and experienced in managing the impact of having too little and too much rainfall. These changing weather patterns are likely to continue to present an operational challenge.



Essex water wise gardener Terence Gandy with his collection of water butts.

**Case study**    **Water resources**

Searching for new ways to improve how we retain, recycle and distribute precious water resources in our regions is a key part of the business.

Water resources in the south are not scarce, but Essex is the driest county in the UK. We need to avoid waste, reduce leakage and seek the highest standards throughout both our regions.

The demand for water in Essex is forecast to increase in the medium/long term and this, coupled with the uncertainties of climate change, creates a unique challenge for NWL. We need to plan demand management and water resource development – only 50% of the water for Essex is sourced from within the area in a dry year.

We focus on three main areas to influence demand for water:

- reducing leakage – we have achieved a significant reduction over the past 11 years;

- water efficiency – we created a range of specific initiatives for our domestic customers. As a result of our work in this area we are now acknowledged industry leaders for promoting water efficiency; and
- metering – about 40% of domestic customers in Essex now use a water meter.

Customers in Essex will benefit from plans to further develop water resources. We are adopting a responsible and pragmatic approach to the need for long term planning to secure water resources in Essex:

- the innovative Langford Recycling Scheme has been helping to maintain water levels in our reservoirs since 2003. It provided 12% extra water in the Hanningfield reservoir during summer 2006; and
- we are making progress with our plans to increase the Abberton reservoir near Colchester by 60%.

## Directors' report and business review *continued*

### 5. Risks and resources *continued*



*Graham Robinson, one of NWL's electrical apprentices.*

As part of NWL's corporate responsibility model, research has been carried out into the impact of climate change on assets and water resources and a Climate Change Policy has been developed. NWL is monitoring its carbon footprint and opportunities to reduce this are being pursued (see case study on page 9). The water industry is one of the largest users of energy in its processes and we are working to inform customers about the energy wasted when water is wasted.

#### **Social, environmental and ethical risks**

The principal social, environmental or ethical risk considered to be significant to the value of the Group is the possibility of the removal of the opportunity to use 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. However, NWL's existing contract with Lafarge to use sewage sludge pellets as a fuel replacement in cement manufacture, gives NWL a viable alternative way of disposing of sludge in the medium term.

#### **Water resources**

Following a wet winter, our reservoirs are in a strong position at the time of writing this report. NWL has sufficient water reserves in its northern area, largely due to Kielder Water and the ability it provides to augment the major rivers in the area during periods of drought. Its southern area is in one of the driest parts of the UK and rainfall, until recently, has been low since November 2004.

In Essex, NWL did not need to introduce a hosepipe ban during the drought which affected supplies across much of south east England during 2006. Our investment to reduce leakage, our ability to pump water from Norfolk via the Ely Ouse to Essex Transfer Scheme and the water available from the innovative Langford Recycling

Scheme, helped maintain our reservoir levels. The Langford Recycling Scheme provided 12% extra water in Hanningfield reservoir last summer.

Our ongoing and long running water efficiency promotions and good relationship with our customers produced a positive response to our requests for additional efforts on water saving and a consequent significant reduction in demand.

Metering has an important role to play in managing demand. In addition to our optional metering scheme, we have introduced a successful scheme to install water meters when properties are sold in the Essex area and we now have about 40% of domestic customers in Essex on a metered supply.

Alongside these important measures to manage demand, we believe that we need to augment water resources in the south to secure water supplies for customers in what is one of Britain's driest regions. During 2007, we will be applying for planning permission for a project that will increase the capacity of the Abberton reservoir near Colchester by 60%.



*A new roof being put onto Lodgewood water tower, near Walpole in Suffolk.*



**Directors’ remuneration and interests**

Information about directors’ remuneration and their interests in the shares of the Company is contained in the directors’ remuneration report on pages 41 to 49.

**Indemnification of directors**

The Company has in place directors’ and officers’ insurance and, on 28 November 2005, entered into a deed of indemnity to grant the directors 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 as at the date of approving the directors’ report and business review. The deed, together with directors’ service contracts, will be available for inspection by shareholders at the AGM, or from the Company Secretary.

**Annual General Meeting**

The notice convening the AGM, to be held on 2 August 2007, was sent to shareholders with this report, together with an explanation of the business to be conducted at the meeting, and a form of proxy.

**Auditors**

Ernst & Young LLP have indicated their willingness to continue in office and a resolution proposing their re-appointment as auditors will be put to shareholders at the AGM.

**Financial statements preparation and going concern**

The directors consider that it is appropriate to prepare the financial statements for the financial year on a going concern basis. The directors have arrived at their decision based on consideration of the Company’s detailed budget for 2007/08 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 business plan.

**Directors’ declaration**

As required under Section 234ZA of the Companies Act 1985, so far as each current 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.

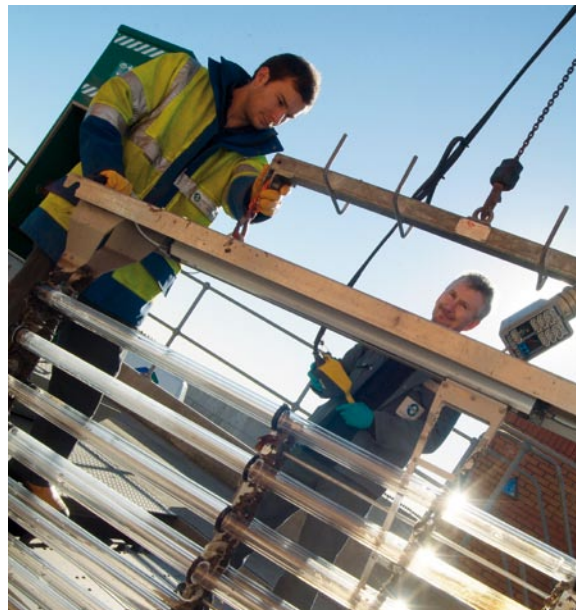
By order of the Board

**Martin Parker**  
Company Secretary  
5 June 2007

Registered office: Northumbria House, Abbey Road, Pity Me, Durham, DH1 5FJ  
Registered in England and Wales No. 4760441



Secretary of State for Environment, Food and Rural Affairs, David Miliband MP and NWL’s John Mowbray at the launch of Exploring Your Environment (EYE), which aims to encourage everyone to get actively involved in learning about and safeguarding the environment.



NWL’s Neil Haswell and Michael Grimes carrying out planned 12,000 hour lamp changes on the UV plant at Hendon sewage treatment works in Sunderland.

# Appendix to the directors' report and business review

## Group financial KPIs

### Gearing to RCV

**Definition and calculation:** The ratio of Group net debt to NWL's 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 Group 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. Group net debt is disclosed in the audited financial statements.

### Cash interest cover

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

**Purpose:** Measures the ability of the Group 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 Group'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.

## NWL financial KPIs

### Regulatory gearing

**Definition and calculation:** The ratio of NWL net debt to NWL's 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 Group 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. NWL's net debt can be found in the audited regulatory accounts and Ofwat annual reports on financial performance.

## NWL non-financial KPIs

### 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.

## NWL non-financial KPIs *continued*

### 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 Environmental 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 NWL's coastal treatment works on the environment.

**Source of underlying data:** Information recorded and reported by the 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 NWL's sewerage system and its impact on the environment.

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

### Customer

#### 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 performance of NWL.

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

#### 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.

### 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 number of accidents reported in 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 are held within the Human Resources Management System – reports show leavers against headcount.

## Board directors' biographies



### 1. Sir Derek Wanless Chairman

Sir Derek Wanless was appointed to the Board as an independent non-executive director in December 2003. He was appointed to the board of NWL in January 2006, and in July 2006 became Chairman of NWG and NWL following Sir Fred Holliday's retirement. He became a director of National Westminster Bank plc in 1991 and its Group Chief Executive in 1992. He retired from this position in 1999. In 2002 and 2004, he reviewed and reported on trends affecting health services for the UK Government. Sir Derek is currently a non-executive director of Northern Rock plc, Vice Chairman of the Statistics Commission and a member of the Board for Actuarial Standards at the FRC. Sir Derek chairs the Nomination Committee and is a member of the Remuneration Committee.

### 2. John Cuthbert Managing Director

John Cuthbert was appointed to the Board in May 2003. John joined the water industry in 1991 and was appointed Managing Director of North East Water plc in 1993. Following the acquisition of the former Northumbrian Water Group plc by Lyonnaise des Eaux in 1995, he transferred within the Group to become Managing Director of Essex and Suffolk Water plc. John took over as Managing Director of the former Northumbrian Water Group plc, and also of Northumbrian Water Limited, in 2001. John is a member of the Nomination Committee.

### 3. Chris Green

#### Finance Director

Chris Green was appointed to the Board in May 2003. Chris joined the former Northumbrian Water Group plc in January 1990 and was initially involved in its diversified business activities before being appointed as Finance Director in 1997. Chris was appointed as Finance Director of Northumbrian Water Limited in April 2000 following the merger of that company with Essex and Suffolk Water plc.

### 4. Sir Patrick Brown

#### Senior Independent Non-executive Director

Sir Patrick Brown was appointed to the Board in May 2003 and to the board of NWL in January 2006. He held various positions in the Department of Transport and the Department of the Environment, becoming Second Permanent Secretary and Chief Executive of the Property Services Agency in 1990. He was Permanent Secretary for the Department of Transport from 1991 to 1997. Sir Patrick became a non-executive director of the Go-Ahead Group plc in 1999 and its Chairman in 2002, a post that he still holds. In 2004, Sir Patrick was appointed non-executive Chairman of Amey plc and Amey UK plc. Sir Patrick chairs the Audit Committee and is a member of the Nomination and Remuneration Committees.

### 5. Claude Lamoureux

#### Non-executive Director

Claude Lamoureux was appointed to the boards of NWG and NWL on 1 December 2006. He is President and CEO of the Ontario Teachers' Pension Plan Board (OTPP). Previously, he spent 25 years as a financial executive with Metropolitan Life in Canada and the U.S. He also serves on the boards of the Ontario Securities Commission Investor Education Fund and the Canadian Institute of Chartered Accountants. Claude is a co-founder of the Canadian Coalition for Good Governance and chair of the Accounting and Auditing Practices Committee of the International Corporate Governance Network. OTPP holds 25% of the issued share capital of Northumbrian Water Group plc and Claude is, therefore, not regarded as an independent director.

### 6. Martin Nègre

#### Independent Non-executive Director

Martin Nègre was appointed to the Board in May 2003 and to the board of NWL in January 2006. He was, between April 2000 and April 2001, the CEO of the former Northumbrian Water Group plc and the chief corporate representative of its parent company, Suez, in the United Kingdom. He is currently the Chairman of Ecofin Global Utilities Hedge Fund Limited, an Irish Stock

Exchange listed fund, Chairman of Ecofin Special Situations Utilities Fund, a director of Ecofin Water & Power Opportunities plc, a London listed investment trust of which he was Chairman for three years, as well as a director of Bolux Utilities (Sicav Luxembourg). All the above funds are focused on utilities. In 2005, he was appointed a director of Promethean plc, an AIM-listed investment company. Martin chairs the Remuneration Committee and is a member of the Nomination Committee.

### 7. Alex Scott-Barrett

#### Independent Non-executive Director

Alex Scott-Barrett was appointed to the Board of NWG in September 2006, having previously joined the board of NWL in November 2005. Alex qualified as a chartered accountant with Coopers & Lybrand in 1981 and joined Cazenove, a City corporate stockbroker, in 1982. He worked initially as an analyst and transferred to the corporate finance department in 1986, becoming a partner of the firm in 1988. In 1996, he became a director of the firm's fund management division and from 2000 to 2003 was the Chief Operating Officer of that division. Alex left Cazenove in 2003, becoming non-executive Chairman of Suffolk Life Group plc in August 2003 and a non-executive director of General Capital Group plc in June 2004. Alex is a member of the Audit, Nomination and Remuneration Committees.

### 8. Jenny Williams

#### Independent Non-executive Director

Jenny Williams joined the Board in May 2004, and the board of NWL in January 2006. She is a Commissioner and Chief Executive of the Gambling Commission. In addition to being Head of Water Finance and Flotation at the time of water privatisation, Jenny has held a variety of directorships in a range of Government departments, including the Home Office, the Department of the Environment, Transport and the Regions and the Inland Revenue. She was a Director-General and board member of the Lord Chancellor's Department from 2001 to 2003. Jenny is a member of the Audit and Nomination Committees.

### 9. Martin Parker

#### Company Secretary

Martin Parker was appointed as Company Secretary in May 2003. Martin joined the former Northumbrian Water Group plc in 1990, concentrating on acquisitions, overseas projects and contracts with industrial customers, before being appointed Head of Group Legal Services in 1998, and Company Secretary and Head of Legal Affairs for NWL in 2000. Martin is Secretary of all the Board Committees, except the CRC.

# Corporate governance report

## Introduction and general compliance statement

The Board believes best practice in corporate governance is an important tool in helping it carry out its responsibilities. The Board considers that, during the year and up to the date of this report, it has complied with the main and supporting principles and the provisions of the Combined Code 2003, except in respect of membership of the Remuneration Committee. The reason for this departure is set out in the directors' remuneration report. This report, the directors' report and business review and the directors' remuneration report describe how the Company has applied the principles of the Combined Code during the year. A revised Combined Code applies to the current financial year which commenced on 1 April 2007, and the Board considers that it complies with the provisions of the revised Code.

The board of NWL also endeavours to maintain its own high standards of corporate governance and to comply with the Combined Code, wherever practicable.

The Board endeavours to act in accordance with the Group's code of conduct, which addresses the Group's responsibilities to a range of stakeholders and for the environment. This code is on the Company's website.

## The Board

The Board sets and implements the Company's strategy and ensures compliance with Group policies and legal and regulatory obligations. The Group's mission and strategy is set out in the directors' report and business review on page 7.

The Board agenda is proposed by the Managing Director and Company Secretary, with input from NWL's management team, for approval by the Chairman.

During the year, the Company revised its guidelines which set out the matters reserved to the Board for approval and matters which are, or can be, delegated to the committees and management. These guidelines include financial limits for each level of authority below Board level. Terms of reference of the main committees have been approved by the Board, and are on the Company's website. Standing or Executive Committees can take decisions not delegated to specific committees between Board meetings. All directors receive notice of Standing Committee meetings and are able to participate if they wish. Decisions taken by the Standing or Executive Committees are reported at the next Board meeting.

The Board met seven times during the year and held an additional strategy meeting in March 2007. Attendance at meetings was good throughout the year, with all current directors recording 100% attendance at Board and appropriate committee meetings. Sir Fred Holliday recorded 100% attendance at Board and appropriate

committee meetings from 1 April 2006 until his retirement from the Board on 27 July 2006. Ron Lepin, who resigned from the Board on 1 December 2006, attended three out of the five Board meetings he was eligible to attend.

At each meeting the directors receive reports from the Managing Director, the Finance Director and the chairmen of any committees which have met since the previous Board meeting.

The Chairman ensures that important issues are given enough time at meetings and that all directors can express their views. This enables full and vigorous discussion of key items.

The non-executive directors met formally on two occasions without the executive directors and are in regular contact with each other throughout the year. The non-executive directors also met once without the Chairman, but did not consider additional formal meetings to be necessary.

## Board balance and independence

There are currently eight directors – the Chairman, two executive directors, the senior independent non-executive director and four other non-executive directors. Sir Derek Wanless is the non-executive Chairman. He is also a non-executive director of Northern Rock plc. The executive directors are John Cuthbert (Managing Director) and Chris Green (Finance Director). Sir Patrick Brown is the senior independent non-executive director and the other independent non-executive directors are Martin Nègre, Alex Scott-Barrett and Jenny Williams. Claude Lamoureux is also a non-executive director, but is not independent as he is President and CEO of OTPP, which holds 25% of the issued share capital of the Company.

The Company complies with the Combined Code's requirement that half of the directors, excluding the Chairman, are independent non-executive directors. The Chairman was independent on appointment. Biographical details of the directors appear on pages 34 and 35 and details of their service contracts are in the directors' remuneration report on page 44.

The Chairman and Managing Director have clearly defined written responsibilities that have been agreed by the Board. The Chairman is responsible for leadership of the Board and for creating the conditions for overall Board and individual director effectiveness, both inside and outside the boardroom. He also conducts an annual performance evaluation of each of the directors. The Managing Director is responsible for running the Company's business on a day to day basis, and is assisted by NWL's management team.

Sir Patrick Brown, as senior independent non-executive director, is available to shareholders who wish to raise any concerns, and leads the non-executive directors in their evaluation of the Chairman's performance.

The non-executive directors bring to the Board many years of business experience as well as financial expertise and the ability and willingness to challenge and support the executive directors.

The Company Secretary, Martin Parker, assists the Board to ensure that good corporate governance compliance is achieved. He is also Company Secretary of NWL, and is secretary to all committees (other than CRC).

### Information and professional development

All directors have access to independent professional advice to assist them in the performance of their duties, at the Company's expense, and to the Company Secretary for advice and assistance. The Chairman, with the assistance of the Company Secretary, monitors the induction and training requirements of directors. All new directors receive an induction information pack and are offered site visits and meetings with managers. Managers from within the Group submit papers or give presentations at Board meetings. Industry representatives meet the Board to discuss current issues.

The Company Secretary ensures that directors are kept informed and that information flows effectively within the Group by:

- keeping in regular contact with directors;
- sending Board papers to directors before each Board meeting;
- sending briefing packs to directors in the months when Board meetings are not held; and
- providing a Directors' Team Room intranet site containing Board and committee papers, minutes, analyst reports and reference documents, such as the Combined Code and the Articles, to which all directors have access.

### Performance evaluation

A full evaluation of the performance of the Board, its committees and of individual directors was conducted in October 2006. Each director completed a detailed questionnaire prior to a personal discussion with the Chairman. The questionnaire was prepared by the Chairman and Company Secretary and was designed to address strategic issues as well as the approach of the Board to operational and financial matters, the role of the non-executive directors and the quality of information received by the Board. The results of the evaluation were considered by the Board at its meeting in November and were generally very positive, but the Board agreed to improve the induction process, to refine its work on regulatory developments and to expand the NWG

and NWL strategy meetings. The performance of NWL's board, committees and individual directors was evaluated at the same time. The Chairman's comments on the evaluation of the directors seeking appointment or re-appointment at the AGM, and the non-executive directors' comments on the evaluation of the Chairman, who is also seeking re-appointment at the AGM, are provided in the notice of the meeting.

### External appointments

To date, executive directors have only accepted non-executive positions outside the Group where this would benefit either the Group or the local community. These positions have tended to be with educational institutions, economic regeneration groups or similar bodies and any fees received have been paid over to the Company or donated to charity. The Board has now agreed that executive directors of the Company who are appointed to non-executive directorships of a more commercial nature may retain the fees, subject to obtaining the Chairman's consent before an appointment is accepted. Only one such external appointment per director will generally be permitted and there are currently no such appointments.

### Board committees

The Board has Audit, Nomination and Remuneration Committees to assist it in the performance of its duties. During the year, the Treasury Committee was disbanded and its work taken on by the Board as a whole. The Board sets the terms of reference of the committees and receives regular reports from their chairmen at board meetings. The terms of reference of committees were updated during the year, and are available on the Company's website or from the Company Secretary.

### Remuneration Committee

The work of the Remuneration Committee and details of the directors' remuneration are set out in the directors' remuneration report on pages 41 to 49.

