

NORTHUMBRIAN WATER GROUP PLC

REPORT AND FINANCIAL STATEMENTS FOR

THE YEAR ENDED

31 MARCH 2005

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Contents

	Page
Chairman's statement	1
Managing Director's review	4
Operating and financial review	6
Appendix to the operating and financial review	34
Board directors' biographies	36
Directors' report	38
Corporate governance report	43
Directors' remuneration report	50
Directors' responsibilities	57
Report of the Auditors	58
Consolidated profit and loss account	60
Consolidated statement of recognised gains and losses	60
Balance sheets	61
Consolidated cash flow statement	62
Notes to the consolidated cash flow statement	63
Notes to the financial statements	64
Shareholder information	85

Northumbrian Water Group plc

Northumbrian Water Group plc (the Company or NWG) is the holding company of Northumbrian Services Limited (NSL), which in turn owns a number of companies (together the Group). Of these, the largest are Northumbrian Water Limited (NWL), Entec UK Limited (Entec), an environmental and engineering consultancy, Analytical & Environmental Services Limited (AES), an environmental monitoring company and Fastflow Pipeline Services Limited (Fastflow), which provides water and gas network renewal and refurbishment services. Northumbrian Water International (NWI), a division of NSL, manages waste water treatment plants in Scotland and the Republic of Ireland, and water operations in Gibraltar.

NWL, the largest company within the Group, is a regulated water and sewerage company operating in the north east and south east of England (trading as Northumbrian Water and Essex & Suffolk Water respectively), and is committed to maintaining its excellent reputation for customer service and environmental protection. NWL currently provides water and sewerage services to 2.6 million people in north east England, and water services to 1.7 million people in south east England.

NWG was incorporated on 12 May 2003 but did not trade in the period from 12 May 2003 to 23 May 2003. The financial statements for 2003/04 included the ten months' trading figures to 31 March 2004, together with a pro forma statement comprising the actual ten months trading results and eight weeks of pre-acquisition profits. The 2003/04 pro forma results are provided here for comparison purposes.

Highlights 2004/05

- Turnover of £578.6 million for the year to 31 March 2005 (ten months to 31 March 2004: £442.1 million; 2003/04 pro forma: £520.8 million). This increase principally reflects the successful application to the Office of Water Services (Ofwat) for an interim increase of price limits (IDoK) at NWL.
- Profit before tax of £108.8 million; (ten months to 31 March 2004 before exceptionals: £56.5 million; 2003/04 pro forma before exceptionals: £65.0 million). Interest charges include a credit of £14.1 million amortisation of debt fair value (ten months and pro forma to 31 March 2004: £5.3 million).
- Proposed final dividend of 7.13 pence per share, giving a total dividend of 10.00 pence per share for the year (2003/04: 6.95 pence per share, for the ten month period and 8.34 pence per share on a pro forma basis). Dividends from the core business, NWL, are in line with Ofwat final determination assumptions.
- Dividend policy of around 3% real growth p.a. for the regulatory period 2005-10.
- Financial position strengthened by Kielder securitisation, IDoK, improved ratings and £100 million issue to 2033 Eurobond.
- Continuing high levels of drinking water quality, customer service and environmental protection.
- Strong share price growth of 58% over the year.
- Periodic review of price limits by Ofwat concluded. This removes uncertainty and sets the increase in NWL's price limits for 2005-10 at 15% before inflation.

Chairman's statement

Business highlights

This year has been dominated by the Ofwat review of price limits and the culmination of the regulatory process to set them for the next five years. As the focus of the Group is largely on our core business, the decision of the water regulator, Ofwat, was particularly important to us.

The regulator's final determination, announced in December 2004, was more balanced than the draft determination announced earlier in the year, but it still contains tough and challenging efficiency targets. The NWL board accepted the new price limits at its meeting on 15 December 2004 and that decision has been endorsed by the NWG Board. We are pleased that this period of uncertainty is now behind us.

We have completed the financial restructuring programme initiated following the AIM listing in May 2003 and have removed any concerns that may have existed at that time. We were confident of the sustainability of the business, but said it would take time to conclude the actions we believed were needed. Our improved credit rating, the willingness of the market to lend us money and the growth in our share price over the year demonstrates that others now share our confidence.

Recent stock market activity has included the sale by Suez of its 25% shareholding in the Group to Ontario Teachers, a Canadian pension fund. The Ontario Teachers' Pension Plan Board is one of Canada's largest financial institutions which invests to secure the retirement income of 255,000 active and retired teachers of the province of Ontario, Canada.