### Nomination Committee

The members of the Nomination Committee are Sir Derek Wanless (Chairman), Sir Patrick Brown, John Cuthbert, Martin Nègre, Alex Scott-Barrett and Jenny Williams, and the membership is compliant with the Combined Code. Sir Fred Holliday was Chairman of the Committee until he retired from the Board on 27 July 2006. Alex Scott-Barrett joined the Committee on 30 November 2006.

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The Committee also reviews succession planning for the Board, NWL board and senior appointments and will make recommendations to the Board when appropriate. The Committee's general policy is to use external recruitment consultants or to advertise

## Corporate governance report *continued*

in order to identify suitable candidates. Since 1 April 2006, all non-executive directors are appointed for a term of one year. In accordance with the Articles, all directors are subject to re-election at the AGM at least every three years.

The Nomination Committee met five times during the year and all members attended all appropriate meetings. During the year, the Committee considered:

- the appointment of Alex Scott-Barrett to the NWG Board. External consultants were not used for this appointment as Mr Scott-Barrett was already a director of NWL and had demonstrated his experience and expertise. External consultants had, however, been used to facilitate his appointment to the NWL board;
- the appointment of Simon Lyster to the NWL board following a search by external recruitment consultants and interviews with potential candidates;
- the appointment of Claude Lamoureux to the NWG and NWL boards, following Ron Lepin's resignation from the boards and from OTTP;
- treatment of fees received by executive directors for external directorships; and
- extensions to the appointments of non-executive directors on the NWG and NWL boards whose contracts for services expired during the year.

### Accountability and audit

#### Audit Committee

The Audit Committee members are Sir Patrick Brown (Chairman), Alex Scott-Barrett and Jenny Williams. Sir Patrick and Jenny Williams have both served throughout the year. Sir Derek Wanless stood down from the Committee on 27 July 2006 when he became Chairman of the Board, and was replaced by Alex Scott-Barrett. All members recorded 100% attendance at committee meetings.

Sir Derek is a former director and Group Chief Executive of National Westminster Bank plc and a non-executive director of Northern Rock plc. Alex Scott-Barrett is a chartered accountant and was Chief Operating Officer of Cazenove's fund management division before becoming non-executive Chairman of Suffolk Life Group plc, and a non-executive director of General Capital Group plc. The Board is satisfied that Sir Derek and Alex Scott-Barrett both have recent and relevant financial experience.

The Committee's membership complies with the Combined Code. The Chairman, Managing Director and Finance Director are invited to Audit Committee meetings with the permission of its Chairman, but have no right of attendance. Managers from within the Group are invited to Audit Committee meetings to discuss issues relating to their areas of the business. Sir Patrick meets regularly with the Internal Audit Manager, and with the external auditors.

The Committee members receive regular briefings from the external auditors to enable them to keep up to date on financial reporting standards.

The purpose of the Audit Committee is to assist both executive and non-executive directors of NWG to discharge their individual and collective responsibilities in relation to:

- ensuring the financial and accounting systems of NWG and its subsidiaries are providing accurate and up to date information on their current position;
- ensuring NWG's published financial statements represent a true and fair reflection of this position; and
- assessing the scope and effectiveness of the Group's risk management systems and the integrity of its internal financial controls.

The Committee met four times during the year and its work included:

- monitoring the integrity of the financial statements of the Company;
- reviewing the Company's internal financial controls by considering reports of both the internal and external auditors, directing questions to management and reviewing the financial risks and controls information provided to them on an annual basis;
- monitoring and reviewing the effectiveness of the internal audit function by reviewing the scope of the annual audit plan, the results of those audits, and monitoring the completion of actions identified during the audit. In addition, a formal questionnaire was sent to committee members and directors;
- monitoring and reviewing the performance and effectiveness of the external auditors, in particular by reviewing the scope and costs of the audit process;
- reviewing the external auditors' independence by monitoring the extent of the provision of non-audit services and receiving reports from the external auditors;
- monitoring the potential impact and management of significant risks on the business using a risk methodology which meets the recommendations of the 2005 Turnbull guidance. This methodology sets out and rates all identified risks, including operational, external, financial, environmental, social and governance risks;
- monitoring the effectiveness of the Group's whistleblowing policy by receiving reports on any incidents; and
- reviewing the Company's interim and preliminary results' announcements and the associated interim and final reports and financial statements.

Given the importance of NWL to the Group's business, the Committee works closely with the Audit Committee of NWL. In particular, both committees review significant



regulatory reports for Ofwat, and regularly review NWL's debt recovery strategy and performance.

The Audit Committee Chairman reports to the Board following each meeting of the Committee, and committee minutes are circulated to the Board.

### External auditors

Ernst & Young LLP have been the Group's auditors since 2003. The key audit partner will change every five years.

### Non-audit services

The Committee has approved a procedure for the approval of non-audit services to safeguard the objectivity and independence of the external auditors, which complies with the requirements of the APB's Ethical Standard No. 5. The external auditors are not permitted to provide bookkeeping, financial information systems design and information, or internal audit outsourcing services. Permitted services require prior approval, either from the Audit Committee Chairman, if under £50,000, or from the Audit Committee, if over £50,000. The Company requires the auditors to report annually details of all non-audit services provided. A breakdown of the cost of audit and non-audit services provided by the auditors is set out in note 4 to the financial statements.

On 29 May 2007, Ernst & Young confirmed to the Audit Committee, in accordance with ISA260 (Communication of audit matters to those charged with governance), that they have considered their relationship with the Company and that, in their professional judgement, the objectivity of the audit engagement partner and audit staff is not impaired.

### Review of internal control

The Board has overall responsibility for maintaining a sound system of internal control and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the 2005 Turnbull guidance. The actions necessary to address weaknesses and otherwise improve the system of internal control are communicated to management. Internal Audit monitor implementation of these actions and report back to the Audit Committee. This process has been in place throughout the year and up to the date of approval of the annual report and financial statements 2006/07. There are inherent limitations in any system of internal control and even the most effective system can only provide a reasonable, and not absolute, assurance against material misstatement or loss.

The Board has reviewed the effectiveness of the Group's system of internal control, outlined below, as follows during the year. The Internal Audit team manages a

process whereby all of the financial controls within the Company are identified and certified by the relevant manager as having operated for the full year. As part of a programme of work (which is agreed with the Audit Committee), these controls are tested throughout the year. A report detailing any areas of concern is produced after each audit. As part of the same process all of the key business risks are identified. Each risk is assessed on an unmanaged basis, the controls that are in place to mitigate the risks are detailed and the risk is then re-assessed after these controls.

Internal Audit's findings and recommendations are presented to the Audit Committee along with agreed actions. Internal Audit updates progress against any agreed actions until the control weakness is resolved.

### Organisational structure

The trading subsidiaries have their own boards of directors (the Subsidiary Boards) which are responsible for the operational and financial control of their own businesses. The Subsidiary Boards report to the Managing Director, or Finance Director, and to the Company's Board on matters including major strategic, financial, organisational, compliance and regulatory issues.

The NWL management team manages the major business of the Group and consists of John Cuthbert (Managing Director), Chris Green (Finance Director), Graham Neave (Operations Director and on NWL board), Ceri Jones (Regulation & Scientific Services Director and on NWL board), John Devall (Water & Networks (South) Director), Ian Donald (Customer Services Director), Diane Morton (HR Director), Colin Price (Technical Director) and Henry Wilson (Waste Water & Networks (North) Director). The NWL management team meets monthly to consider and discuss progress against annual and monthly financial and operational targets. It prepares an annual budget and business plan for consideration and approval by the NWL board. NWL operates a balanced scorecard system which monitors progress against KPIs and which covers all areas of operation of the business.

The Board is able to monitor the impact of social, environment and ethical matters on the Group's business, to assess the impact of significant risks on the business, and to evaluate methods of managing these risks through reports it receives from the Subsidiary Boards and the Audit Committee. The only environmental risk considered to be significant by the Board is the potential loss of the use of agricultural land for processed sewage treatment sludge disposal. How NWL is managing this risk is described in the directors' report and business review on page 30.

For a number of years, the Subsidiary Boards have performed a full annual business risk analysis, to meet the recommendations of the 2005 Turnbull guidance.

# Corporate governance report *continued*

This methodology is described above, in relation to the work of the Audit Committee. The results of the risk reviews are reported in detail to the Audit Committee, and a summary is reported to the Company's directors. Accompanying the risk model is a detailed review of each company's internal financial controls, along with either confirmation that the controls have operated throughout the year or details of any exceptions. Action points arising from these reviews are followed up as part of the internal audit process.

Some subsidiaries, such as NWL, consider risks more frequently. The NWL management team considers significant risks in a structured way every two months, assessing the likelihood and potential impact of the relevant risks both before and after risk management measures have been put in place. Further details about how risks and uncertainties facing the Group are assessed and managed are included in the directors' report and business review on pages 28 to 30.

On a monthly basis, the Managing Director and the Finance Director compare the actual operational and financial performance of each business with its plan and budget. Targets are set to measure performance and regular forecasts are made.

## Information and reporting system

Each Subsidiary Board holds a copy of the Company's financial control manual and terms of reference, which contain full details of the procedures for distribution of information and financial reporting. Each Subsidiary Board has developed financial control systems appropriate to its activities.

## Budgets and business planning

The Group prepares detailed medium term business plans and annual budgets which are reviewed by the Managing Director and Finance Director and submitted to the Board for approval. Business plans and budgets include an assessment of the key risks and success factors facing each business unit.

The approval of the Board is required for major investments, including those in new markets, and large capital expenditure programmes. The treasury strategy, which is approved by the Board, requires that investments are limited to certain money market and treasury instruments, and that the Group's exposure to any single bank, building society or market is controlled, with maximum deposits allowed with any single counterparty. The Group's investment strategy aims to fix interest rates for part of the Group's borrowings and investments for periods determined by the forecast cash flow of the individual businesses. This manages the exposure to the risk of changes in short term interest rates. Foreign currency exposure is also managed as part of the treasury strategy approved by the Board.

The Board therefore believes that there are effective systems in place to identify and manage significant risks and that it receives sufficient information to enable it to assess these risks.

The work of the CRC is described on page 13 and on the corporate responsibility section of the Company's website.

## Investor relations

The Company welcomes constructive communication with all its shareholders. Details of the Company's investor relations activities during the year are described in the directors' report and business review on page 11. Investor feedback reports from investor meetings, prepared by the Company's advisers, are considered at Board meetings, and analysts' notes on the Company are made available to all directors on the Board's intranet Team Room. The Board believes that these methods of investor feedback provide the senior independent non-executive director and the other non-executive directors with a balanced understanding of the issues and concerns of major shareholders. The senior independent director is available to shareholders who wish to raise any matters of concern and the Chairman welcomes contact with any shareholders who have matters they wish to discuss. From February 2007, it was agreed that the Chairman would write to any new shareholders with holdings over 1% of the issued share capital confirming that the non-executive directors are available to meet them upon request. The Company has not received any requests from institutional shareholders to meet with non-executive directors.

All shareholders are encouraged to contact the Company with queries or suggestions. A welcome letter is sent to all new non-corporate shareholders, which includes information on services available to shareholders.

## AGM

Shareholders are encouraged to attend the Company's AGM at which they can meet and question the directors. The Company will make a presentation at the AGM to highlight the key business developments and events during the year. The full Board is expected to be available at the AGM to answer shareholders' questions. Voting at the AGM will be on a show of hands but the proxy votes cast on each resolution will be displayed after each resolution has been voted on. If the voting on a show of hands produces a different result from that which would have been achieved on a poll, the Chairman will call a poll so that the result of the voting on that resolution reflects the wishes of the majority of shareholders. The proxy votes cast at each AGM are disclosed on our website.

## Martin Parker

Company Secretary  
5 June 2007

# Directors' remuneration report

## **Information not requiring audit**

### **The Remuneration Committee**

The Remuneration Committee of the Board (the Committee) determines the remuneration and terms of employment of the Chairman of the Company, executive directors and senior management of the Group in accordance with a remuneration policy approved by the Board. The Committee members are Martin Nègre (Chairman), Sir Patrick Brown, Alex Scott-Barrett, who are all considered by the Company to be independent, and Sir Derek Wanless. Before Sir Derek's appointment as Chairman of NWG on 27 July 2006 he was an independent non-executive director and a member of the Remuneration Committee. Although the Combined Code in place on that date required all members of the Committee to be independent non-executive directors, the amendment permitting company chairmen to sit on the Remuneration Committee, with effect from 1 April 2007, had already been published. The Board wanted the Committee to continue to have the benefit of Sir Derek's experience and asked him to retain his seat on the Committee. Therefore, between 27 July 2006 and 31 March 2007, the membership of the Committee was not compliant with the Combined Code.

The Committee met five times during the year with 100% attendance by all members. As the Committee works closely with NWL's Remuneration Committee, Committee papers and minutes are circulated to all NWL and NWG non-executive directors, who can give their views direct to the Committee Chairman and can attend meetings if they wish. The Committee's terms of reference are available on the Company's website. The Committee received advice during the year from its appointed remuneration consultants, New Bridge Street Consultants LLP (NBSC), and also from the Managing Director. NBSC continues to assist the Committee in maintaining best practice in relation to remuneration. NBSC does not provide any other service to the Company.

The Committee is always available to engage with major shareholders and their representatives to discuss remuneration matters, although no such approaches have been received.

During the year the Committee:

- agreed bonuses for 2005/06;
- agreed salaries for 2006/07 and 2007/08;
- decided the vesting percentage to be applied to the LTIP awards made on 27 January 2004, which vested on 27 January 2007;
- agreed performance conditions for future LTIP awards, after consultation with major shareholders. Further information is set out below under LTIP;
- agreed to increase the upper limits of future LTIP awards from 75% to 100% of annual salary, subject to approval by shareholders at the AGM on 2 August 2007; and
- set performance targets for executive directors and senior managers.

### **Statement of remuneration policy**

The Committee has considered the principles and provisions of the Combined Code when setting its policy and believes it is fully compliant. The policy of the Company, which applied throughout 2006/07 and applies for 2007/08 and subsequent financial years, is to provide remuneration that is sufficient to attract, retain and motivate directors of the quality required to run the Company successfully. That being said, the Committee's paramount principle is to pay fairly. The Committee is aware of the risk of remuneration being ratcheted up as a result of benchmarking exercises and confirms that this has not happened. Consistent with its fair pay policy, when considering the remuneration packages of senior executives and directors, the Committee takes into account pay awards to other employees in the Group.

The remuneration policy of the Committee is:

- the setting of base salaries to be largely influenced by individual contributions and internal relativities rather than external comparators;
- the annual bonus plan should recognise the interests of all of the Company's stakeholders (shareholders, customers and employees) rather than be focused solely on profits; and
- management should share in the longer term value created for the Company's investors, but equity incentive schemes should only reward if there is clear outperformance of the market and other quoted companies.

The implementation of this remuneration policy is described over the page.

## Directors' remuneration report *continued*

### Elements of remuneration

The remuneration of the executive directors consists of basic salary and benefits, including pension and participation in the Company's SIP, all of which are not performance related. The performance related elements are annual bonus and LTIP awards. The relative importance of the performance and non performance related elements is monitored and the Committee recognises the importance of the performance related elements. Even with the proposed increases, the LTIP awards will remain below general market levels.

### Executive directors: basic salary and benefits

The basic salaries paid to each director during the year are set out in Table 1 on page 45. Basic salary is the only pensionable element of the executive directors' remuneration packages. Data received from NBSC has indicated that the Managing Director's basic salary is less than the median paid to his counterparts at other quoted water companies. For the second year in succession, however, John Cuthbert has declined salary increases recommended by the Committee. He has, therefore, had no increase in his basic salary in 2006 or 2007.

Benefits provided to the executive directors include membership of a defined benefit pension scheme, car allowance and healthcare.

### Non-executive directors: fees and benefits

As Chairman, Sir Derek Wanless receives an annual fee of £125,000. All other non-executive directors are paid a fee of £30,000 per annum. Additional fees of £5,000 and £7,500 per annum are paid to the Chairmen of the Remuneration and Audit Committees respectively. Sir Derek and the other non-executive directors do not receive benefits in kind. When Sir Fred Holliday was Chairman he received an annual fee of £125,000 and benefits in kind, which included the use of a company car and driver and work-related accommodation. The car, driver and accommodation were available to the Company when not being used by Sir Fred. The Chairman and the non-executive directors do not participate in bonus, pension or share schemes operated by the Company. Details of non-executive directors' remuneration are set out in Table 1 on page 45.

Non-executive directors' fees have not been reviewed for some time, but will in future be reviewed annually by the Chairman and the executive directors. From 1 April 2007, the Chairman's annual fee will be £150,000 and the non-executive directors' fees will be £35,000 per annum, with the Chairmen of the Remuneration and Audit Committees receiving additional fees of £5,000 and £10,000 per annum, respectively.

### Annual bonus

Since 2005/06 the annual bonus plan reflects the interests of all of the Company's stakeholders. Maximum annual bonuses for the executive directors in 2006/07 are 70% of salary, which are apportioned as follows:

Stakeholder	Bonus metric	Maximum bonus available as a % of salary
Shareholders	Profit before tax (PBT)	40
Customers	Overall Performance Assessment (OPA) rating	5
Employees	Percentage lost time through sickness	5
	Bespoke personal targets	20
<b>Total</b>		<b>70</b>

John Cuthbert's personal targets related principally to improving the sustainability of the pension scheme, business strategy, investor relations and succession planning, as well as a range of financial matters. Chris Green's personal targets were focused mainly on funding and credit rating, the maintenance of key financial ratios and measures, and the relationships with major debt and equity investors and analysts.

Taking account of performance against personal targets and the OPA, PBT and lost time performance, bonuses equal to 62% and 64.5% of basic salary were approved for payment to John Cuthbert and Chris Green, respectively. Bonus payments are included in Table 1 on page 45.

**LTIP**

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company. Details of the levels of award and performance conditions are shown in Table 2 on page 46.

A conclusion of the review that took place during 2005/06 was that the LTIP remained the most appropriate equity incentive plan, particularly in the light of the Company's dividend policy. The Committee agreed that total shareholder return (TSR) performance conditions remained the best performance measure to ensure that executives are rewarded fairly for value created for the Company's investors. However, changes were made to the structure of the TSR conditions, which are more consistent with best practice.

Following the de-listing of several water companies, and after taking advice from NBSC, it was decided during 2006/07 that the water company comparator group was of insufficient size to be a fair comparator. After consultation with major shareholders, it was decided to replace this comparator group with a larger group containing all the water and sewerage companies of England and Wales and using relative return on capital employed as the performance target. This target was chosen because:

- it directly compares NWL's financial performance against that of its peers;
- it is objectively measured and verified by a third party (Ofwat);
- NWL is the largest company in the Group;
- there is no subjectivity in determining what level of return would be a good and excellent result (it being a relative measure to which quartile analysis is applied); and
- the comparative approach should be able to deal with the five year pricing reviews without the Remuneration Committee having to reset targets.

For the awards granted on 21 December 2006 the three years to be reviewed are 2006/07, 2007/08 and 2008/09. Over the three year performance period the return on capital employed will be calculated on a compounded annualised return basis rather than a straight average of the three years. As part of this review the Committee back-tested this performance condition and it was observed that this was a tougher condition than TSR over previous performance periods.

In addition, awards will only vest if the Committee is satisfied that the Company's TSR performance is consistent with the underlying business performance of the Company.

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 performance conditions described above were chosen to align the interests of participants in the LTIP with those of shareholders. Rewards should only be earned over a number of years in circumstances where shareholders have benefited. 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.

The first LTIP award, granted on 27 January 2004, became available to vest on 27 January 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 the Company's TSR performance against the FTSE 250 Index and 61% of the award relating to the Company's TSR performance against the other listed water companies). Details of the number of awards which lapsed and those which were exercised by the directors of the Company are shown in Table 3 on page 47.

**Directors' interests in LTIP awards**

The directors' conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP as at 31 March 2007, are set out in Table 3 on page 47.

Ordinary 10 pence shares required to fulfil LTIP awards which have vested may be provided by Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited. The Trustees are Sir Patrick Brown, Martin Nègre and Anita Frew (a non-executive director of NWL). At 31 March 2007, the Trust held a total of

## Directors' remuneration report *continued*

716,917 ordinary 10 pence shares. In line with ABI guidelines, dividends are waived on these shares and the voting rights attached to these shares will not be exercised at the AGM. The shares held in the Trust represent a percentage of the total number of shares awarded under the LTIP to hedge against its potential obligation to provide shares for awards which vest.

### Performance graph

The TSR performance graph is shown at Table 4 on page 47.

### Service contracts

From 1 April 2006, all non-executive directors are appointed for a term of 12 months with a six month notice period on either side. The executive directors have service contracts with 12 months' notice periods and which expire when the directors reach normal retirement age. Details of the contracts of the executive and non-executive directors who served during the year are shown in Table 5 on page 48.

Terms and conditions of appointment of non-executive directors are available for inspection at the Company's registered office during normal business hours and at the AGM. The terms of appointment set out the expected time commitment for each non-executive director.

### External appointments of executive directors

The Board's position on external appointments is described in the corporate governance report on page 37. To date, no fees for external appointments have been retained by executive directors.

### Directors' pensions and pension benefits

The main features of the Northumbrian Water Pension Scheme are set out in note 26 to the financial statements. The Committee has reviewed its pensions policy in the light of the introduction of the new pension rules in April 2006 and details are given in the notes below Table 6 on page 48.

It is intended that the executive directors' pensions will be modified with effect from 1 January 2008, in line with the changes proposed for the pension scheme as a whole. It is also proposed to close the existing executive pension arrangements to new entrants on that date.

The accrued defined benefit pensions and corresponding transfer values for the executive directors are set out in Table 6 on page 48.

### Directors' interests in shares and debentures

The directors' beneficial interests in the ordinary 10 pence shares of the Company, and in debentures of Northumbrian Services Limited, a subsidiary of the Company, as at 31 March 2007 are set out in Tables 7 and 8 on page 49.

### Directors' interests in shares under the SIP

The Company SIP is open to UK employees with more than three months' service. Further details of the SIP are set out in the directors' report and business review on page 13. During the year, the executive directors had the opportunity to participate in the SIP and their interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP, are set out in Table 9 on page 49.

This directors' remuneration report, which has been produced in accordance with Schedule 7A of the Companies Act 1985, as introduced by the Directors' Remuneration Report Regulations 2002, was approved by the Board and signed on its behalf by the Company Secretary. It will be put to the shareholders for approval at the Company's AGM.

### Martin Parker

Company Secretary  
5 June 2007

These tables form the part of the directors' remuneration report which are audited (except for Tables 2, 4 and 5 which do not require auditing).

**Table 1**  
**Directors' emoluments (audited)**

The emoluments of the directors of the Company for their services as directors of the Company and (where relevant) its subsidiaries, are set out below, rounded to the nearest thousand pounds:

	Fees £000	Basic salary £000	Benefits <sup>1</sup> £000	Bonus <sup>2</sup> £000	Total for the year ended 31 March 2007 £000	Total for the year ended 31 March 2006 £000
<b>Executive Directors</b>						
John Cuthbert	–	270	6	167	<b>443</b>	398
Chris Green	–	200	9	129	<b>338</b>	275
<b>Non-executive Directors</b>						
Sir Derek Wanless <sup>3</sup>	93	–	–	–	<b>93</b>	30
Sir Patrick Brown <sup>4</sup>	38	–	–	–	<b>38</b>	38
Christophe Cros <sup>5</sup>	–	–	–	–	<b>–</b>	2
Bernard Guirkingier <sup>5</sup>	–	–	–	–	<b>–</b>	2
Sir Fred Holliday <sup>6</sup>	40	–	10	–	<b>50</b>	149
Claude Lamoureux <sup>7,8</sup>	10	–	–	–	<b>10</b>	–
Ron Lepin <sup>8,9</sup>	20	–	–	–	<b>20</b>	12
Martin Nègre <sup>10</sup>	35	–	–	–	<b>35</b>	35
Alex Scott-Barrett <sup>11</sup>	15	–	–	–	<b>15</b>	–
Jenny Williams	30	–	–	–	<b>30</b>	30
<b>Total remuneration</b>	<b>281</b>	<b>470</b>	<b>25</b>	<b>296</b>	<b>1,072</b>	<b>971</b>

Notes:

- The remuneration of each executive director includes non-cash benefits comprising the provision of car allowances and healthcare. The non-cash benefits for Sir Fred Holliday comprised the provision of the use of a company car, driver and work-related accommodation.
- The annual bonus is payable in June 2007, for performance during the year ended 31 March 2007.
- Non-executive director during 2005/06 and from 1 April 2006 until his appointment as Chairman on 27 July 2006.
- Includes additional fee paid as Chairman of Audit Committee.
- The fees of these directors were payable to Suez. Both directors resigned on 28 April 2005.
- Retired as Chairman on 27 July 2006.
- Appointed 1 December 2006.
- Fee payable to Ontario Teachers' Pension Plan Board.
- Resigned 1 December 2006.
- Includes additional fee paid as Chairman of the Remuneration Committee.
- Appointed on 26 September 2006.

# Directors' remuneration report *continued*

**Table 2**  
**Summary of LTIP awards and performance conditions (unaudited)**

LTIP awards made 27 January 2004 and 22 December 2004	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth 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. 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 were over shares worth 70% of salary.
Performance conditions	As 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 and future awards	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth 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.



**Table 3**  
**Directors' interests in LTIP awards (audited)**

As at 31 March 2007, the directors had the following conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP:

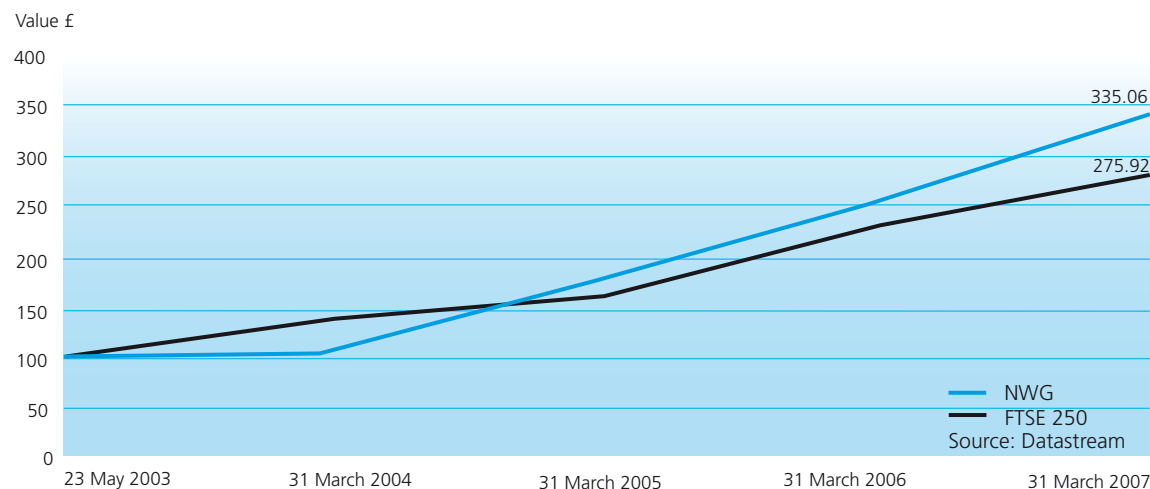
	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2007 <sup>1</sup>
John Cuthbert	27.1.04 <sup>2</sup>	85,603	–	23,866	61,737 <sup>3</sup>	–
	22.12.04 <sup>4</sup>	67,001	–	–	–	67,001
	9.12.05 <sup>5</sup>	75,903	–	–	–	75,903
	21.12.06 <sup>6</sup>	–	66,721	–	–	66,721
<b>Totals</b>		228,507	66,721	23,866	61,737	209,625
Chris Green	27.1.04 <sup>2</sup>	56,618	–	15,785	40,833 <sup>3</sup>	–
	22.12.04 <sup>4</sup>	44,221	–	–	–	44,221
	9.12.05 <sup>5</sup>	50,602	–	–	–	50,602
	21.12.06 <sup>6</sup>	–	49,423	–	–	49,423
<b>Totals</b>		151,441	49,423	15,785	40,833	144,246

## Notes:

- There have been no changes to any of the above interests in awards under the LTIP from the end of the year to 5 June 2007.
- The market value of the shares on the date of the award was 113.50 pence per share. The three year performance period ran from 1 October 2003 to 30 September 2006 and shares became available to vest on 27 January 2007.
- Shares vested on 29 January 2007 and the closing price on that date was 294.5 pence per share.
- The market value of the shares on the date of the award was 174.50 pence per share. The three year performance period runs from 1 October 2004 to 30 September 2007.
- 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.
- 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.
- 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, £0.4 million was charged to equity.
- Details of the performance conditions are shown at Table 2 on page 46.
- The market price of the shares on 31 March 2007 was 310.00 pence per share. During the year, the highest market price was 320.00 pence per share and the lowest market price was 231.50 pence per share.
- Aggregate gross gains made by directors on exercise of awards at date of vesting was £302,069 (2006: £nil).

**Table 4**  
**TSR graph (unaudited)**

The graph below shows a comparison between the TSR for the Company's shares for the period 23 May 2003 (the date the Company's shares were listed on AIM) to 31 March 2007, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as the Company is a constituent of the FTSE 250.



## Note:

This graph shows the value, by 31 March 2007, of £100 invested in Northumbrian Water Group plc on 23 May 2003 (the date the Company'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.

## Directors' remuneration report *continued*

**Table 5**  
**Directors' service contracts (unaudited)**

Details of the contracts of the directors who served during the year are shown below:

	Initial appointment	Current contract start date	Unexpired term <sup>1</sup>	Notice period by either side	Current contract end date
<b>Executive Directors<sup>2</sup></b>					
John Cuthbert	22 May 2003	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
Chris Green	22 May 2003	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
<b>Non-executive Directors<sup>3</sup></b>					
Sir Derek Wanless	1 December 2003	1 December 2006	6 months	6 months	30 November 2007
Sir Fred Holliday	23 May 2003	23 May 2006	N/A	N/A	Retired 27 July 2006
Sir Patrick Brown	12 May 2003	12 May 2007	11 months	6 months	11 May 2008
Ron Lepin	24 October 2005	24 October 2006	N/A	N/A	Resigned 1 December 2006
Martin Nègre	12 May 2003	12 May 2007	11 months	6 months	11 May 2008
Alex Scott-Barrett	26 September 2006	26 September 2006	4 months	6 months	25 September 2007
Claude Lamoureux	1 December 2006	1 December 2006	6 months	6 months	30 November 2007
Jenny Williams	27 May 2004	27 May 2007	12 months	6 months	26 May 2008

Notes:

1. Calculated as at 5 June 2007 and rounded to nearest whole month.
2. The service contracts of the executive directors do not contain provisions relating to compensation for termination. In the event of termination by the Company, the Remuneration Committee would make recommendations to the Board on what payments, if any, should be made to the director, depending on the circumstances of the termination, and taking into account the provisions of the Combined Code regarding non-payment for failure. The Company would also expect directors to seek to mitigate their loss.
3. Contracts do not provide for compensation for loss of office in excess of fees accrued.

**Table 6**  
**Directors' pensions and pension benefits (audited)**

The accrued defined benefit pensions and corresponding transfer values for the executive directors are set below:

	Accrued pension at 31 March 2006 £000	Accrued pension at 31 March 2007 £000	Increase in accrued pension £000	Increase in accrued pension net of inflation £000	Transfer value of net increase in accrued pension less directors' contributions £000	Transfer value of accrued pension at 1 April 2006 £000	Transfer value of accrued pension at 31 March 2007 £000	Total change in transfer value less directors' contributions £000
John Cuthbert	125.9	133.8	7.9	1.8	31.0	1,983.2	2,301.0	317.8
Chris Green	67.4	83.3	15.9	12.7	208.6	1,077.5	1,373.6	296.1

Notes:

1. Accrued pensions shown are the amounts that would be paid annually on retirement based on service to the end of the year.
2. Voluntary contributions paid by the directors and resulting benefits are not shown.
3. The change in transfer value allows for fluctuations in the transfer value due to factors beyond the control of the Company and directors, such as changes in stock market conditions.
4. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11.
5. The directors participate in a salary sacrifice arrangement and, therefore, paid no contributions to the scheme during the year.
6. From 6 April 2006, following pension changes introduced in the Finance Act 2006, the Scheme removed the earnings cap restriction. Benefit calculations for John Cuthbert and Chris Green had been subject to the earnings cap. As a result of the removal of the earnings cap, an unfunded unapproved pension arrangement, designed to provide John Cuthbert with pension benefits based on salary in excess of the earnings cap, was terminated. The additional liability on the pension scheme as a consequence of the removal of the earnings cap was met by the Company.

**Table 7**  
**Directors' interests in shares (audited)**

The directors had the following beneficial or family interests in the ordinary 10 pence shares of the Company as at 31 March 2007:

	Number of shares held at the start of the year or subsequent date of appointment	Number of shares held as at 31 March 2007 <sup>1</sup>
Sir Patrick Brown	43,000	43,000
John Cuthbert <sup>2</sup>	100,000	126,350
Chris Green <sup>3</sup>	65,000	89,042
Sir Fred Holliday <sup>4</sup>	8,700	–
Claude Lamoureux <sup>5</sup>	–	–
Ron Lepin <sup>6</sup>	–	–
Martin Nègre <sup>7</sup>	190,000	170,000
Alex Scott-Barrett <sup>8</sup>	–	–
Sir Derek Wanless	30,000	30,000
Jenny Williams	6,000	6,000

## Notes:

- There have been no changes in any of the above interests from the end of the year to 5 June 2007.
- 26,350 of the shares held at 31 March 2007 are beneficially owned by Mrs Lynn Cuthbert.
- These shares are beneficially owned by Mrs Geraldine Green.
- Retired 26 July 2006.
- Appointed 1 December 2006.
- Resigned 1 December 2006.
- Mrs Linda Nègre beneficially owned 20,000 of the shares held at 1 April 2006. Mrs Nègre sold her shares on 16 August 2006.
- Appointed on 26 September 2006.

**Table 8**  
**Directors' interests in debentures (audited)**

The directors had the following beneficial or family interests in debentures of Northumbrian Services Limited as at 31 March 2007:

	Class of debentures	Amount of debentures held at the start of the year or subsequent date of appointment <sup>1</sup>	Amount of debentures held as at 31 March 2007
John Cuthbert	8.625% Eurobonds 28.6.2006	40,000	–
Chris Green <sup>2</sup>	8.625% Eurobonds 28.6.2006	25,000	–

## Notes:

- These debentures were redeemed on 28 June 2006 at par.
- These debentures were beneficially owned by Mrs Geraldine Green.

**Table 9**  
**Directors' interests in shares under the SIP (audited)**

The directors who held office as at 31 March 2007 had the following interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP:

	Number of SIP shares held at the start of the year <sup>1</sup>	Number of SIP shares held as at 31 March 2007 <sup>1</sup>	Number of SIP shares held as at 5 June 2007 <sup>1</sup>
John Cuthbert	2,780	3,565	4,176
Chris Green	2,780	3,565	4,176

## Notes:

- These figures include the shares paid for by the participant and the free shares granted by the Company.
- A summary of the SIP can be found in the directors' report and business review on page 13.

# Statement of directors' responsibilities in relation to the Group financial statements

The directors are responsible for preparing the Annual Report and the Group financial statements in accordance with applicable United Kingdom law and those International Financial Reporting Standards (IFRS) as adopted by the European Union.

The directors are required to prepare Group financial statements for each financial year which present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those Group financial statements the directors are required to:

- select suitable accounting policies in accordance with IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors and then apply them consistently;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Group's financial position and financial performance; and
- state that the Group has complied with IFRS, subject to any material departures disclosed and explained in the financial statements.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that the Group financial statements comply with the Companies Act 1985 and Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group 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.

# Report of the Auditors on the Group financial statements

## Independent auditors' report to the members of Northumbrian Water Group plc

We have audited the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2007 which comprise the Consolidated income statement, the Consolidated statement of recognised income and expense, the Consolidated balance sheet, the Consolidated cash flow statement and the related notes 1 to 30. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2007 and on the information in the Directors' remuneration report that is described as having been audited.

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

## Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable United Kingdom law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Statement of directors' responsibilities.

Our responsibility is to audit the Group 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 Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' report and business review is consistent with the financial statements.

In addition we report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding director's remuneration and other transactions is not disclosed.

We review whether the Corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 Combined Code specified for our

review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited Group financial statements. The other information comprises only NWG at a glance, Highlights, the Chairman's statement, the Directors' report and business review, Appendix to the directors' report and business review, Board directors' biographies, the Corporate governance report, the unaudited part of the Directors' remuneration report and Shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group 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 Group financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group'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 Group 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 Group financial statements.

## Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 March 2007 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Directors' report and business review is consistent with the Group financial statements.