We have enjoyed a long and successful relationship with Suez and are delighted that Ontario Teachers have shown faith in the strength of our Group. It is pleasing to note that their commitment to us is because they value the focus of the Group.

Financial performance

Turnover for the year to 31 March 2005 was £578.6 million, an increase of 11% on the pro forma turnover for the year to 31 March 2004 (ten months to 31 March 2004: £442.1 million; 2003/04 pro forma: £520.8 million), largely due to the 10% real increase in NWL's price limits granted by Ofwat in December 2003, for application during the year.

Operating profit for the year to 31 March 2005 was £204.7 million, a 25% increase on the pro forma for the previous year (ten months to 31 March 2004: £143.6 million; 2003/04 pro forma: £164.3 million).

We strengthened our financial structure; in May 2004, we raised a net £212 million by securitising our contract with the Environment Agency (EA) to operate the Kielder Water transfer scheme. In December 2004, we increased NWL's 2033 Eurobond by a further £100 million and, since the year end, we negotiated committed bank facilities for NSL and NWL. NSL will use facilities amounting to £125 million, together with available cash, to cover the repayment of its 2006 Eurobonds maturing in June next year. Facilities of £150 million at NWL are for liquidity and working capital requirements.

The credit rating of our core business, NWL, has also improved. We received our first Moody's credit rating for NWL of Baa1 in April 2004 (consistent with the Fitch rating of BBB+ announced on 11 December 2003) and, during the same month, Standard & Poor's (S&P's) improved its outlook for NWL from BBB stable to BBB positive. This rating was further improved on 25 January 2005 when S&P's upgraded its rating of NWL to BBB+ stable.

NWG has experienced significant share price growth since its flotation, and we believe this reflects the actions we have taken to address the short term liquidity concerns of the ratings agencies, the refinancing of the acquisition facilities, NWL's successful application for an interim price increase from April 2004 and the outcome of the more recent periodic review of price limits.

The Board will recommend a final dividend of 7.13 pence per share for the year ended 31 March 2005 to shareholders at the Annual General Meeting (AGM) on 28 July 2005. Together with the interim dividend of 2.87 pence per share, the dividend for the year will be 10.00 pence per share (ten months to 31 March 2004: 6.95 pence per share). This represents an increase of 20% on the dividend for the 2003/04 pro forma trading period. The dividend cover for the year is 1.9 times and 1.8 excluding deferred tax and the amortisation of the debt fair value.

The proposed dividend reflects increased confidence following the substantial improvements made to the Group's balance sheet over the last year and the removal of uncertainty following the Ofwat periodic review of prices.

The board of our main subsidiary, NWL, has proposed a dividend policy consistent with the underlying assumptions adopted by Ofwat in its recent final determination.

Looking to the end of the current regulatory period, NWG expects to be able to maintain a progressive dividend policy with real increases of around 3% p.a.

The Board believes this provides shareholders with a sustainable policy consistent with the regulatory environment within which NWL operates and reflects the ongoing benefits at the Group from refinancing. The policy is also consistent with maintaining Group and NWL gearing at around current levels over the medium term (excluding the unamortised fair value adjustment, due to acquisition debt at 23 May 2003).

Employees

Once again, the Board and I are grateful for the continuing commitment and support of employees throughout the Group, and for their willingness to go beyond the call of duty.

This year, our staff had the opportunity to show just how committed they are and to demonstrate, very publicly, their dedication to their customers and their company. An incident occurred in January 2005 in Hexham, Northumberland, where extremes of floodwater washed away the water mains serving the town. Long hours were spent in very difficult weather conditions installing a new temporary supply in record time. Employees from around the business volunteered for a variety of tasks including: handing out bottled water; deploying and refilling static water tanks; delivering information to customers' homes and carefully restoring pressure in the mains. At the same time, other staff provided cover for the day-to-day business that continued uninterrupted throughout the entire period.

I know from meeting customers and the letters we have received that the people of Hexham were very appreciative of their effort and dedication. It is an excellent example of the commitment and team spirit that has helped NWL to deliver consistently high service over the years.

I would like to record my personal thanks, and those of the NWG and NWL boards, to all the employees who played their part in resolving this extraordinary situation.