**Ernst & Young LLP**  
Registered Auditor

Newcastle upon Tyne  
5 June 2007

# Consolidated income statement

For the year ended 31 March 2007

	Notes	Year to 31.3.2007 £m	Year to 31.3.2006 £m
<b>Continuing operations</b>			
<b>Revenue</b>	2	<b>633.5</b>	591.5
Operating costs	3	<b>(375.3)</b>	(355.3)
<b>Profit on ordinary activities before interest</b>	2	<b>258.2</b>	236.2
Finance costs payable	6	<b>(127.0)</b>	(112.7)
Finance income receivable	6	<b>15.8</b>	6.7
Share of profit after tax of associates and jointly controlled entities		<b>0.8</b>	0.1
<b>Profit on ordinary activities before taxation</b>	2	<b>147.8</b>	130.3
– current taxation	7	<b>(8.6)</b>	(15.6)
– deferred taxation	7	<b>(28.0)</b>	(23.6)
– overseas tax	7	<b>–</b>	(0.1)
<b>Profit for the year from continuing operations</b>		<b>111.2</b>	91.0
<b>Discontinued operations</b>			
Profit for the year from discontinued operations	8	<b>–</b>	15.4
<b>Profit for the year</b>		<b>111.2</b>	106.4
Attributable to:			
Equity shareholders of the Company		<b>110.9</b>	105.9
Minority interests		<b>0.3</b>	0.5
		<b>111.2</b>	106.4
Basic earnings per share for profit attributable to ordinary equity holders of the parent			
	9	<b>21.42p</b>	20.45p
Diluted earnings per share for profit attributable to ordinary equity holders of the parent			
	9	<b>21.38p</b>	20.42p
Basic earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent			
	9	<b>21.42p</b>	17.48p
Diluted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent			
	9	<b>21.38p</b>	17.45p
Adjusted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments)			
	9	<b>24.95p</b>	19.52p
Ordinary final dividend proposed per share	10	<b>7.52p</b>	7.04p
Special dividend paid per share	10	<b>–</b>	2.82p
Dividend paid per share	10	<b>10.79p</b>	10.65p

# Consolidated statement of recognised income and expense

For the year ended 31 March 2007

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Actuarial gains	25.0	52.7
Losses on cash flow hedges	–	(3.8)
Gains on cash flow hedges	2.4	1.0
Tax on items charged or credited to equity	(7.5)	(15.6)
Translation differences	(0.2)	–
Total income and expense recognised in equity	19.7	34.3
Transferred to the income statement on cash flow hedges	(2.9)	–
Profit for the year	111.2	106.4
<b>Total recognised income and expense</b>	<b>128.0</b>	<b>140.7</b>
Attributable to:		
Equity shareholders of the Company	127.7	140.2
Minority interests	0.3	0.5
	<b>128.0</b>	<b>140.7</b>

# Consolidated balance sheet

As at 31 March 2007

	Notes	31.3.2007 £m	31.3.2006 £m
<b>Non-current assets</b>			
Goodwill	11	3.6	3.7
Other intangible assets	11	64.2	64.2
Property, plant and equipment	12	3,119.9	2,985.6
Investments in jointly controlled entities	13	3.6	3.6
Financial assets		18.0	20.1
Pension asset	26	42.7	–
Other investments	13	0.2	0.3
		<b>3,252.2</b>	3,077.5
<b>Current assets</b>			
Inventories	14	3.7	3.3
Trade and other receivables	15	124.5	111.6
Cash and cash equivalents	16	316.9	176.6
		<b>445.1</b>	291.5
<b>Total assets</b>		<b>3,697.3</b>	3,369.0
<b>Non-current liabilities</b>			
Interest bearing loans and borrowings	18	2,382.1	1,972.9
Provisions	20	2.9	3.1
Deferred income tax liabilities	7	531.2	495.6
Pension liability	26	–	3.7
Other payables		10.0	10.6
Grants		193.3	179.3
		<b>3,119.5</b>	2,665.2
<b>Current liabilities</b>			
Interest bearing loans and borrowings	18	34.5	236.7
Provisions	20	0.2	0.3
Trade and other payables	17	165.6	156.3
Income tax payable		4.4	9.7
		<b>204.7</b>	403.0
<b>Total liabilities</b>		<b>3,324.2</b>	3,068.2
<b>Net assets</b>		<b>373.1</b>	300.8
<b>Capital and reserves</b>			
Issued capital	22/23	51.9	51.9
Share premium reserve	23	446.5	446.5
Cash flow hedge reserve	23	1.0	1.5
Treasury shares	23	(1.3)	(1.7)
Currency translation	23	(0.2)	–
Retained earnings	23	(126.5)	(198.9)
<b>Equity shareholders' funds</b>		<b>371.4</b>	299.3
Minority interests	22	1.7	1.5
<b>Total capital and reserves</b>		<b>373.1</b>	300.8

Approved by the Board on 5 June 2007 and signed on its behalf by:

**Sir Derek Wanless**  
Chairman

**John Cuthbert**  
Managing Director



# Consolidated cash flow statement

For the year ended 31 March 2007

	Notes	Year to 31.3.2007 £m	Year to 31.3.2006 £m
<b>Operating activities</b>			
<b>Reconciliation of profit before interest to net cash flows from operating activities</b>			
Profit on ordinary activities before interest		258.2	236.2
Profit before interest on discontinued operations		–	1.2
Depreciation and other similar non-cash charges		92.9	88.4
Other non-cash charges		(6.2)	(4.8)
Net charge for provisions, less payments		(0.3)	(0.5)
Difference between pension contributions paid and amounts recognised in the income statement		4.4	2.8
Increase in inventories		(0.4)	(2.6)
(Increase)/decrease in trade and other receivables		(13.6)	4.0
Increase/(decrease) in trade and other payables		0.9	(9.7)
Cash generated from operations		335.9	315.0
Advanced contributions in respect of retirement benefits		(25.8)	(22.8)
Net interest paid		(124.7)	(119.7)
Income taxes paid		(14.6)	(6.5)
<b>Net cash flows from operating activities</b>		<b>170.8</b>	<b>166.0</b>
<b>Investing activities</b>			
Interest received		12.5	4.1
Capital grants received		18.8	21.4
Purchase of subsidiary undertaking (net of cash acquired)		–	2.4
Proceeds on disposal of subsidiary undertakings		–	18.6
Proceeds on disposal of property, plant and equipment		2.2	2.0
Dividends received from jointly controlled entities		0.9	0.8
Purchase of property, plant and equipment		(211.4)	(206.7)
Other cash items		–	0.2
<b>Net cash flows from investing activities</b>		<b>(177.0)</b>	<b>(157.2)</b>
<b>Financing activities</b>			
New borrowings		425.0	210.2
New loans issued		–	(2.1)
Maturity of investments		2.1	2.0
Settled hedge instruments		3.4	(3.7)
Issue costs of new borrowings		(0.4)	(1.4)
Own shares purchased		(0.2)	(0.8)
Dividends paid to minority interests		(0.1)	(0.3)
Dividends paid to equity shareholders		(55.8)	(69.7)
Repayment of borrowings		(201.1)	(46.6)
Payment of principal under hire purchase contracts and finance leases		(4.8)	(4.7)
<b>Net cash flows from financing activities</b>		<b>168.1</b>	<b>82.9</b>
<b>Increase in cash and cash equivalents</b>		<b>161.9</b>	<b>91.7</b>
Cash and cash equivalents at start of year	16	153.9	62.2
<b>Cash and cash equivalents at end of year</b>	16	<b>315.8</b>	<b>153.9</b>
<b>Net cash flow in respect of discontinued operations</b>			
Cash consideration		–	29.8
Cash and cash equivalents disposed		–	(11.1)
Expenses paid in connection with disposals		–	(0.1)
		–	18.6

# Notes to the consolidated financial statements

## 1. Accounting policies

### (a) Statement of compliance

The consolidated financial statements have been prepared in accordance with IFRS as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2007 and in accordance with the Companies Act 1985. The consolidated financial statements are also consistent with IFRS as issued by the IASB. The directors consider the following accounting policies to be relevant in relation to the Group's financial statements. The financial statements of the Group for the year ended 31 March 2007 were authorised for issue by the Board of directors on 5 June 2007 and the balance sheet was signed on the Board's behalf by Sir Derek Wanless (Chairman) and John Cuthbert (Managing Director).

Northumbrian Water Group plc is a public limited company incorporated and domiciled in England and Wales. The Company's ordinary shares are traded on the London Stock Exchange.

The Group financial statements are presented in sterling and all values are rounded to the nearest one hundred thousand pounds (£0.1 million) except where otherwise indicated.

### (b) Basis of consolidation

The consolidated financial statements include the Company and its subsidiary undertakings. The results of subsidiaries acquired during the period are included from the date of their acquisition. The results of subsidiaries disposed of during the period are included to the date of their disposal. Inter segment sales and profits are eliminated fully on consolidation. Where, for commercial reasons, the accounting reference date of a subsidiary is a date other than that of the Company, management accounts made up to the Company's accounting reference date have been used. In accordance with SIC 12 'Consolidation – Special Purpose Entities', the financial statements of two companies are consolidated as special purpose entities, with effect from 12 May 2004, the date of the transaction which utilised these entities.

Where necessary, adjustments are made to bring the accounting policies used under relevant local GAAP in the individual financial statements of the Company, subsidiaries and jointly controlled entities into line with those used by the Group under IFRS.

Minority interests represent the portion of profit or loss and net assets in subsidiaries that is not held by the Group and is presented separately within equity in the consolidated balance sheet, separately from parent shareholders' equity.

### (c) Associates and jointly controlled entities

Investments in associates and jointly controlled entities in the Group financial statements are accounted for using the equity method of accounting where the Group exercises significant influence over the associate. Significant influence is generally presumed to exist where the Group's effective ownership is 20% or more. The Group's share of the post tax profits less losses of associates and jointly controlled entities is included in the consolidated income statement and the carrying value in the balance sheet comprises the Group's share of their net assets/liabilities less distributions received and any impairment losses. Goodwill arising on the acquisition of associates and jointly controlled entities, representing the excess of the cost of investment compared to the Group's share of net fair value of the associate's identifiable assets, liabilities and contingent liabilities, is included in the carrying amount of the associate and is not amortised. Financial statements of jointly controlled entities and associates are prepared for the same reporting period as the Group. Where necessary, adjustments are made to bring the accounting policies used into line with those of the Group; to take into account fair values assigned at the date of acquisition and to reflect impairment losses where appropriate. Adjustments are also made to the Group's financial statements to eliminate the Group's share of unrealised gains and losses on transactions between the Group and its jointly controlled entities and associates.

### (d) Goodwill

Goodwill arising on the acquisition of subsidiary undertakings and businesses represents the excess of the fair value of the consideration given over the fair value of the identifiable assets and liabilities acquired. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. The Group has £0.2 million of goodwill at 1 April 2004. Prior to 1 April 2004, goodwill was amortised over its estimated useful life; such amortisation ceased on 31 March 2004. Goodwill relating to acquisitions since 1 April 2004 is not amortised. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired. For the purposes of impairment testing, goodwill is allocated to the related cash-generating units monitored

by management at statutory company level. Where the recoverable amount of the cash-generating unit is less than its carrying amount, including goodwill, an impairment loss is recognised in the income statement. The carrying amount of goodwill allocated to a cash-generating unit is taken into account when determining the gain or loss on disposal of the unit, or of an operation within it.

#### **(e) Intangible assets other than goodwill**

Other intangible fixed assets represent the right to receive income under the operating agreement with the Environment Agency in respect of the Kielder Water transfer scheme. The value of this intangible asset has been assessed with reference to the net monies raised in accordance with the 'Kielder securitisation' on 12 May 2004. The term of the operating agreement is in perpetuity and accordingly no amortisation is provided. The value of this intangible is assessed for impairment on an annual basis, in accordance with IAS 36 'Impairment of Assets'.

Expenditure on internally developed intangible assets, excluding development costs, is taken to the income statement in the year in which it is incurred. Intangible assets acquired separately from a business are carried initially at cost. An intangible asset acquired as part of a business combination is recognised outside goodwill if the asset is separable or arises from contractual or other legal rights and its fair value can be measured reliably. Development expenditure is recognised as an intangible asset only after its technical feasibility and commercial viability can be demonstrated, the availability of adequate technical and financial resources and an intention to complete the project have been confirmed and the correlation between development costs and future revenues has been established.

#### **(f) Property, plant and equipment**

##### ***Property, plant and equipment and depreciation***

Property, plant and equipment, including assets in the course of construction, comprise infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls) and other assets (including properties, overground plant and equipment).

Property, plant and equipment are included at cost less accumulated depreciation and any provision for impairment. Cost comprises the aggregate amount paid and the fair value of any other consideration given to acquire the asset and includes costs directly attributable to making the asset capable of operating as intended. Borrowing costs attributed to assets under construction are recognised as an expense as incurred.

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives, which are principally as follows: freehold buildings, 30-60 years; short leasehold land and buildings, 25 years or lease term if shorter; operational structures, plant and machinery, 4-92 years; infrastructure assets 13-200 years (see below), fixtures, fittings, tools and equipment, 4-10 years.

The carrying values of property, plant and equipment are reviewed for impairment if events or changes in circumstances indicate the carrying value may not be recoverable, and are written down immediately to their recoverable amount. Useful lives and residual values are reviewed annually and where adjustments are required these are made prospectively.

Assets in the course of construction are not depreciated until commissioned.

##### ***Infrastructure assets***

In the regulated water services business, infrastructure assets comprise a network of systems being mains and sewers, reservoirs, dams and sea outfalls.

Infrastructure assets were measured at a date prior to transition to IFRS (23 May 2003) at their fair value, which was adopted as deemed historical cost on transition to IFRS. The assets and liabilities were measured at fair value as a result of the acquisition on 23 May 2003.

Expenditure on infrastructure assets which enhances the asset base is treated as fixed asset additions whilst maintenance expenditure which does not enhance the asset base is charged as an operating cost.

# Notes to the consolidated financial statements

## *continued*

Infrastructure assets are depreciated evenly to their estimated residual values over their estimated economic lives, which are principally as follows:

Dams and impounding reservoirs	150 years
Water mains	100 years
Sea outfalls	60 years
Sewers	200 years
Dedicated pipelines	4-20 years

### **(g) Financial assets**

Financial assets comprise loans to third parties, recoverable in more than one year and include cash held on long term deposit as a guaranteed investment contract relating to the Kielder securitisation. These assets are recognised at cost and are measured annually based on the ability of the borrower to repay. Any impairment is taken to the income statement in the period in which it arises. Loans and receivables are measured at amortised cost using the effective interest rate method. The Group assesses at each balance sheet date whether a financial asset or group of financial assets is impaired.

### **(h) Foreign currencies and foreign currency transactions**

Transactions in foreign currencies are initially recorded in the functional currency by applying the spot exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are re-translated at the functional currency rate of exchange ruling at the balance sheet date. The functional and presentational currency of Northumbrian Water Group plc is United Kingdom sterling (£). Assets and liabilities of subsidiaries and jointly controlled entities in foreign currencies are translated into sterling at rates of exchange ruling at the end of the financial period and the results of foreign subsidiaries are translated at the average rate of exchange for the period. Differences on exchange arising from the re-translation of the opening net investment in subsidiary companies and jointly controlled entities, and from the translation of the results of those companies at average rate, are taken to equity. All other foreign exchange differences are taken to the income statement in the period in which they arise.

Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period.

This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

### **(i) Inventories**

Inventories are stated at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs, as well as an element of overheads that have been incurred in bringing the inventories to their present locations and condition.

### **(j) Revenues**

#### ***Provision of services***

Revenue, which excludes value added tax, represents the fair value of the income receivable in the ordinary course of business for services provided. Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured.

Revenue is not recognised until the services have been provided to the customer. Revenue for services relates to the year, excluding any amounts paid in advance. Revenue for measured water and waste water charges includes amounts billed plus an estimation of the amounts unbilled at the year end. The accrual is estimated using a defined methodology based upon daily average water consumption, which is calculated based upon historical billing information.

Long term contracts revenue (included in results for discontinued operations) is recognised to reflect the proportion of the work carried out at the year end, by recording revenue as contract activity progresses. Revenues derived from variations on contracts are recognised only when they have been accepted by the customer.

**Interest**

Revenue is recognised as the interest accrues, taking into account the effective yield of the asset.

**Dividends**

Revenue is recognised when the shareholders' right to receive the revenue is established.

**(k) Grants and contributions**

Grants are recognised at their fair value where there is reasonable assurance that the grant will be received and all attaching conditions will be complied with. Revenue grants are credited to the income statement in the period to which they relate. Capital grants and contributions relating to property, plant and equipment are treated as deferred income and amortised to the income statement over the expected useful economic lives of the related assets.

**(l) Leases**

Where assets are financed by leasing arrangements which transfer substantially all the risks and rewards of ownership to the Group, the assets are treated as if they had been purchased at their fair value or, if lower, at the present value of the minimum lease payments. Rentals or leasing payments are treated as consisting of a capital element and finance charges, the capital element reducing the outstanding liability and the finance charges being charged to the income statement over the period of the leasing contract at a constant rate on the reducing outstanding liability.

Rentals under operating leases (where the lessor retains substantially all the risks and rewards of ownership) are expensed in the income statement on a straight line basis over the lease term.

**(m) Pensions and other post-employment benefits****Defined benefit scheme**

The cost of providing benefits under the defined benefit scheme is determined using the projected unit credit method, which attributes entitlement to benefits to the current period (to determine current service cost) and to the current and prior periods (to determine the present value of defined benefit obligation) and is based on actuarial advice. Past service costs are recognised in the income statement on a straight line basis over the vesting period or immediately if the benefits have vested. When a settlement (eliminating all obligations for benefits already accrued) or a curtailment (reducing future obligations as a result of a material reduction in the scheme membership or a reduction in future entitlement) occurs, the obligation and related plan assets are re-measured using current actuarial assumptions and the resultant gain or loss recognised in the income statement during the period in which the settlement or curtailment occurs.

The interest element of the defined benefit cost represents the change in present value of scheme obligations resulting from the passage of time, and is determined by applying the discount rate to the opening present value of the benefit obligation, taking into account material changes in the obligation during the year. The expected return on plan assets is based on an assessment made at the beginning of the year of long term market returns on scheme assets, adjusted for the effect on the fair value of plan assets of contributions received and benefits paid during the year. The difference between the expected return on plan assets and the interest cost is recognised in the income statement within operating costs.

Actuarial gains and losses on experience adjustments and changes in actuarial assumptions are recognised in full in the period in which they occur in the SORIE.

**Defined contribution scheme**

The Group also operates a defined contribution scheme. Obligations for contributions to the scheme are recognised as an expense in the income statement in the period in which they arise.

**(n) 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).

# Notes to the consolidated financial statements

## *continued*

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.

### **(o) Taxes**

#### **Current tax**

Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from, or paid, to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted by the balance sheet date.

#### **Deferred tax**

Deferred tax is provided using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax liabilities are recognised for all taxable temporary differences, except:

- where the deferred tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in jointly controlled entities, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred tax assets are recognised for all deductible temporary differences, carry-forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry-forward of unused tax credits and unused tax losses can be utilised except:

- where the deferred tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in jointly controlled entities, deferred tax assets are recognised only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilised.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilised. Unrecognised deferred tax assets are re-assessed at each balance sheet date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the year when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted, or substantively enacted, at the balance sheet date.

Deferred tax is recognised in the income statement unless it relates to items accounted for in equity.

Deferred tax assets and deferred tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current tax liabilities and the deferred taxes relate to the same taxable entity and the same taxation authority.

#### **Value added tax**

Revenues, expenses and assets are recognised net of the amount of value added tax except:

- where the value added tax incurred on a purchase of assets or services is not recoverable from the taxation authority, in which case the value added tax is recognised as part of the cost of acquisition of the asset or as part of the expense item as applicable; and
- receivables and payables that are stated with the amount of value added tax included.

The net amount of value added tax recoverable from, or payable to, the taxation authority is included as part of receivables or payables in the balance sheet.

#### **(p) Derivative financial instruments**

The Group 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 Group in line with the Group's risk management policies. Interest rate swap agreements are used to manage interest rate exposures. Derivative financial instruments are stated at their fair value.

Under IAS 39, derivative financial instruments are always measured at fair value, with hedge accounting employed in respect of those derivatives fulfilling the stringent requirements for hedge accounting as prescribed under IAS 39. In summary, these criteria relate to initial designation and documentation of the hedge relationship, prospective testing of the relationship to demonstrate the expectation that the hedge will be highly effective throughout its life, and subsequent retrospective testing of the hedge to verify effectiveness.

The fair value of forward exchange contracts is calculated by reference to current forward exchange rates for contracts with similar maturity profiles. The fair value of interest rate swaps is determined by reference to market values for similar instruments.

Hedging transactions undertaken by the Company are classified as either fair value hedges when they hedge the exposure to changes in the fair value of a recognised asset or liability; or cash flow hedges where they hedge exposure to variability in currency cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecasted transaction.

In relation to fair value hedges, which meet the conditions for hedge accounting, any gain or loss from re-measuring the hedging instrument at fair value is recognised immediately in the income statement. Any gain or loss on the hedged item attributable to the hedged risk is adjusted against the carrying amount of the hedged item and recognised in the income statement. Where the adjustment is to the carrying amount of a hedged interest-bearing financial instrument, the adjustment is amortised to the net profit and loss such that it is fully amortised by maturity.

In relation to cash flow hedges to hedge firm currency commitments which meet the conditions for hedge accounting, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and the ineffective portion is recognised in the income statement.