Board

We have two main boards within the Group, for NWG and NWL, both of which I chair. The other subsidiaries also have boards, which report to the NWG Board on a regular basis. The corporate governance report within this annual report sets out the number of occasions on which the NWG Board has met and the various other committees that Board members have attended in the performance of their duties.

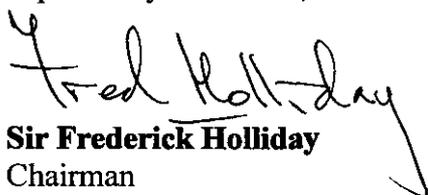
Although we are not required to report in detail on the activities of the boards of subsidiary companies in this report, I would like to place on record my thanks to the members of the board of NWL, for their dedication in what has been a particularly important and busy year. In addition to their involvement with the long and complex price review process, the NWL board also met with members of the NWG Board to consider the Hexham incident and the lessons to be learned. The two boards are separate, and each has its complement of independent non-executive directors, but it is useful for the two to come together on occasions such as this to consider matters that affect the success of both companies.

As we announced last year, Jenny Williams and Bernard Guirkinger joined the Board on 27 May 2004, Jenny as an independent non-executive director and Bernard as a Suez representative. I would like to express my thanks to Alain Chaigneau, the second Suez representative, who stood down from the Board on 17 March 2005, and was replaced by Christophe Cros on the same day. Following the disposal by Suez of its 25% shareholding in NWG, both Bernard and Christophe resigned on 28 April 2005 and I would like to extend my gratitude for their support.

We were pleased to learn in December last year that non-executive director Derek Wanless had been made a knight bachelor in the New Year's Honours list in recognition of his public service. We warmly congratulate Sir Derek.

Strategy and prospects

Now that we know the outcome of the Ofwat periodic review, and with our financial restructuring complete, we can devote all our efforts to achieving our objectives by concentrating on our core competencies across the Group. Our operating performance continues to be strong and, alongside the high standards of service expected by customers, we are confident NWG will continue to deliver value to its shareholders.



Sir Frederick Holliday
Chairman

7 June 2005

Managing Director's review

Key achievements

The Chairman mentions in his statement that the process of Ofwat's final determination was probably the single most significant event within the Group during the year. As expected, the targets set for NWL are exacting and the regulator's and customers' expectations are high, but the outlook for the business remains positive. The implications of the determination for NWL, for capital investment and for levels of service, are outlined in the future development and performance section on pages 18 and 19.

NWL had another very good year, beating all but one of its customer service targets, maintaining its very high drinking water standards and protecting the quality of the water environment by meeting all its sewage treatment works' discharge consents.

2004/05 was the final year of the last Ofwat price review period (2000-05) and of the corresponding capital investment period. I am pleased to report that NWL was able to deliver its investment programme for the five year period within the allowance made by Ofwat at the 1999 price review.

The next five years will see continuing high levels of investment, to meet the requirements of UK and EU legislation and also to meet the investment priorities expressed by NWL's customers for improvements to discoloured drinking water and to sewer flooding.

One of our investment projects from last year had a very successful first year of operation and achieved a high level of acclaim for its innovation and environmental credentials. NWL's Langford recycling plant in Essex takes waste water that used to be discharged to sea and puts it through sophisticated treatment processes so that it can be retained as a water resource. During the year, it won the Environment Award at the national Utility Industry Achievement Awards, the Water Award at the national Institution of Chemical Engineers (IChemE) Awards, a merit award from the Institution of Civil Engineering (ICE) Eastern Region, and a prestigious Golden Apple at the Green Apple Environment Awards. NWL as a whole also won the Constructing Excellence Achievement Award in 2005.

Another award-winning project is our Wear Valley project, which involved the construction of a new water treatment plant in an area of outstanding natural beauty. In total, this project has won nine awards including the IChemE Foster Wheeler Award for Innovation in Project Management, the Landmark Environmental Award, Civil Engineering Contractors Association Project of the Year, The Green Organisation 'Green Apple' Silver Award, Constructing Excellence North East - Best Practice Award, winner of the ICE Robert Stephenson Award for Design Category, a commendation from ICE Robert Stephenson Award for Construction Category, Business in the Community 'Big Tick' for Shields Environmental Award Category and the 'World of Difference Award' from the Chartered Institute of Water and Environmental Management.