When the hedged firm commitment results in the recognition of a non-financial asset or a non-financial liability then, at the time the asset or liability is recognised, the associated gains or losses that had previously been recognised in equity are included in the initial measurement of the acquisition cost or other carrying amount of the asset or liability. For all other cash flow hedges, the gains or losses that are recognised in equity are transferred to the income statement in the same periods in which the hedged firm commitment affects the net profit and loss.

For derivatives that do not qualify for hedge accounting, any gains or losses arising from changes in fair value are taken directly to the income statement.

# Notes to the consolidated financial statements

## *continued*

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

### **(q) Interest bearing loans and borrowings**

All loans and borrowings are initially stated at the amount of the net proceeds, being fair value of the consideration received net of issue costs associated with the borrowing. Finance costs (including issue costs) are taken to the income statement over the term of the debt at a constant rate on the balance sheet carrying amount. The carrying amount is increased by the finance charges amortised and reduced by payments made in respect of the accounting period. Loans and borrowings acquired at acquisition are restated to fair value. The adjustment arising on acquisition is amortised to the income statement on the basis of the maturity profile of each instrument. Realised gains and losses that occur from the early termination of loans and borrowings are taken to the income statement in that period.

Borrowing costs are recognised as an expense when incurred.

Net debt is the sum of all current and non-current liabilities less cash and cash equivalents, financial investments and loans receivable.

### **(r) Loans and receivables**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, do not qualify as trading assets and have not been designated as either fair value through profit and loss or available for sale. Gains and losses are recognised in income when the investments are de-recognised or impaired, as well as through the amortisation process.

### **(s) Cash and cash equivalents**

Cash and cash equivalents disclosed in the balance sheet comprise cash at bank and in hand and short term deposits with a remaining maturity of up to ten months or less, which are held for the purpose of meeting short term cash commitments rather than for investment or other purposes. Cash equivalents are readily convertible to a known amount of cash and subject to an insignificant risk of changes in value.

For the purpose of the consolidated cash flow statement, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.

### **(t) Trade and other receivables**

Trade receivables are recognised and carried at original invoice amount less an allowance for any uncollectable amounts. Invoices for unmeasured water and waste water charges are due on fixed dates; other receivables generally have 30 day payment terms. An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written off when identified. Trade and other receivables do not carry any interest.

### **(u) Investments**

Investments are initially recorded at the fair value of the consideration given and including the acquisition charges associated with the investment.

### **(v) Provisions**

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources will be required and a reliable estimate can be made of the amount of the obligation.

### **(w) Impairment of assets**

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable



amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses on continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

An assessment is made at each reporting date as to whether there is any indication that previously recognised impairment losses may no longer exist or may have decreased. If such indication exists, the recoverable amount is estimated. A previously recognised impairment loss is reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in the income statement unless the asset is carried at revalued amount, in which case the reversal is treated as a revaluation increase. After such a reversal the depreciation charge is adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life.

#### **(x) De-recognition of financial assets and liabilities**

A financial asset or liability is generally de-recognised when the contract that gives rise to it is settled, sold, cancelled or expires. Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the recognition of a new liability, such that the difference in the respective carrying amounts together with any costs or fees incurred are recognised in the income statement.

#### **(y) Accounting standards**

During the year, the IASB and IFRIC have issued the following standards and interpretations with an effective date after the date of these financial statements.

<b>International Accounting Standards (IAS/IFRS)</b>	<b>Effective date</b>
IFRS 7: Financial Instruments: Disclosures	1 January 2007
IFRS 8: Operating Segments	1 January 2009
IAS 1: Amendment to IAS 1 – Presentation of Financial Statements: Capital disclosures	1 January 2007

<b>International Financial Reporting Interpretation Committee (IFRIC)</b>	<b>Effective date</b>
IFRIC 8: Scope of IFRS 2	1 May 2006
IFRIC 9: Reassessment of Embedded Derivatives	1 June 2006
IFRIC 10: Interim Financial Reporting and Impairment	1 November 2006
IFRIC 11: IFRS 2 – Group and Treasury Share Transactions	1 March 2007
IFRIC 12: Service Concession Arrangements	1 January 2008

The directors do not anticipate that the adoption of these standards and interpretations will have a material impact on the Group's financial statements in the period of initial application.

Upon adoption of IFRS 7, the Group will have to disclose additional information about its financial instruments, their significance and the nature and extent of risks that they give rise to. More specifically the Group will need to disclose the fair value of its financial instruments and its risk exposure in greater detail. There will be no effect on reported income or net assets.

#### **(z) Key assumptions**

The directors consider that the key assumptions applied at the balance sheet date, which may have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are those assumptions used in arriving at the pension asset/liability under IAS 19. These key assumptions and their possible impact are disclosed in note 26, 'Pensions and other post-retirement benefits'.

# Notes to the consolidated financial statements

## continued

### 2. Segmental analysis

The primary segment reporting format is determined to be business segments. The secondary segment reporting is determined to be geographical; more than 98% of the Group's activities are within the UK and therefore revenue, profit before interest, assets and liabilities are attributable to one geographical segment.

#### Northumbrian Water Limited

NWL is one of the ten regulated water and sewerage businesses in England and Wales. NWL operates 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. NWL also has non-regulated activities closely related to its principal regulated activity.

#### Water and waste water contracts

NWG owns a number of special purpose companies for specific water and waste water contracts in Scotland, Ireland and Gibraltar.

#### Related services

AES provides environmental monitoring services, analysis and technical consultancy to major industrial groups, environmental regulators and local authorities throughout the UK and Ireland. On 31 March 2007, the business of AES merged with NWL and continues to operate as a trading division of NWL.

Agreer provides overseas aid funded project work in developing countries through a number of funding agencies.

Transfer prices between business segments are set on an arm's length basis in a manner similar to transactions with third parties. Segment revenue, segment expense and segment result include transfers between business segments. Those transfers are eliminated on consolidation.

#### Revenue

	Northumbrian Water Limited £m	Water and waste water contracts £m	Related services £m	Total £m	Discontinued operations £m	Total revenue from continuing operations £m
<b>Year ended 31 March 2007</b>						
Segment revenue	586.5	37.0	25.3	648.8	–	648.8
Inter segment revenue	–	–	(15.3)	(15.3)	–	(15.3)
Revenue to external customers	586.5	37.0	10.0	633.5	–	633.5
<b>Year ended 31 March 2006</b>						
Segment revenue	555.5	28.4	53.3	637.2	(28.5)	608.7
Inter segment revenue	–	(2.0)	(24.5)	(26.5)	9.3	(17.2)
Revenue to external customers	555.5	26.4	28.8	610.7	(19.2)	591.5

All revenue above represents the rendering of services.

**Profit on ordinary activities before interest**

	Northumbrian Water Limited £m	Water and waste water contracts £m	Related services £m	Total £m	Discontinued operations £m	Total profit from continuing operations £m
<b>Year ended 31 March 2007</b>						
Segment profit before interest	242.6	11.9	0.3	254.8	–	254.8
Central unallocated costs and provisions						3.4
Profit on ordinary activities before interest						258.2
Net finance costs						(111.2)
Share of profit from associates and jointly controlled entities						0.8
Profit on ordinary activities before taxation						147.8
Taxation						(36.6)
Profit for the year from continuing operations						111.2
<b>Year ended 31 March 2006</b>						
Segment profit before interest	234.6	1.8	16.4	252.8	(15.8)	237.0
Central unallocated costs and provisions						(0.8)
Profit on ordinary activities before interest						236.2
Net finance costs						(106.0)
Share of profit from associates and jointly controlled entities						0.1
Profit on ordinary activities before taxation						130.3
Taxation						(39.3)
Profit for the year from continuing operations						91.0

The profit disclosed in 2006 as discontinued operations is included in the result of related services and comprises a trading profit £1.2 million and a gain on disposal of £14.6 million.

**Assets and liabilities**

	Northumbrian Water Limited		Water and waste water contracts		Related services		Total	
	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m
Segment assets	3,159.8	3,007.8	137.5	139.2	4.0	6.7	3,301.3	3,153.7
Unallocated assets							396.0	215.3
							3,697.3	3,369.0
Segment liabilities	301.7	272.2	20.7	25.2	5.8	3.1	328.2	300.5
Unallocated liabilities							2,996.0	2,767.7
							3,324.2	3,068.2

# Notes to the consolidated financial statements

## continued

Unallocated net assets and liabilities comprise taxation, interest, pension and net debt.

	Northumbrian Water Limited		Water and waste water contracts		Related services		Total	
	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m
Other segment information:								
Property, plant and equipment additions	225.0	211.9	1.0	0.9	1.2	1.0	227.2	213.8
Goodwill, property, plant and equipment additions on acquisition	–	–	–	68.4	–	–	–	68.4
Depreciation	86.7	84.0	5.4	3.3	0.7	1.1	92.8	88.4
Impairment of intangible	–	–	–	–	0.1	–	0.1	–

### 3. Operating costs

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Materials and consumables	20.4	20.0
Manpower costs (see note 5)	92.7	97.3
Own work capitalised	(24.4)	(22.5)
Depreciation of property, plant and equipment	92.8	88.0
Profit on disposal of property, plant and equipment	(2.1)	(1.8)
Impairment of goodwill	0.1	–
Amortisation of capital grants	(4.5)	(3.7)
Costs of research and development	2.1	2.3
Operating lease payments	1.2	1.2
Bad debt charge	13.3	12.2
Other operating costs	183.7	162.3
Operating costs	375.3	355.3

### 4. Auditors' remuneration

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Audit of the financial statements*	0.3	0.3
Other fees to auditors		
– taxation services	–	0.1
– regulatory services	0.1	–

\* £84,000 of this relates to the Company (2006: £80,000).

## 5. Employee information

The total employment costs of all employees (including directors) of the Group were:

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Wages and salaries	79.6	81.6
Social security costs	6.8	6.8
Other pension costs	6.3	8.9
<b>Total employment costs</b>	<b>92.7</b>	<b>97.3</b>
Total employment costs were charged as follows:		
Capital schemes and infrastructure renewals	24.2	22.1
Manpower costs	68.5	75.2
	<b>92.7</b>	<b>97.3</b>

Included in wages and salaries is a total expense of shared-based payments of £0.7 million (2006: £0.6 million) which arises from transactions accounted for as equity-settled share-based payment transactions.

The average monthly number of employees of the Group during the year was:

	Year to 31.3.2007 Number	Year to 31.3.2006 Number
Northumbrian Water Limited	2,554	2,540
Water and waste water contracts	153	150
Related services	333	733
	<b>3,040</b>	<b>3,423</b>

The average number of employees for related services includes nil employees (2006: 378) in respect of discontinued operations.

The information required by Schedule 6 of the Companies Act is contained in the directors' remuneration report under directors' emoluments, directors' pensions and pension benefits, directors' interests in shares and debentures, directors' interests in LTIP awards and directors' interests in shares under the Share Incentive Plan.

## 6 Finance costs payable/(income receivable)

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Finance costs payable on debentures, bank and other loans and overdrafts	128.4	122.4
Amortisation of discount, fees, loan issue costs and other financing items	(7.1)	(12.7)
Settled hedge instruments	2.9	–
Finance costs payable on hire purchase contracts and finance leases	2.8	3.0
<b>Total finance costs payable</b>	<b>127.0</b>	<b>112.7</b>
Finance income receivable	(15.8)	(6.7)
<b>Net finance costs payable</b>	<b>111.2</b>	<b>106.0</b>

# Notes to the consolidated financial statements

## continued

### 7. Taxation

#### (a) Tax on profit on ordinary activities

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Current tax:		
UK corporation tax – continuing operations	21.0	16.3
– discontinued operations (see note 8)	–	0.6
– income tax reported in equity on cash flow hedges	0.1	–
– adjustment in respect of prior periods	(12.5)	(0.7)
UK corporation tax	8.6	16.2
Overseas tax	–	0.1
Total current tax	8.6	16.3
Deferred tax:		
Origination and reversal of temporary differences in the year		
Deferred tax – continuing operations	21.0	22.5
– discontinued operations (see note 8)	–	0.1
– income tax reported in equity on cash flow hedges	(0.1)	–
– adjustment in respect of prior periods	7.1	1.1
Total deferred tax	28.0	23.7
Tax charge in the income statement	36.6	40.0
The tax charge in the income statement is disclosed as follows:		
Tax expense on continuing operations	36.6	39.3
Tax expense on discontinued operations (see note 8)	–	0.7
	36.6	40.0

#### (b) Tax relating to items charged or credited to equity

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Current tax:		
Current tax recycled to income statement on cash flow hedges	(0.1)	–
Deferred tax:		
Actuarial gains and losses on pension schemes	7.5	15.8
Deferred tax recycled to income statement on cash flow hedges	0.1	–
Tax on share-based payment	–	(0.2)
Tax charge in the statement of recognised income and expense	7.5	15.6

**(c) Reconciliation of the total tax charge**

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Profit before taxation from continuing operations	147.8	130.3
Profit before taxation from discontinued operations	–	16.1
Accounting profit before tax	147.8	146.4
Accounting profit multiplied by standard rate of corporation tax (30%) (2006: 30%)	44.3	43.9
Effects of:		
Expenses not deductible for tax purposes	0.7	0.8
Depreciation in respect of non-qualifying items	0.7	0.9
Non-taxable income	(0.8)	(0.5)
Non-taxable profit on disposal of subsidiaries	–	(4.4)
Retirement benefits	–	2.8
Adjustment to tax charge in respect of prior periods	(5.4)	0.4
Non-taxable amortisation of financing items	(2.3)	(3.9)
Other	(0.6)	–
Total tax expense reported in the income statement	36.6	40.0

The effective tax rate for the current year was 24.8% (2006: 27.3%). The reduction of 2.5% is explained by adjustments in respect of prior periods arising from changes in capital allowances claims and a revision to retirement benefits, a reduction in the amortisation of financing items, and the absence of any disposal of subsidiaries in the current year.

**(d) Unrecognised tax losses**

The Group has tax losses of £9.1 million (2006: £10.8 million) which have arisen in its Gibraltar subsidiary for which a deferred tax asset has not been recognised as they may not be used to offset taxable profits elsewhere in the Group and it is not expected that the subsidiary will utilise significant amounts in the foreseeable future. The losses are, however, available for offset against future taxable profits without time limit.

**(e) Temporary differences associated with Group investments**

At 31 March 2007, there was no recognised deferred tax liability (2006: £nil) for taxes that would be payable on the unremitted earnings of the Group's subsidiaries as the Group has determined that undistributed profits of its subsidiaries will not be distributed in the foreseeable future.

The temporary differences associated with investments in subsidiaries for which a deferred tax liability has not been recognised aggregate to £7.2 million (2006: £7.0 million).

**(f) Deferred tax**

The deferred tax included in the income statement is as follows:

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Accelerated capital allowances	22.3	20.4
Provisions	1.3	0.9
Deferred income	(5.3)	(4.5)
Retirement benefits	5.4	7.2
Losses carried forward	(0.3)	(0.5)
Finance costs payable	5.5	–
Other	(0.9)	0.2
	28.0	23.7

# Notes to the consolidated financial statements

## *continued*

The deferred tax included in the balance sheet is as follows:

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Deferred tax assets:		
Provisions	1.7	3.0
Deferred income	56.7	51.4
Retirement benefits	–	2.9
Losses available for offset against future taxable income	5.6	4.8
Share-based payments	0.3	0.3
Finance costs payable	–	5.5
Cash flow hedges	1.2	1.2
Other	0.3	0.4
Deferred tax asset	<b>65.8</b>	69.5
Deferred tax liabilities:		
Accelerated capital allowances	555.1	532.4
Intangible asset	19.3	19.3
Fair value adjustment on previous business combinations	12.6	13.0
Retirement benefits	9.9	–
Other	0.1	0.4
Deferred tax liability	<b>597.0</b>	565.1
Net deferred tax liability	<b>531.2</b>	495.6

### **(g) Factors that may affect future tax charges**

The Group expects to continue to incur high levels of capital expenditure and be able to claim tax relief in excess of depreciation for the remainder of NWL's current regulatory period. The annual excess was already expected to reduce because tax deductions for deferred revenue expenditure are now claimed on a depreciation basis (as set out in HM Revenue and Customs' Tax Bulletin 53) but the timing of future capital allowances claims is subject to proposals announced by the UK Government on 21 March 2007 to revise the rates of allowances with effect from 1 April 2008. A reduction in the main rate of corporation tax from 30% to 28% has also been proposed with effect from the same date.

The proposed changes to capital allowances that are expected to affect the Group are a reduction in the rate of allowances for items of general plant and machinery from 25% to 20% per annum; an increase in the rate of allowances for long life assets from 6% to 10% per annum; the phased abolition of industrial building allowances by 31 March 2011; and the introduction of a new allowance rate of 10% per annum for 'building-related' fixtures (the definition of which is to be the subject of consultation).

The 2007 Finance Bill includes proposals for the reduction in the rate of corporation tax from 30% to 28% as well as for the removal of potential balancing adjustments in respect of assets on which industrial buildings allowances are being claimed. These changes had not been enacted or substantively enacted by the date of these financial statements. In the directors' view, had the above changes been enacted, the Group's deferred tax liability at 31 March 2007 would have been increased by approximately £74 million.



## 8. Discontinued operations

In line with the Group's focus on core competencies of water and waste water management, the Group disposed of Fastflow Pipeline Services Limited (FPS) on 8 July 2005, Entec UK Limited (Entec) on 5 October 2005 and ULG Northumbrian Limited (ULG) on 10 April 2006. The results of the discontinued operations are disclosed within related services. No tax arose on the disposals due to the availability of the substantial shareholdings exemption. The results of FPS, Entec and ULG for the period to their date of disposal are presented below:

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Revenue	–	28.5
Inter segment	–	(9.3)
External revenue	–	19.2
Operating costs	–	(18.0)
Profit on ordinary activities before interest	–	1.2
Profit on disposal of discontinued operations	–	14.6
Profit before interest on discontinued operations	–	15.8
Net finance costs	–	0.3
Profit on ordinary activities before taxation	–	16.1
Current tax	–	(0.6)
Deferred tax	–	(0.1)
Profit for the year from discontinued operations	–	15.4

The tax charge is analysed as follows:

On profit on ordinary activities for the year	–	(0.7)
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The major classes of assets and liabilities of FPS, Entec and ULG at their date of disposal were as follows:

	£m
<b>Assets</b>	
Property, plant and equipment	4.3
Inventories	3.8
Receivables	9.1
Deferred taxation	0.5
Cash and cash equivalents	11.1
	28.8
<b>Liabilities</b>	
Payables	11.0
Provisions	1.3
Loans	0.4
	12.7

# Notes to the consolidated financial statements

## continued

### 9. Earnings per share

Basic earnings per share (EPS) is calculated by dividing the profit attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares in issue during the year. Treasury shares held are excluded from the weighted average number of shares for basic EPS. EPS for continuing operations is also disclosed.

	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence
Net profit attributable to equity holders of the parent – continuing operations	110.9	517.7	21.42	90.5	517.9	17.48
Net profit attributable to equity holders of the parent – discontinued operations	–	–	–	15.4	–	2.97
Basic EPS	110.9	517.7	21.42	105.9	517.9	20.45

The weighted average number of shares for diluted EPS is calculated by including the treasury shares held.