A particularly innovative contract that became operational during the year, was the arrangement between NWL and cement manufacturer, Lafarge, which now uses sewage sludge pellets, from NWL's Bran Sands sludge plant on Teesside, as a fuel in the manufacture of cement. The contract was signed following a demanding full-scale trial and it provides NWL with a secure and sustainable outlet for its sludge, minimises disposal costs and provides a worthwhile use for this product.

Further afield, progress was made in NWL's Ayrshire and Cork projects. In Scotland, commissioning and performance testing of the sludge treatment centre at Ayrshire was completed and this concludes the design and construction phase of the project. Similarly, in the Republic of Ireland, completion of commissioning and testing of the treatment works at Cork in September 2004 marked the beginning of the operations and maintenance phase of the project.

In particular I would like to take this opportunity to thank all of our employees across the Group for their individual contributions to what has been another successful year. I would like to add my own thanks to those of the Chairman to employees who strove so valiantly to restore water to the Hexham area following the disruption in January. They worked for long hours in appalling weather conditions and justifiably earned the praise of the town's residents. We have always been aware of the dedication of our people, but they truly surpassed our expectations in their willingness to do what was necessary to get the job done.

Outlook

We retain the focus on our core water and waste water competence. That focus underpins our expectation that we will continue to build upon the track record of service delivery, environmental performance and stakeholder value on which our reputation is based.

Our proposed dividend policy reflects the confidence of the Board following the substantial financial restructuring and of the regulatory review of prices. It is consistent with the regulatory expectations of our core business and the Board believes it provides a sustainable return to shareholders.



John Cuthbert

Managing Director

7 June 2005

Operating and financial review

Introduction

The new operating and financial review standard comes into force next year and the Board has endeavoured to follow the new standard in this year's annual report. The review which follows, reflects our interpretation of the content and style of the requirements of the new standard. The review contains significantly more information for stakeholders and we would welcome their feedback prior to the introduction of the regulations next year.

Nature, objectives and strategies

The Group's businesses

The composition of the Group is set out at the start of the annual report, with the largest element by far being NWL, a regulated water and sewerage company. Further details on our other operations can be found on pages 15 to 17.

NWL drives the performance of the Group both in terms of its size and its turnover and it continues to be the main focus for the Group. As a consequence, the financial performance of the Group is dominated by the water industry regulatory price review which takes place every five years.

The water industry is subject to a range of UK and EU legislation. Standards, particularly those that relate to the environment, are being tightened on a regular basis and require increasing levels of investment. The standards of service provided by NWL are monitored by three main regulators – Ofwat for customer levels of service, the EA for environmental protection and the Drinking Water Inspectorate (DWI) for drinking water quality. NWL works closely with these and the other organisations that have an interest in the services it provides.

However, Ofwat's main role is as the water industry's economic regulator, which it principally exercises through the price-setting process. Ofwat sets price limits for NWL every five years.

Water companies are largely natural monopolies and, recognising this, the Government, following Ofwat's advice and wide consultation, is cautiously opening up to competition the market for provision of water to large industrial and commercial customers. In accordance with the Water Act 2003, preparations were made during the year for the introduction of competitive licences for the retail supply of water and common carriage where a licensee is entitled to use a water undertaker's network to supply customers (see page 11 for further details).

NWL operates in two different regions; Northumbrian Water in the north east of England and Essex and Suffolk in the south east. Its northern operating area is in a region of modest economic growth, with a declining industrial customer base and industrial demand for water, but with a growing demand from domestic customers. It is well placed to meet anticipated demand due to well developed resources, such as Kielder Water, and the above average rainfall experienced in the region. By comparison, NWL's southern operating area is in a region that has experienced, and is likely to continue to experience, rapid economic and population growth, although it has also 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 demands in a region where water resources are already constrained.

Despite differing socio-economic characteristics, and increases in levels of water and sewerage charges during the year, NWL's proactive cash collection approach has allowed it to maintain its collection rates. This is against a background of increasing bad debt across the industry in recent years, following the removal by the Government in 1999 of powers of disconnection for non-payment.

In the north, NWL has been successful in extending its expertise into the provision of industrial effluent treatment services through its massive treatment works at Bran Sands on Teesside.

Entec, Fastflow and AES all provide services to NWL, under conditions that are subject to transfer pricing regulations. They, and the other subsidiaries, continue to be successful in winning contracts in competitive markets.

Business strategy

Mission

To be a national leader in the provision of sustainable water, waste water and environmental solutions and, through its competitive position, to deliver stakeholder value and grow its business.