	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence
Net profit attributable to equity holders of the parent – continuing operations	110.9	518.6	21.38	90.5	518.6	17.45
Net profit attributable to equity holders of the parent – discontinued operations	–	–	–	15.4	–	2.97
Diluted EPS	110.9	518.6	21.38	105.9	518.6	20.42

Adjusted EPS is considered by the directors to give a better indication of the Group's underlying performance due to the non-cash nature of the adjusted items and is calculated as follows:

	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence
Basic EPS	110.9	517.7	21.42	90.5	517.9	17.48
Deferred tax	28.0	–	5.41	23.6	–	4.55
Amortisation of debt fair value	(7.7)	–	(1.49)	(13.0)	–	(2.51)
Derivatives	(2.0)	–	(0.39)	–	–	–
Adjusted EPS	129.2	517.7	24.95	101.1	517.9	19.52

## 10. Dividends paid and proposed

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Declared and paid during the year:		
Equity dividends on ordinary shares:		
Final dividend for 2005/06: 7.04p (2004/05: 7.13p)	36.4	36.9
Interim dividend for 2006/07: 3.75p (2005/06: 3.52p)	19.4	18.2
Special dividend for 2006/07: nil (2005/06: 2.82p)	–	14.6
<b>Dividends paid</b>	<b>55.8</b>	<b>69.7</b>
Proposed for approval by shareholders at the AGM:		
Final dividend for 2006/07: 7.52p (2005/06: 7.04p)	39.0	36.5

## 11. Intangible assets

	Goodwill £m	Other £m	Total £m
Cost:			
At 1 April 2005	0.2	64.2	64.4
Acquisition of subsidiary	3.6	–	3.6
<b>At 1 April 2006 and 31 March 2007</b>	<b>3.8</b>	<b>64.2</b>	<b>68.0</b>
Impairment:			
At 1 April 2005 and 1 April 2006	(0.1)	–	(0.1)
Impairment	(0.1)	–	(0.1)
<b>At 1 April 2006 and 31 March 2007</b>	<b>(0.2)</b>	<b>–</b>	<b>(0.2)</b>
<b>Net book value at 31 March 2007</b>	<b>3.6</b>	<b>64.2</b>	<b>67.8</b>
Net book value at 31 March 2006	3.7	64.2	67.9
Net book value at 1 April 2005	0.1	64.2	64.3

As from 1 April 2004, the date of transition to IFRS, goodwill is no longer amortised but is now subject to an annual impairment review.

Goodwill has been allocated to the water and waste water cash-generating unit and the other intangible asset has been allocated to the Northumbrian Water Limited cash-generating unit, which are also the reportable segments.

The other intangible asset represents the right in perpetuity to receive income under the operating agreement with the Environment Agency in respect of the Kielder Water transfer scheme and, therefore, the directors consider the asset has an indefinite life. Accordingly, future cash flows, which increase in line with inflation, have been discounted at a rate of 5.08% in perpetuity. This represents a long term nominal gilt yield and an assumed credit spread. This calculation satisfied the Group that the carrying value at 31 March 2007 had not been impaired. Furthermore, it is improbable that the discount rate would increase to such a level that the carrying value would be impaired.

# Notes to the consolidated financial statements

*continued*

## 12. Property, plant and equipment

	Freehold land and buildings £m	Short leasehold land and buildings £m	Infrastructure assets £m	Operational structures, plant and machinery £m	Fixtures, fittings, tools and equipment £m	Assets in the course of construction £m	Total £m
Cost:							
At 1 April 2005	87.6	5.0	1,361.6	1,693.9	150.2	69.0	3,367.3
Additions	–	–	0.3	0.8	1.2	211.5	213.8
Schemes commissioned	0.7	–	78.0	102.6	11.6	(192.9)	–
Acquisition of subsidiary	–	–	–	38.9	25.9	–	64.8
Discontinued operations	(0.5)	(4.4)	–	(4.0)	(4.3)	–	(13.2)
Reclassifications	(1.2)	–	15.7	16.0	(23.1)	(7.3)	0.1
Disposals	(0.2)	(0.6)	(12.1)	(0.5)	(0.1)	–	(13.5)
At 1 April 2006	86.4	–	1,443.5	1,847.7	161.4	80.3	3,619.3
Additions	–	–	0.2	0.3	1.7	225.0	227.2
Schemes commissioned	6.2	–	100.1	94.6	4.4	(205.3)	–
Reclassifications	–	–	0.6	(0.6)	–	–	–
Disposals	(0.2)	–	(9.9)	–	(0.2)	–	(10.3)
<b>At 31 March 2007</b>	<b>92.4</b>	<b>–</b>	<b>1,534.5</b>	<b>1,942.0</b>	<b>167.3</b>	<b>100.0</b>	<b>3,836.2</b>
Depreciation:							
At 1 April 2005	27.2	2.9	37.7	403.5	95.7	–	567.0
Charge for the year	1.4	0.1	19.3	61.0	6.6	–	88.4
Reclassifications	–	–	0.9	(0.4)	–	–	0.5
Discontinued operations	–	(2.9)	–	(3.2)	(2.8)	–	(8.9)
Disposals	(0.6)	(0.1)	(12.1)	(0.2)	(0.3)	–	(13.3)
At 1 April 2006	28.0	–	45.8	460.7	99.2	–	633.7
Charge for the year	2.2	–	20.4	60.4	9.8	–	92.8
Disposals	(0.1)	–	(9.9)	–	(0.2)	–	(10.2)
<b>At 31 March 2007</b>	<b>30.1</b>	<b>–</b>	<b>56.3</b>	<b>521.1</b>	<b>108.8</b>	<b>–</b>	<b>716.3</b>
<b>Net book value at 31 March 2007</b>	<b>62.3</b>	<b>–</b>	<b>1,478.2</b>	<b>1,420.9</b>	<b>58.5</b>	<b>100.0</b>	<b>3,119.9</b>
Net book value at 31 March 2006	58.4	–	1,397.7	1,387.0	62.2	80.3	2,985.6
Net book value at 1 April 2005	60.4	2.1	1,323.9	1,290.4	54.5	69.0	2,800.3

Operational structures, plant and machinery include an element of land and buildings dedicated to those assets. The Group does not capitalise finance costs.

The net book value of property, plant and equipment held under hire purchase contracts and finance leases was as follows:

	31.3.2007 £m	31.3.2006 £m
Infrastructure assets	–	2.2
Operational structures, plant and machinery	23.2	24.0
	<b>23.2</b>	<b>26.2</b>

### 13. Investments

	31.3.2007 £m	31.3.2006 £m
Investments in jointly controlled entities	3.6	3.6
Other investments	0.2	0.3
	<b>3.8</b>	<b>3.9</b>

#### (a) Investments in associates

The Group held a 50% interest in Ayr Environmental Services Limited (Ayes), the principal trading associate. On 23 December 2005, the Group increased its shareholding from 50% to 75% for a consideration of £1.5 million. Following the increase in shareholding, Ayes is fully consolidated into the Group's results. The Group previously accounted for its interest in Ayes using the equity method.

The financial information of the Group's investment in Ayes up to the date of full consolidation consisted of £4.3 million and £0.6 million in respect of revenue and loss after tax, respectively.

#### Business combination

Following the increased shareholding in Ayes, on 23 December 2005, book and fair values of the net assets at date of acquisition were as follows:

	Book values £m	Fair value to the Group £m
Property, plant and equipment	64.8	64.8
Receivables	9.1	9.1
Cash and cash equivalents	3.9	3.9
Payables	(3.2)	(3.2)
Borrowings	(70.7)	(70.7)
Deferred tax	(5.4)	(5.4)
Net liabilities	(1.5)	(1.5)
Goodwill arising on acquisition		3.6
		<b>2.1</b>
Discharged by:		
Cash consideration		1.5
Associate losses accounted under equity method – now written off		0.6
		<b>2.1</b>

From the date of acquisition, 23 December 2005, Ayes has contributed a net loss to the Group of £0.4 million. If the combination had taken place on 1 April 2005, the profit of the Group would have been £105.8 million and revenue from continuing operations would have been £600.0 million.

No intangible assets were identified on acquisition. Accordingly, £3.6 million of goodwill was recognised, being the premium paid over the fair value of net liabilities.

#### (b) Investments in jointly controlled entities

The Group holds 50% of the nominal value of issued ordinary £1 shares in Vehicle Lease and Service Limited (VLS), the Group's principal jointly controlled entity. VLS was incorporated in England and Wales and undertakes the business of hiring, leasing and servicing of vehicles and plant.

The Group also holds a 50% interest in Agreco, a jointly controlled entity incorporated in Belgium.

# Notes to the consolidated financial statements

## continued

The following table illustrates summarised financial information of the Group's share of the results of VLS and Agreco.

	VLS 31.3.2007 £m	Agreco 31.3.2007 £m	VLS 31.3.2006 £m	Agreco 31.3.2006 £m
Revenue	5.8	1.3	6.0	0.9
Operating costs	(4.9)	(1.1)	(5.0)	(0.7)
Profit on ordinary activities before interest	0.9	0.2	1.0	0.2
Finance costs payable	(0.3)	–	(0.3)	–
Finance income receivable	0.1	–	–	–
Profit on ordinary activities before taxation	0.7	0.2	0.7	0.2
– current taxation	(0.1)	–	(0.2)	–
Profit for the year	0.6	0.2	0.5	0.2
Share of the jointly controlled entities' balance sheet:				
Non-current assets	5.6	–	5.2	–
Current assets	5.1	1.5	6.1	0.7
Share of gross assets	10.7	1.5	11.3	0.7
Current liabilities	(3.5)	(1.3)	(3.9)	(0.5)
Non-current liabilities	(3.8)	–	(4.0)	–
Share of gross liabilities	(7.3)	(1.3)	(7.9)	(0.5)
Net assets	3.4	0.2	3.4	0.2

### (c) The Group's interests in principal subsidiaries at 31 March 2006 and 31 March 2007 were as follows:

Name of undertaking	Country of incorporation or registration and operation	Description of shares held	Proportion of nominal value of issued shares held by Group (%)	Business activity
Northumbrian Services Limited	England and Wales	Ordinary shares of £1	100	Holding of investments and loans
Northumbrian Water Limited	England and Wales	Ordinary shares of £1	100	Water and sewerage services
Northumbrian Water Finance plc	England and Wales	Ordinary shares of £1	100	Holding of finance instruments
Caledonian Environmental Services plc	Scotland	Ordinary shares of £1	75	Waste water services
Caledonian Environmental Levenmouth Treatment Services Limited	Scotland	Ordinary shares of £1	75	Waste water services
Ayr Environmental Services Limited	Scotland	Ordinary shares of £1	75	Waste water services
Ayr Environmental Services Operations Limited	Scotland	Ordinary shares of £1	100	Waste water services
AquaGib Limited	Gibraltar	Ordinary shares of £1	67	Water and sewerage services
Northumbrian Water Projects Limited	England and Wales	Ordinary shares of £1	100	Waste water services
Analytical & Environmental Services Limited*	England and Wales	Ordinary shares of £1	100	Analytical laboratory and scientific services
SA Agrer NV	Belgium	Ordinary shares of £1	100	Aid funded project work

\* On 31 March 2007, the business of AES merged with NWL and continues to operate as a trading division of NWL.

The directors consider that to give full particulars of all subsidiary and associated undertakings would lead to a statement of excessive length. The above information relates to those subsidiary and associated undertakings or groups of undertakings whose results or financial position, in the opinion of the directors, principally affect the figures of the Group. A full list of the Company's subsidiaries is attached to the Company's latest annual return filed at Companies House.

#### 14. Inventories

	31.3.2007 £m	31.3.2006 £m
Stores	3.7	3.3

#### 15. Trade and other receivables

	31.3.2007 £m	31.3.2006 £m
Trade receivables	61.7	53.9
Amounts owed by jointly controlled entities	0.7	0.9
Prepayments and accrued income	45.6	40.7
Financial assets	2.1	2.5
Other receivables	14.4	13.6
	<b>124.5</b>	<b>111.6</b>

#### 16. Cash and cash equivalents

	31.3.2007 £m	31.3.2006 £m
Cash at bank and in hand	53.3	48.4
Short term deposits	263.6	128.2
	<b>316.9</b>	<b>176.6</b>

Cash at bank earns interest at floating rates based on daily bank deposit rates. Short term deposits are made for varying periods of up to ten months depending on the immediate cash requirements of the Group.

For the purposes of the consolidated cash flow statement, cash and cash equivalents comprise the following at 31 March:

	31.3.2007 £m	31.3.2006 £m
Cash at bank and in hand	53.3	48.4
Short term deposits	263.6	128.2
Bank overdrafts	(1.1)	(22.7)
	<b>315.8</b>	<b>153.9</b>

# Notes to the consolidated financial statements

## continued

### 17. Trade and other payables

	31.3.2007 £m	31.3.2006 £m
Trade payables	8.7	11.0
Other payables	17.2	16.1
Interest payable	43.5	49.4
Accruals and deferred income	96.2	79.8
	<b>165.6</b>	156.3

### 18. Interest bearing loans and borrowings

	31.3.2007 £m	31.3.2006 £m
Current:		
Bank overdrafts	1.1	22.7
Current instalments due on borrowings (principal £22.5 million, 2006: £201.8 million)	28.6	209.5
Current obligations under finance leases and hire purchase contracts (see note 19)	4.8	4.5
	<b>34.5</b>	236.7

#### Non-current:

Non-current obligations under finance leases and hire purchase contracts (principal £56.4 million, 2006: £56.7 million) (see note 19)	56.5	56.9
Non-current instalments on borrowings (principal £2,281.6 million, 2006: £1,866.6 million)	2,325.6	1,916.0
	<b>2,382.1</b>	1,972.9

#### Borrowings comprise the following:

Loans (principal £569.9 million, 2006: £374.9 million)	579.0	386.3
Eurobonds – due 28 June 2006 bearing interest rate of 8.625% (principal £nil, 2006: £171.2 million)	–	172.3
Eurobonds – due 11 October 2017 bearing interest rate of 6.0% (principal £300.0 million, 2006: £300.0 million)	312.1	313.3
Eurobonds – due 6 February 2023 bearing interest rate of 6.875% (principal £350.0 million, 2006: £350.0 million)	395.5	398.5
Eurobonds – due 29 April 2033 bearing interest rate of 5.625% (principal £350.0 million, 2006: £350.0 million)	345.6	345.5
Eurobonds – due 23 January 2034 bearing interest rate of 5.87526% (principal £248.0 million, 2006: £248.0 million)	240.1	239.7
Eurobonds – due 31 March 2037 bearing interest rate of 6.627% (principal £61.6 million, 2006: £61.6 million)	58.6	58.6
Index linked Eurobonds – due 15 July 2036 bearing interest rate of 2.033% (principal £157.6 million, 2006: £152.6 million)	156.5	151.4
Index linked Eurobonds – due 30 January 2041 bearing interest rate of 1.6274% (principal £61.6 million, 2006: £60.1 million)	61.8	59.9
Index linked Eurobonds – due 16 July 2049 bearing interest rate of 1.7118% (principal £102.7 million, 2006: £nil)	102.5	–
Index linked Eurobonds – due 16 July 2053 bearing interest rate of 1.7484% (principal £102.7 million, 2006: £nil)	102.5	–
	<b>2,354.2</b>	2,125.5
Less current instalments due on bank loans (principal £22.5 million, 2006: £201.8 million)	28.6	209.5
	<b>2,325.6</b>	1,916.0



The difference between the principal value of £2,281.6 million (2006: £1,866.6 million) and the carrying value of £2,325.6 million (2006: £1,916.0 million) are unamortised issue costs of £16.1 million (2006: £16.7 million) and a credit of £60.1 million (2006: £66.1 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

The Eurobonds – due 23 January 2034 are secured on the income receivable under the Kielder Water transfer scheme for the period to 23 January 2034.

The value of the capital and interest elements of the index linked Eurobonds are linked to movements in the UK Retail Price Index.

### 19. Obligations under hire purchase contracts and finance leases

	31.3.2007 £m	31.3.2006 £m
Amounts due:		
Not later than one year	4.8	4.5
After one year but not more than five years	21.3	17.7
Later than five years	53.5	58.1
	<b>79.6</b>	80.3
Less finance charges allocated to future periods	<b>(18.3)</b>	(18.9)
Present value of minimum lease payments	<b>61.3</b>	61.4
Disclosed as due:		
Not later than one year	4.8	4.5
After more than one year	56.5	56.9
	<b>61.3</b>	61.4

#### Lease commitments

The Group has entered into non-cancellable operating leases in respect of land and buildings, plant, machinery and motor vehicles. The future minimum rentals payable under non-cancellable operating leases are as follows:

	31.3.2007 £m	31.3.2006 £m
Not later than one year	0.6	1.0
After one year but not more than five years	2.8	2.6
After five years	25.9	25.9
	<b>29.3</b>	29.5

# Notes to the consolidated financial statements

## *continued*

### 20. Provisions

	£m
At 1 April 2006	
Current	0.3
Non-current	3.1
	3.4
Utilised	(0.3)
<b>At 31 March 2007</b>	<b>3.1</b>
Analysed as:	
Current	0.2
Non-current	2.9
	<b>3.1</b>

The provision represents outstanding discretionary pension liabilities. The discretionary pension liabilities have been calculated by an independent actuary and are expected to be paid over the remaining lives, which is approximately ten years.

### 21. Financial instruments

#### (a) Group strategy

The level of capital expenditure which the Group is obliged to incur is such that it cannot be wholly financed by internally generated sources. As a result, the Group 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 Group's strategy is to finance such investment by raising medium to long term debt, to provide a balance sheet match with long term assets and to fix a major proportion of interest rates.

#### (b) Treasury operations

The main purpose of the Group's treasury function is to assess the Group's ongoing capital requirement and to raise funding on a timely basis, taking advantage of any favourable market opportunities. It also invests any surplus funds the Group may have, based upon its forecast requirements and in accordance with the Group's treasury policy. On occasions, derivatives are used as part of this process but the Group's policies prohibit their use for speculation.

#### (c) Risks arising from the Group's financial instruments

The main risks arising from the Group's financial instruments are liquidity risk, interest rate risk and foreign currency risk. The Board reviews and agrees policies for managing each of these risks and they are summarised below. All treasury activities are conducted in accordance with these policies.

#### (d) Liquidity risk

As regards day to day liquidity, the Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0 million and with a bank agreement availability period of no less than three months. At 31 March 2007, the Group had £75.0 million available in standby committed bank facilities (2006: £275.0 million).

#### (e) Interest rate risk

The Group finances its operations through a mixture of retained profits and bank borrowings. It borrows at both fixed and floating rates of interest and, accordingly, uses interest rate swaps to generate the desired interest profile and to manage the Group's 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 2007, 65% (2006: 80%) of the Group's borrowings were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

**(f) 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 £3.0 million sterling equivalent of a translation nature, should be covered immediately on identification.

**(g) Market price risk**

The Group's exposure to market price risk principally comprises interest rate exposures. The Group's policy is to accept a degree of interest rate risk. On the basis of the Group's analysis, it is estimated that a 1% rise in interest rates would not have a material effect on the Group's pre-tax profits.

**(h) Credit risk**

There are no significant concentrations of credit risk within the Group. The maximum credit risk exposure relating to financial assets is represented by carrying value as at the balance sheet date.

**(i) Interest rate risk profile of financial assets and liabilities**

The interest rate profile of the financial assets and liabilities of the Group as at 31 March is as follows:

**Year ended 31 March 2007**

	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
<b>Fixed rate:</b>							
Loans receivable	0.2	–	–	–	–	1.0	1.2
Eurobonds	(4.0)	(4.0)	(4.1)	(4.4)	(5.1)	(1,330.3)	(1,351.9)
Subordinated loans	–	–	–	–	–	(6.3)	(6.3)
Bank loans	(21.8)	(20.3)	(19.4)	(17.8)	(16.1)	(119.9)	(215.3)
Obligations under finance leases and hire purchase contracts	(2.2)	(1.8)	(1.2)	(0.7)	(0.3)	(0.1)	(6.3)
<b>Fixed rate at 31 March 2007</b>	<b>(27.8)</b>	<b>(26.1)</b>	<b>(24.7)</b>	<b>(22.9)</b>	<b>(21.5)</b>	<b>(1,455.6)</b>	<b>(1,578.6)</b>
<b>Variable rate:</b>							
Cash and cash equivalents	316.9	–	–	–	–	–	316.9
Financial investments	1.9	1.7	1.4	1.2	0.9	11.8	18.9
Eurobonds	–	–	–	–	–	(423.3)	(423.3)
Bank loans	(2.8)	(77.9)	(2.5)	(127.5)	(101.2)	(45.5)	(357.4)
Overdrafts	(1.1)	–	–	–	–	–	(1.1)
Obligations under finance leases and hire purchase contracts	(2.6)	(3.4)	(4.0)	(4.6)	(5.3)	(35.1)	(55.0)
<b>Variable rate at 31 March 2007</b>	<b>312.3</b>	<b>(79.6)</b>	<b>(5.1)</b>	<b>(130.9)</b>	<b>(105.6)</b>	<b>(492.1)</b>	<b>(501.0)</b>
<b>Net borrowings at 31 March 2007</b>							<b>(2,079.6)</b>

# Notes to the consolidated financial statements

*continued*

## Year ended 31 March 2006

	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
Fixed rate:							
Loans receivable	0.4	0.2	–	–	–	1.0	1.6
Eurobonds	(176.3)	(4.0)	(3.9)	(4.0)	(4.1)	(1,335.6)	(1,527.9)
Subordinated loans	–	–	–	–	–	(6.1)	(6.1)
Bank loans	(15.5)	(21.1)	(20.6)	(19.3)	(17.7)	(135.8)	(230.0)
Obligations under finance leases and hire purchase contracts	(2.2)	(1.7)	(1.3)	(0.7)	(0.3)	(0.2)	(6.4)
Fixed rate at 31 March 2006	(193.6)	(26.6)	(25.8)	(24.0)	(22.1)	(1,476.7)	(1,768.8)
Variable rate:							
Cash and cash equivalents	176.6	–	–	–	–	–	176.6
Financial investments	2.1	1.9	1.7	1.4	1.2	12.7	21.0
Eurobonds	–	–	–	–	–	(211.3)	(211.3)
Bank loans	(17.5)	(2.8)	(2.8)	(2.9)	(2.5)	(121.7)	(150.2)
Overdrafts	(22.7)	–	–	–	–	–	(22.7)
Obligations under finance leases and hire purchase contracts	(2.3)	(2.5)	(3.1)	(3.7)	(4.3)	(39.1)	(55.0)
Variable rate at 31 March 2006	136.2	(3.4)	(4.2)	(5.2)	(5.6)	(359.4)	(241.6)
Net borrowings at 31 March 2006							(2,010.4)

The variable rate net borrowings comprise sterling denominated bank borrowings and deposits that bear interest at rates based upon up to 12 months LIBOR.

### (j) Currency exposures

At 31 March 2007, after taking into account the effects of forward foreign exchange contracts, the Group had no currency exposures (2006: £nil).

### (k) Borrowing facilities

The Group has various undrawn committed borrowing facilities. The facilities available at 31 March, in respect of which all conditions precedent have been met, are as follows:

	31.3.2007 £m	31.3.2006 £m
Expiring in one year or less	–	200.0
Expiring in more than two years but not more than five years	75.0	75.0
	75.0	275.0

**(l) Fair values of financial assets and financial liabilities**

A comparison by category of book values and fair values of the Group's financial assets and liabilities as at 31 March is set out below:

	Book value		Fair value	
	31.3.2007 £m	31.3.2006 £m	31.3.2007 £m	31.3.2006 £m
<b>Financial assets:</b>				
Cash and cash equivalents	316.9	176.6	316.9	176.6
Financial investments	18.9	21.0	18.9	21.0
Sterling loans receivable	1.2	1.6	1.2	1.6
Interest rate swaps	–	–	–	1.0
<b>Financial liabilities:</b>				
Overdraft	(1.1)	(22.7)	(1.1)	(22.7)
Bank loans (principal of £563.6 million, 2006: £368.8 million)	(572.7)	(380.2)	(566.3)	(377.2)
Subordinated loan stock	(6.3)	(6.1)	(6.3)	(6.1)
Eurobonds (principal of £1,734.2 million, 2006: £1,693.5 million)	(1,775.2)	(1,739.2)	(1,837.8)	(1,861.0)
Obligations under finance leases and hire purchase contracts (principal of £61.2 million, 2006: £61.2 million)	(61.3)	(61.4)	(61.3)	(61.4)
	<b>(2,079.6)</b>	<b>(2,010.4)</b>	<b>(2,135.8)</b>	<b>(2,128.2)</b>

The fair values of the interest rate swaps, forward foreign currency contracts and sterling denominated long term fixed rate debt with a book value of £1,775.2 million (2006: £1,739.2 million), have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

The difference between the principal value of £2,359.0 million (2006: £2,123.5 million) and the carrying value of £2,409.2 million (2006: £2,180.8 million) are unamortised issue costs of £16.1 million (2006: £16.7 million) and a credit of £66.3 million (2006: £74.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

**(m) Hedges****Cash flow hedges – currency forward contracts**

At 31 March 2007, the Group held the following forward exchange contracts, designated as hedges of expected future purchases for which the Group has firm commitments. The forward currency contracts are being used to hedge the foreign currency risk of the firm commitments. The terms of these contracts are as follows:

Currency bought	Maturity	Exchange rate €
Eur 67,431.92	30.4.2007	1.4693
Eur 192,376	30.4.2007	1.4693
Eur 535,000	10.5.2007	1.4739
Eur 473,100	29.6.2007	1.5088
Eur 473,100	28.9.2007	1.5022
Eur 473,100	30.11.2007	1.4978
Eur 473,100	31.3.2008	1.4891

These hedges were designated as highly effective. At 31 March 2007, no change occurred in the fair value and, therefore, no gain or loss has been included in equity.

# Notes to the consolidated financial statements

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At 31 March 2006, the Group had two forward exchange contracts, designated as hedges of expected future purchases for which the Group has firm commitments. The forward currency contracts were being used to hedge the foreign currency risk of the firm commitments. The terms of these contracts were as follows:

Currency bought	Maturity	Exchange rate €
Eur 61,586.98	28.4.2006	1.4338
Eur 505,980.06	21.6.2006	1.4338

These hedges were designated as highly effective. At 31 March 2006, no change occurred in the fair value and, therefore, no gain or loss was included in equity.

### Cash flow hedges – interest rate swap

At 31 March 2007, the Group held one interest rate swap, designated as a hedge of future interest cash flows, for which the Group has firm commitments. The swap is used to convert cash deposit interest receipts to a fixed rate basis. The terms of this swap are as follows:

Notional amount	Start date	Termination date	Fixed rate %
GBP 50 million	16.3.2007	16.3.2009	5.665

This hedge was designated as highly effective.

During the year, the Group entered into a hedging instrument in order to protect the Group 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 £0.5 million. This gain has been transferred to equity.

At 31 March 2006, the Group held one forward starting interest rate swap, designated as a hedge of future interest cash flows, for which the Group had firm commitments. The swap was used to convert loan interest payments linked to LIBOR to a fixed rate basis. The terms of this forward starting swap were as follows:

Notional amount	Start date	Termination date	Fixed rate %
GBP 125 million	28.6.2006	28.6.2011	4.626

This hedge was designated as highly effective and an unrealised gain of £1.0 million relating to the interest rate swap is included in equity. On 26 June 2006, the interest rate swap was cancelled. As a result, the Group discontinued hedge accounting prospectively for the interest rate swap and the cumulative gain of £2.9 million was transferred out of equity into the income statement for the year ended 31 March 2007. The increase in fair value to the date of disposal of £1.9 million gain was included in equity.

## 22. Authorised and issued share capital

	31.3.2007 £m	31.3.2006 £m
Authorised:		
700 million ordinary shares of 10 pence each	70.0	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence each	51.9	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 716,917 (2006: 976,668) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 43 and 46. As at 31 March 2007, the share price of the ordinary 10 pence shares in the Company was 310.00 pence (2006: 238.75 pence).

### 23. Reconciliation of movements in equity

	Equity share capital £m	Share premium reserve £m	Cash flow hedge reserve £m	Treasury shares £m	Currency translation £m	Retained earnings £m	Total equity £m	Minority interests £m	Total £m
At 1 April 2005	51.9	446.3	4.3	(0.9)	–	(272.4)	229.2	1.1	230.3
Shares purchased	–	–	–	(0.8)	–	–	(0.8)	–	(0.8)
Refund of share issue costs	–	0.2	–	–	–	–	0.2	–	0.2
Total recognised income and expense for the year	–	–	(2.8)	–	–	143.0	140.2	0.5	140.7
Share-based payment	–	–	–	–	–	0.2	0.2	–	0.2
Equity dividends paid	–	–	–	–	–	(69.7)	(69.7)	(0.1)	(69.8)
At 1 April 2006	51.9	446.5	1.5	(1.7)	–	(198.9)	299.3	1.5	300.8
Shares purchased	–	–	–	(0.2)	–	–	(0.2)	–	(0.2)
Total recognised income and expense for the year	–	–	(0.5)	–	(0.2)	128.4	127.7	0.3	128.0
Share-based payment	–	–	–	–	–	0.4	0.4	–	0.4
Exercise of LTIP awards	–	–	–	0.6	–	(0.6)	–	–	–
Equity dividends paid	–	–	–	–	–	(55.8)	(55.8)	(0.1)	(55.9)
<b>At 31 March 2007</b>	<b>51.9</b>	<b>446.5</b>	<b>1.0</b>	<b>(1.3)</b>	<b>(0.2)</b>	<b>(126.5)</b>	<b>371.4</b>	<b>1.7</b>	<b>373.1</b>

#### *Nature and purpose of other reserves*

##### Cash flow hedge reserve

This reserve is used to reflect the portion of the gain or loss on a hedging instrument in a cash flow hedge that is determined to be an effective hedge.

##### Treasury shares

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, acquires shares to be used in the future to satisfy the vesting and exercise of awards under the Company's LTIP.

### 24. Additional cash flow information

#### Analysis of net debt as at 31 March 2007

	As at 1.4.2006 £m	Cash flow £m	Other non-cash movements £m	As at 31.3.2007 £m
Cash and cash equivalents	153.9	161.9	–	<b>315.8</b>
Loans (principal of £2,284.0 million, 2006: £2,045.8 million)	(2,102.9)	(225.6)	(5.6)	<b>(2,334.1)</b>
Finance leases (principal of £61.2 million, 2006: £61.2 million)	(61.4)	4.8	(4.7)	<b>(61.3)</b>
	(2,010.4)	(58.9)	(10.3)	<b>(2,079.6)</b>

# Notes to the consolidated financial statements

## continued

The difference between the principal value of £2,345.2 million (2006: £2,107.0 million) and the carrying value of £2,395.4 million (2006: £2,164.3 million) are unamortised issue costs of £16.1 million (2006: £16.7 million) and a credit of £66.3 million (2006: £74.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

Non-cash movements on loans relate to the principal uplift on index linked borrowings and amortisation of loan issue costs offset by the amortisation of debt fair value for the year. Non-cash movements on finance leases relate to the inception of new finance leases on the acquisition of plant and machinery during the year.

### Analysis of net debt as at 31 March 2006

	As at 1.4.2005 £m	Cash flow £m	In respect of acquisitions £m	In respect of disposals £m	Other non-cash movements £m	As at 31.3.2006 £m
Cash and cash equivalents	62.2	98.9	3.9	(11.1)	–	153.9
Loans (principal of £2,045.8 million, 2005: £1,810.1 million)	(1,881.2)	(162.1)	(70.7)	1.4	9.7	(2,102.9)
Finance leases (principal of £61.2 million, 2005: £61.8 million)	(62.0)	4.7	–	–	(4.1)	(61.4)
	(1,881.0)	(58.5)	(66.8)	(9.7)	5.6	(2,010.4)

The difference between the principal value of £2,107.0 million (2005: £1,871.9 million) and the carrying value of £2,164.3 million (2005: £1,943.2 million) are unamortised issue costs of £16.7 million (2005: £15.7 million) and a credit of £74.0 million (2005: £87.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

### 25. Financial commitments

#### Capital expenditure

	31.3.2007 £m	31.3.2006 £m
Expenditure contracted for	109.0	96.8

In addition to these commitments, the Group has longer term expenditure plans, which include investment to meet shortfalls in performance and condition, and to provide for new demand and growth within the water and sewerage business.

### 26. Pensions and other post-retirement benefits

The Group operates a defined benefit pension scheme providing benefits based on final pensionable remuneration to 2,310 active members at 31 March 2007 (2006: 2,351). The Northumbrian Water Pension Scheme (NWPS), 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 £520 million. The valuation also took account of debt on the employer payments in respect of the withdrawal of two participating employers and added £10 million 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:

	Sub-fund			
	WPS %	North %	South %	MIS %
Members' contributions	6	5	5	5/6
Employers' 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 £36.1 million by April 2006 and £23.3 million by April 2007. The capital injections cover:

- employers' contributions, and the strain on the fund arising from ill-health retirements, for the five 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 £0.3 million per annum.

The employers' proposals were accepted by the NWPS Trustee.

The Group also contributes to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP). Members and employers contribute 3% and 6% of salary respectively. The NWGPPP is provided by an insurance company and members have their own individual policy. There were 248 contributing members at 31 March 2007 (2006: 258). The Group made contributions amounting to £0.3 million (2006: £0.3 million) to the defined contribution pension scheme.

The additional disclosures regarding the Group's defined benefit scheme as required under IAS 19 'Employee benefits', and the relevant impact on the Group's financial statements are set out below.

A qualified actuary, using revised assumptions that are consistent with the requirements of IAS 19, has updated the actuarial valuation described above as at 31 March 2007. Investments have been valued, for this purpose, at fair value.

IAS 19 actuarial assumptions:

	31.3.2007	31.3.2006
Pay increases*	4.1%	3.9%
Pension increases	3.1%	2.9%
Price inflation	3.1%	2.9%
Discount rate	5.3%	4.9%
Mortality assumptions	PMA/PFA92	PMA/PFA92
– Life expectancy for an active member – female (years)	27.6	27.5
– Life expectancy for an active member – male (years)	24.6	24.5

\* Including promotional salary scale.

# Notes to the consolidated financial statements

## continued

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

	Long term expected rate of return 31.3.2007 %	31.3.2007 £m	Long term expected rate of return 31.3.2006 %	31.3.2006 £m
Equities	7.5	498.5	7.2	451.6
Corporate bonds	5.3	50.3	4.9	48.2
Government bonds	4.5	65.9	4.2	60.5
Property	6.0	86.7	5.7	65.1
Cash	5.3	9.4	4.5	34.4
Total fair value of assets		710.8		659.8
Present value of liabilities		(668.1)		(663.5)
Surplus/(deficit)		42.7		(3.7)

The amounts recognised in the income statement and in the statement of recognised income and expense for the year are analysed as follows:

	31.3.2007 £m	31.3.2006 £m
Recognised in the income statement:		
Current service cost	15.6	12.0
Past service cost	0.4	–
Interest cost	32.4	32.3
Expected return on plan assets	(42.9)	(36.5)
Losses on curtailments and settlements	–	0.3
Recognised in operating costs in arriving at profit on ordinary activities before interest	5.5	8.1

The increase in the current service cost in 2007 reflects the salary sacrifice arrangement, whereby the majority of employees opted for a reduction in salary in return for the employer meeting their pension contribution.

Recognised in the statement of recognised income and expense:

Net actuarial gains recognised in the statement of recognised income and expense	25.0	52.7
Cumulative recognitions since adopting the standard	135.4	110.4

History of experience gains and losses:

	31.3.2007 £m	31.3.2006 £m	31.3.2005 £m	31.3.2004 £m
Fair value of assets	710.8	659.8	523.8	472.1
Present value of defined benefit obligation	(668.1)	(663.5)	(600.2)	(565.7)
Surplus/(deficit)	42.7	(3.7)	(76.4)	(93.6)
Experience adjustments arising on plan assets	0.6	87.1	25.6	28.5
Experience adjustments arising on plan liabilities	24.4	(34.4)	(4.4)	8.0

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

	31.3.2007 £m	31.3.2006 £m
At 1 April	663.5	600.2
Current service cost	15.6	12.0
Past service cost	0.4	–
Interest cost	32.4	32.3
Contributions by plan participants	0.3	3.3
Actuarial (gains)/losses on obligations	(24.4)	34.4
Income which increases liabilities	–	(0.7)
Benefits paid	(19.7)	(18.3)
Losses on curtailments and settlements	–	0.3
<b>At 31 March</b>	<b>668.1</b>	<b>663.5</b>
Present value of funded obligations	668.1	661.9
Present value of unfunded obligations	–	1.6
Present value of defined benefit obligations	668.1	663.5

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

	31.3.2007 £m	31.3.2006 £m
At 1 April	659.8	523.8
Expected return on plan assets	42.9	36.5
Actuarial gains on plan assets	0.6	87.1
Contributions by employer	26.9	28.1
Contributions by plan participants	0.3	3.3
Income which increases liabilities	–	(0.7)
Benefits paid	(19.7)	(18.3)
At 31 March	710.8	659.8

The Group through its subsidiary, AquaGib, also operates a non-contributory defined benefit scheme. The deficit at 31 March 2007, under local GAAP, was £0.7 million (2006: £1.0 million). The Group made contributions amounting to £0.5 million (2006: £0.5 million) to the defined benefit pension scheme.

Sensitivity to key assumptions:

IAS 1 requires disclosure of the sensitivity of the results to the methods and assumptions used.

The costs of a pension arrangement require estimates regarding future experience. The financial assumptions used for IAS 19 reporting are the responsibility of the directors of the Company. These assumptions reflect market conditions at the balance sheet date. Changes in market conditions which result in changes in the net discount rate (essentially the difference between the discount rate and the assumed rates of increases of salaries, deferred pension revaluation or pensions in payment), can have a significant effect on the value of the liabilities reported.

A reduction in the net discount rate will increase the assessed value of liabilities, as a higher value is placed on benefits paid in the future. A rise in the net discount rate will have an opposite effect of similar magnitude. The overall effect of a change in the net discount rate of 0.1% would change the liabilities by around £25 million.

There is also uncertainty around life expectancy for the UK population. The value of current and future pension benefits will depend on how long they are assumed to be in payment.

# Notes to the consolidated financial statements

## *continued*

The disclosures have been prepared using the same mortality assumptions as those used at the most recent formal valuation – namely the standard PA92 tables, including an allowance for future improvements in mortality based on the year of birth of the membership. These assumptions imply an assumed life expectancy for a member aged 60 at 31 March 2007 of 24.6 years (2006: 24.5 years) for males and 27.6 years (2006: 27.5 years) for females.

The effect of increasing the assumed life expectancies by one year would be to increase the value of liabilities by around 2.5%.

### 27. Share incentive plans

#### Long Term Incentive Plan (LTIP)

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company. Further details of the LTIP can be found in the directors' remuneration report on page 43.

The following table illustrates the movements in conditional share awards during the year.

	31.3.2007 Number	31.3.2006 Number
Outstanding at 1 April	1,216,320	915,784
Granted during the year	360,022	374,615
Forfeited/lapsed during the year	(131,876)	(44,451)
Exercised	(329,751)	(29,628)
Outstanding at 31 March	1,114,715	1,216,320
Exercisable at 31 March	11,418	–

The weighted average exercise price throughout the year was £nil (2006: £nil). The fair value of conditional share awards granted during the year was £0.1 million (2006: £0.1 million).