The Group has a well developed, focused strategy with an integrated framework for delivery. Our strategy has grown from the Group's core competencies of water and waste water management. It reflects current market conditions with clear measurable objectives for the future.

Our mission is clear - to be a national leader; our strategy reflects this and provides a clear direction for all of our activities.

Each individual subsidiary company develops its own strategy based on its core competencies. All are focused on organic growth and on delivering effectively and efficiently within their target markets.

Business planning is an important process within the Group and is a key ingredient in delivering the long term objectives of the business. It is central to the delivery of the corporate objectives and also to establishing the targets and key actions against which business units report and are measured.

Business objectives

Objectives

Maintaining excellent reputation and key relationships by:

- creating shareholder value;
- delivering best service levels to customers;
- delivering regulatory outputs; and
- engaging with all key stakeholder groups.

Ensuring a stable financial profile by:

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

Developing 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.

Within NWL the framework for delivery is built on a number of key themes:

- Building our future – an approach which informs employees of the organisational strategy and reinforces the culture and values of the business.
- Roadmap – a tool which illustrates the five year vision and milestones for implementation in key objective areas.
- Functional delivery plans – developed at departmental level, plans focus on specific objectives, targets and delivery of each individual business unit.
- Balanced scorecard – an approach to measure success based on performance indicators.

Current development and performance

Northumbrian Water Group plc

Business development and performance

A large number of performance indicators are in use across the Group, covering both financial and non-financial performance. In the case of NWL, many of these are combined in a balanced scorecard used to calculate employees' bonuses.

A much smaller number of these are Key Performance Indicators, or KPIs. At NWG level the KPIs are all financial, but to illustrate the approach to the non-financial KPIs, those for NWL are described in an appendix (see page 35).

A summary of the Group's progress in achieving its objectives, as measured against the KPIs, is set out below.

a) Financial performance against KPIs

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

KPI ⁽¹⁾	Target		Performance			
			Current year		Previous year ⁽²⁾	
	NWG	NWL	NWG	NWL	NWG	NWL
Gearing to RCV	<80%	<70% ⁽³⁾	76%	68%	81%	62%
Cash interest cover	>2.5x	>3.0x	2.7x	3.4x	2.7x	3.3x
Cash flow to net debt	>13%	>13%	15%	17%	14%	17%

1. Each KPI is defined in the appendix (see page 34).
2. Figures for the previous year are pro forma as at 31 March 2004.
3. Less than 65% for the appointed business.

Group gearing to Regulated Capital Value (RCV) reduced from 81% to 76% over the year as a consequence of the improved cash flows arising from NWL's successful IDoK (see page 12) and, more importantly, helped to maintain cash interest cover at 2.7 times. More details are given in the financial review section on page 30.

At NWL, gearing increased to 68% due to the Kielder securitisation, proceeds of which were used to repay acquisition debt owed by both NSL and NWL. For the licensed business within NWL, gearing was unchanged at 59%.

NWL continued to perform well against operating costs and capital investment efficiency targets. Over the five year period from 2000/01 to 2004/05, NWL beat its efficiency targets with operating costs at an average of 0.8% p.a. below the Ofwat target. This equates to cumulative operating savings of £45 million over the five years. Capital investment for the same period amounted to £36 million outperformance against the Ofwat target.

b) 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.

c) NWL performance against non-financial KPIs

Target	Performance	
	Current year	Previous year
Customer service standards	See narrative below	
Customer satisfaction		
- overall service	88%	91%
- value for money	74%	79%
Drinking water quality	99.9%	99.9%
Environmental performance	100%	97.7%

NWL maintained its high level of service, achieving greater than 99.9% compliance with drinking water regulations, 100% compliance with Look Up Table (LUT) effluent consents, and a star rating on most Director General (DG) measures. The only shortcoming related to DG5, which measures performance on sewer flooding. Due to intense summer storms, NWL's performance slipped on this measure. Whether such storms are rare events, unlikely to recur in the near future, or reflect changed weather patterns associated with climate change, remains to be seen.

Customer satisfaction surveys showed sustained customer satisfaction but reduced perceived value for money. The probable explanation for this is the 10% real increase in prices resulting from the IDoK and the publicity given to prospective price increases over the next five years as a result of Ofwat's 2004 price review.

Financial performance

An overview of the Group financial performance is provided in the financial review section on pages 30 to 33.