The weighted average share price at the date of exercise for the conditional share awards is 296.92 pence (2006: 250.25 pence).

For the conditional awards outstanding as at 31 March 2007, the weighted average remaining contractual life is 1.7 years (2006: 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:

	31.3.2007	31.3.2006
Dividend yield	4.0%	4.5%
Expected share price volatility	22%	23%
Expected comparators' share price volatility	n/a	16%–21%
Share price at award	302.75p	252.00p
Expected FTSE 250 index volatility	12%	11%
Risk free interest rate	5.01%	4.33%
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.

Expected comparators' share price volatility is not a valid input for the awards granted in 2006/07 due to this measure being removed.

### Share Incentive Plan (SIP)

The SIP 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.

The following table illustrates the movements in conditional share awards during the year.

	31.3.2007 Number	31.3.2006 Number
Outstanding at 1 April	136,168	212,119
Granted during the year	118,625	154,478
Forfeited during the year	(3,358)	(5,425)
Exercised	(136,216)	(225,004)
Outstanding at 31 March	115,219	136,168

### 28. Special purpose entities

As noted under accounting policy 1(b), under SIC 12, two companies are consolidated as special purpose entities. The principal special purpose entity is Bakethin Holdings Limited, the shares in which are owned by Bakethin Charitable Trust. The other special purpose entity is Bakethin Finance plc, which is a wholly owned subsidiary of Bakethin Holdings Limited.

Bakethin Finance plc was established for the purpose of issuing guaranteed secured Eurobonds. On 12 May 2004, Bakethin Finance plc issued £248 million of guaranteed secured bonds maturing January 2034. Bakethin Finance plc used the proceeds of the bond issue to make a loan to Reiver Finance Limited to fund the consideration given by that company to Northumbrian Water Limited for the securitisation of the cash flows receivable from the Environment Agency under the Water Resources Operating Agreement relating to Kielder Reservoir. The assignment is for a period of 30 years.

The summarised combined financial statements of the special purpose entities are as follows:

	31.3.2007 £m	31.3.2006 £m
Income statement:		
Finance costs receivable	15.0	15.0
Finance costs payable	(14.9)	(15.0)
<b>Profit for the year</b>	<b>0.1</b>	<b>–</b>
Balance sheet:		
Investments	240.1	239.7
Current assets	4.5	4.5
Non-current liabilities	(241.8)	(241.4)
Current liabilities	(2.7)	(2.8)
<b>Net assets</b>	<b>0.1</b>	<b>–</b>
Cash flow statement:		
<b>Investing activities</b>	<b>–</b>	<b>0.6</b>
<b>Increase in cash and cash equivalents</b>	<b>–</b>	<b>0.6</b>

# Notes to the consolidated financial statements

## *continued*

### 29. Related parties

During the year, the Group entered into transactions, in the ordinary course of business, with other related parties. Those transactions with directors of the Company are disclosed in the directors' remuneration report on pages 41 to 49. In accordance with IAS 24, the directors consider that there are no further disclosures in respect of key management. Transactions entered into, and trading balances outstanding at 31 March with other related parties, are as follows:

	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m
Related party:				
Associates				
<b>2007</b>	–	–	–	–
2006	3.3	–	–	–
Jointly controlled entities				
<b>2007</b>	–	<b>5.2</b>	<b>0.7</b>	<b>6.2</b>
2006	–	4.3	0.9	6.2

Purchases from jointly controlled entities include £2.5 million (2006: £1.6 million) in respect of capital purchases under finance leases, £2.2 million (2006: £2.2 million) in respect of operating leases and £0.5 million (2006: £0.5 million) in respect of finance costs payable under finance leases.

Outstanding balances due from related parties are expected to be settled within 60 days and amounts due to related parties are in respect of leasing arrangements, where the amounts owed will relate specifically to the terms of the lease.

### 30. Contingent liability

The Group's subsidiary responsible for a contract with Scottish Water, Caledonian Environmental Services plc (CES), has received a claim from its Design and Construction Consortium (DCC), primarily in respect of the DCC's additional costs attributed by it to non-conforming influent at the treatment works. CES is defending this claim and has also issued a counterclaim against the DCC. As non-conforming influent is ultimately the responsibility of the client, CES has protected its position by issuing a claim against Scottish Water. The directors do not expect any material loss to arise as a result of these claims.

# Statement of directors' responsibilities in relation to the parent Company financial statements

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

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 those 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 UK 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 that 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.

# Report of the Auditors on the Company financial statements

## Independent auditors' report to the members of Northumbrian Water Group plc

We have audited the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2007 which comprise the balance sheet and the related notes 1 to 10. These parent Company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' remuneration report that is described as having been audited.

We have reported separately on the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2007.

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

## Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' remuneration report and the parent Company 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 parent Company financial statements and the part of the Directors' remuneration report to be audited 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 parent Company financial statements give a true and fair view and whether the parent Company financial statements

and the part of the Directors' remuneration report to be audited have been 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 business 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 parent Company financial statements. The other information comprises only NWG at a glance, Highlights, the Chairman's statement, the Directors' report and business review, Appendix to the directors' report and business review, Board directors' biographies, the Corporate governance report, the unaudited part of the Directors' remuneration report and Shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent Company 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 parent Company financial statements and the part of the Directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the parent Company 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 parent Company financial statements and the part of the Directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the parent Company financial statements and the part of the Directors' remuneration report to be audited.

### Opinion

In our opinion:

- the parent Company 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 2007;
- the parent Company financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' report and business review is consistent with the parent Company financial statements.

### Ernst & Young LLP

Registered Auditor  
Newcastle upon Tyne  
5 June 2007

# Company balance sheet

As at 31 March 2007

	Notes	31.3.2007 £m	31.3.2006 £m
<b>Fixed assets</b>			
Investments in subsidiary undertakings	4	1,022.6	1,022.6
		<b>1,022.6</b>	1,022.6
<b>Current assets</b>			
Debtors: receivable within one year	5	6.9	7.4
Cash at bank		15.6	12.7
		<b>22.5</b>	20.1
<b>Creditors: amounts falling due within one year</b>	6	<b>(10.9)</b>	(9.5)
<b>Net current assets</b>		<b>11.6</b>	10.6
<b>Total assets less current liabilities</b>		<b>1,034.2</b>	1,033.2
<b>Creditors: amounts falling due after more than one year</b>	7	<b>(490.0)</b>	(490.0)
<b>Net assets</b>		<b>544.2</b>	543.2
<b>Capital and reserves</b>			
Called up share capital	8	51.9	51.9
Share premium account	9	446.5	446.5
Treasury shares	9	(1.3)	(1.7)
Profit and loss account	9	47.1	46.5
<b>Equity shareholders' funds</b>		<b>544.2</b>	543.2

Approved by the Board on 5 June 2007 and signed on its behalf by:

**Sir Derek Wanless**  
Chairman

**John Cuthbert**  
Managing Director

# Notes to the Company financial statements

## 1. Accounting policies

### (a) Basis of accounting

The financial statements have been prepared in accordance with applicable United Kingdom law and accounting standards. The accounting policies have been reviewed in accordance with the requirements of FRS 18. The directors consider the following accounting policies to be relevant in relation to the Company's financial statements. The Company's financial statements are included in the consolidated financial statements of Northumbrian Water Group plc. Accordingly, the Company has taken advantage of the exemption from publishing a profit and loss account and cash flow statement and from disclosing related party transactions with its subsidiaries. The Company is also exempt from disclosing the information otherwise required by paragraphs 51 to 93 of FRS 25 Financial Instruments: Disclosure and Presentation, as the consolidated financial statements, in which the Company is included, provide equivalent disclosures for the Group under IAS 32 Financial Instruments: Presentation and Disclosure.

### (b) Fixed asset investments

Fixed asset investments are stated at their purchase cost, less any provision for impairment.

### (c) Taxation

Corporation tax is based on the profit for the year as adjusted for taxation purposes using the rates of tax enacted at 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.

### (d) Interest bearing loans and borrowings

All loans and borrowings are initially stated at the amount of the net proceeds, being fair value of the consideration received net of issue costs associated with the borrowing. Finance costs (including issue costs) are taken to the income statement over the term of the debt at a constant rate on the balance sheet carrying amount. The carrying amount is increased by the finance charges amortised and reduced by payments made in respect of the accounting period.

## 2. Auditors' remuneration

Auditors' remuneration for the year ended 31 March 2007 was £84,000 (2006: £80,000).

Fees paid to Ernst & Young LLP for non-audit services to the Company itself are not disclosed in the individual financial statements of the Company because Group financial statements are prepared which are required to disclose such fees on a consolidated basis.

## 3. Profit attributable to members of the parent Company

The profit dealt with in the financial statements of the parent Company is £56.9 million (2006: £71.0 million).

# Notes to the Company financial statements

## continued

### 4. Investments in subsidiary undertakings

	£m
<b>At 1 April 2006 and 31 March 2007</b>	<b>1,022.6</b>

The Company's interests in principal subsidiaries at 31 March 2006 and 31 March 2007 were as follows:

Name of undertaking	Country of incorporation or registration and operation	Description of shares held	Proportion of nominal value of issued shares held by Group (%)	Business activity
Northumbrian Services Limited	England and Wales	Ordinary shares of £1	100	Holding of investments and loans
Northumbrian Water Limited	England and Wales	Ordinary shares of £1	100	Water and sewerage services
Northumbrian Water Finance plc	England and Wales	Ordinary shares of £1	100	Holding of finance instruments
Caledonian Environmental Services plc	Scotland	Ordinary shares of £1	75	Waste water services
Caledonian Environmental Levenmouth Treatment Services Limited	Scotland	Ordinary shares of £1	75	Waste water services
Ayr Environmental Services Limited	Scotland	Ordinary shares of £1	75	Waste water services
Ayr Environmental Services Operations Limited	Scotland	Ordinary shares of £1	100	Waste water services
AquaGib Limited	Gibraltar	Ordinary shares of £1	67	Water and sewerage services
Northumbrian Water Projects Limited	England and Wales	Ordinary shares of £1	100	Waste water services
Analytical & Environmental Services Limited*	England and Wales	Ordinary shares of £1	100	Analytical laboratory and scientific services
SA Agrer NV	Belgium	Ordinary shares of £1	100	Aid funded project work

\* On 31 March 2007, the business of AES merged with NWL and continues to operate as a trading division of NWL.

The directors consider that to give full particulars of all subsidiary and associated undertakings would lead to a statement of excessive length. A full list of the Company's subsidiaries is attached to the Company's latest annual return filed at Companies House.

## 5. Debtors

	31.3.2007 £m	31.3.2006 £m
Amounts owed by subsidiary undertakings	6.5	3.0
Deferred tax	–	4.0
Prepayments and accrued income	0.2	0.4
Other	0.2	–
	<b>6.9</b>	<b>7.4</b>

Amounts owed by subsidiary undertakings include amounts receivable for the provisional surrender of tax losses amounting to £4.7 million (2006: £1.6 million). The deferred tax asset relates wholly to other timing differences.

The deferred tax asset provided in the financial statements comprises:

	Year to 31.3.2007 £m	Year to 31.3.2006 £m
Other timing differences	–	5.5
Discount	–	(1.5)
Discounted provision for deferred tax	–	4.0

## 6. Creditors: amounts falling due within one year

	31.3.2007 £m	31.3.2006 £m
Amounts owed to subsidiary undertakings	10.6	9.3
Accruals and deferred income	0.3	0.2
	<b>10.9</b>	<b>9.5</b>

## 7. Creditors: amounts falling due after more than one year

	31.3.2007 £m	31.3.2006 £m
Amounts owed to subsidiary undertakings	490.0	490.0

	31.3.2007 £m	31.3.2006 £m
Loans are repayable as follows:		
Not wholly repayable within five years	490.0	490.0

The loan bears a rate of interest linked to LIBOR. The loan will continue until such time as terminated by mutual agreement.

# Notes to the Company financial statements

## continued

### 8. Authorised and issued share capital

	31.3.2007 £m	31.3.2006 £m
Authorised:		
700 million ordinary shares of 10 pence each	<b>70.0</b>	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence each	<b>51.9</b>	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 716,917 (2006: 976,668) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 43 and 46. As at 31 March 2007, the share price of the ordinary 10 pence shares in the Company was 310.00 pence (2006: 238.75 pence).

### 9. Reserves

	Treasury shares £m	Share premium account £m	Profit and loss account £m
At 1 April 2005	(0.9)	446.3	45.0
Profit for the year	–	–	71.0
Purchase of own shares for the LTIP	(0.8)	–	–
Share-based payment	–	–	0.2
Refund of transaction costs	–	0.2	–
Dividends	–	–	(69.7)
At 31 March 2006	(1.7)	446.5	46.5
Profit for the year	–	–	56.9
Purchase of own shares for the LTIP	(0.2)	–	–
Share-based payment	–	–	0.1
Exercise of LTIP awards	0.6	–	(0.6)
Dividends paid	–	–	(55.8)
<b>At 31 March 2007</b>	<b>(1.3)</b>	<b>446.5</b>	<b>47.1</b>

### 10. Commitments

The Company has issued letters of continuing support to subsidiary companies with net liabilities amounting to £4.2 million (2006: £7.2 million) and net current liabilities £nil (2006: £nil). These subsidiary companies are expected to meet their working capital requirements from operating cash flows.

The Company is guarantor to EIB in respect of borrowings to Northumbrian Water Limited. The loan principal outstanding at 31 March 2007 amounted to £376 million (2006: £305.2 million).

The Company is party to a cross guarantee arrangement with other group companies in respect of bank facilities. Overdrafts outstanding at 31 March 2007 in respect of the arrangement amounted to £1.1 million (2006: £21.7 million). The directors do not expect any loss to arise as a result of this arrangement.

The Group's subsidiary responsible for a contract with Scottish Water, Caledonian Environmental Services plc (CES), has received a claim from its Design and Construction Consortium (DCC), primarily in respect of the DCC's additional costs attributed by it to non-conforming influent at the treatment works. CES is defending this claim and has also issued a counterclaim against the DCC. As non-conforming influent is ultimately the responsibility of the client, CES has protected its position by issuing a claim against Scottish Water. The directors do not expect any material loss to arise as a result of these claims.

# Shareholder information

## Electronic communications

Shareholders can choose to receive an email notification when reports are available to view or download from our website, instead of receiving a printed copy. To register, email the words 'Northumbrian Water Group shareholder' to [ecomms@capitaregistrars.com](mailto:ecomms@capitaregistrars.com) and include your full name, address and Investor Code in the body of the email.

## Drip/Scrip

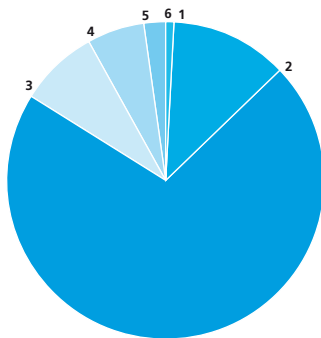
The Company receives occasional requests from shareholders wishing to receive their dividends in the form of shares instead of cash. There are costs involved in providing this service, and at present it would not be cost effective. This issue is kept under regular review.

## ShareDeal

You can make use of a low cost share dealing service provided by Capita Registrars to buy or sell shares in NWG. Further information is available at [www.capitaregistrars.com](http://www.capitaregistrars.com), or by telephoning 0870 458 4577.

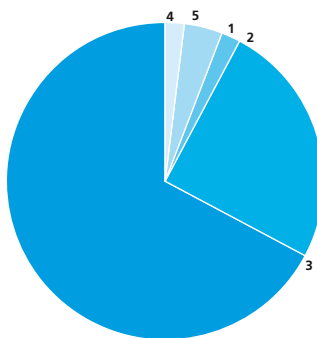
## Shareholder analysis

### Number of shareholders by size of holding as at 31 March 2007



- 1 Shareholders with 1–1,000 shares
- 2 Shareholders with 1,001–5,000 shares
- 3 Shareholders with 5,001–10,000 shares
- 4 Shareholders with 10,001–100,000 shares
- 5 Shareholders with 101,001–1,000,000 shares
- 6 Shareholders with over 1,000,000 shares

### Breakdown of shareholding by type as at 31 March 2007



- 1 Individuals
- 2 Ontario Teachers' Pension Plan Board
- 3 Nominee accounts
- 4 Investment trusts, pensions funds and other institutions
- 5 Banks and bank nominees

## Disability Discrimination Act

If you wish to receive a copy of our annual or interim reports on audio tape, in braille or in a large text version, please telephone us on 0191 301 6704, or email us at [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk).

### For queries about your shares please contact Capita Registrars:

Northern House  
Woodsome Park  
Fenay Bridge  
Huddersfield  
West Yorkshire, HD8 0LA  
Tel: 0870 162 3131  
From overseas: +44 20 8639 3131  
Fax: 01484 600 911  
Email: [shareholder.services@capitaregistrars.com](mailto:shareholder.services@capitaregistrars.com)  
Web: [www.capitaregistrars.com](http://www.capitaregistrars.com)

### For general shareholder queries please contact Secretariat:

Tel: 0191 301 6704/0191 301 6701  
Fax: 0191 301 6705  
Email: [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk)

**To request financial statements and other Company literature please contact Communications:**

Tel: 0191 301 6734

Email: [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk)**Annual General Meeting**

The Notice of Meeting, information about the AGM to be held on 2 August 2007 and the proxy voting card are enclosed with these financial statements. Shareholder questions and special needs requests should be addressed to Secretariat at our registered office address, by telephone on 0191 301 6701, or by email at [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk).

**Company Secretary and registered office**

Martin Parker  
Northumbrian Water Group plc  
Northumbria House  
Abbey Road  
Pity Me  
Durham, DH1 5FJ  
Tel: 0870 608 4820

**Financial calendar****2007**

2 August	AGM
15 August	Ex-dividend date
17 August	Record date
14 September	Final dividend payment
28 November	Interim results announcement
19 December	Ex-dividend date
21 December	Record date

**2008**

1 February	Interim dividend payment
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**Group websites**

[www.nwg.co.uk](http://www.nwg.co.uk)  
[www.nwl.co.uk](http://www.nwl.co.uk)  
[www.eswater.co.uk](http://www.eswater.co.uk)  
[www.aes-services.co.uk](http://www.aes-services.co.uk)  
[www.agrer.com](http://www.agrer.com)

**Northumbrian Water main switchboard**

Tel: 0870 608 4820

**Northumbrian Water customer queries**

Customer services: 0845 717 1100  
Customer accounts: 0845 733 5566

**Essex & Suffolk Water customer queries**

Customer services: 0845 782 0999  
Customer accounts: 0845 782 0111



# Notes

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Printed on Revive paper and board. Revive paper and board has a 75% recycled content (35% de-inked post consumer waste and 40% pre-consumer waste) with the remaining 25% being mill broke and virgin fibres. Recycled papers used in the production of the above grade are a combination of Totally Chlorine Free (TCF), giving zero AOX and Elemental Chlorine Free (ECF), giving a resultant AOX level of <0.5kg per 1,000kg of pulp. This material is recyclable and bio-degradable and is a NAPM approved recycled grade. This paper product complies with EN71 (BS5665) part 3 Toy Safety Regulations and ISO 9706 requirements for permanence of paper. The mill has both ISO 9002 and ISO 14001 accreditation. This report has been printed using vegetable based inks.

[www.nwgg.co.uk](http://www.nwgg.co.uk)

**Northumbrian Water Group plc**

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