Trends

As is the case in most industrial and commercial sectors, stakeholders expect continuous improvement. Regulatory reviews demand further efficiency savings and even better customer service. New legislation increases the required operating standards, needing further capital investment, and competition in the Group's non-regulated markets becomes stiffer. So far the Group has demonstrated an excellent record of meeting, and in many cases exceeding, its targets and in growing its non-core business. We have every confidence that we can continue to deliver the improvements expected of us.

Changes in the external environment

Water industry periodic review of price limits

Following the announcement of Ofwat's draft determination on 5 August, that NWL would be allowed to raise its price limits by 7.8% above the rate of inflation over the years 2005-10, NWL's executive directors had further discussions with the regulator. They raised a number of company-specific issues; movement on these, the final ministerial guidance and representation by WaterVoice, the industry's customer watchdog, and others, contributed to an increase in the final determination for NWL published by Ofwat on 2 December 2004.

This allows NWL to raise its price limits by 15% above the rate of inflation over the next five years. The determination means that, in 2004/05 prices, the average bill for water and sewerage services in NWL's northern area (Northumbrian Water) will rise by £28 over the five year period, to £260 in 2010; the average bill for water-only services in NWL's southern area (Essex & Suffolk Water) will rise by £21, to £153 in 2010. In the north, despite these increases, NWL will have the lowest average household bill for water and sewerage in the industry in 2009/10.

The final determination increased NWL's allowance for capital maintenance and recognised the need to increase investment to prevent discoloured water and further alleviate flooding from sewers in its northern area – issues that were identified as a priority by NWL's customers and the local WaterVoice committee. The full amount requested for these investments by NWL in its business plan was not granted, but the amount allowed in prices will allow significant progress to be made towards reducing the impact of discoloured water and sewer flooding. Additional investment was also allowed to meet water demand from major housing developments in NWL's southern area.

In the final determination, Ofwat made a number of significant changes to its draft proposal. In particular, appropriate allowances were made for increases to base operating expenditure for energy costs and pension contributions, and the impact of new Inland Revenue tax rules on the business was taken into account.

NWG announced, on 15 December 2004, that the NWL board had accepted the final determination.

New water competition measures

Preparations within NWL were made during the year for the introduction of new water competition measures contained in the Water Act 2003. The Act introduces two types of licences for new water suppliers – retail licences, for the retail supply of water, and combined licences, involving both retail supply and the common carriage of water. To be eligible to change supplier, customers must use more than 50 megalitres of water per year at a single premises, and the water must be for non-household use. New water suppliers can apply to Ofwat for licences from the summer of 2005 and licences will be granted from the autumn of 2005.

Ofwat has issued draft guidance on the implementation of the new licence arrangements and established advisory groups during 2004 to consider access terms, eligibility and licensing.

NWL's preparations include the updating of our access code, deriving access prices both for retail and common carriage, and the introduction of a customer transfer protocol. NWL has been influential in the guidance on access pricing and was one of two companies chosen by Ofwat to carry out dry runs of the application and pricing process with a prospective licensee.

The competition process is intended to provide lower prices for customers, while being cost neutral for the current supplier. In calculating access prices, avoided costs (such as the cost of billing for retail licences and the cost of supplying and treating the volume of water and the possible avoidance of capital investment for combined licences) are subtracted from the tariff the customer pays to the incumbent supplier. This means licensees can only gain profitable access by operating more efficiently than the incumbent undertaker.

Northumbrian Water Limited

Financial performance in 2004/05 and year end position

Turnover was £508.2 million for the year to 31 March 2005 (ten months to 31 March 2004: £386.2 million; 2003/04 pro forma: £454.6 million). The increased turnover during the year is mainly due to price increases following an IDoK by Ofwat. NWL successfully applied for an increase in its price limits to fund unanticipated additional costs caused by increased customer bad debt, water quality monitoring and new obligations requiring capital expenditure. In addition, a separate determination compensated for loss of revenue arising from the actual demand for water being lower than that allowed for by Ofwat at its 1999 price review.

Operating costs for the year were £306.4 million (ten months to 31 March 2004: £252.8 million; 2003/04 pro forma: £301.9 million). Depreciation increased by £9.8 million due to further capital investment. Other cost increases reflecting general inflationary price rises have been offset by operational efficiency savings and the non-recurrence of exceptional costs from 2003/04. Operating costs for the appointed business in 2004/05 are £7.6 million lower than those in the 1999 final determination, despite incurring additional costs not funded in that determination. This reflects the continual drive in the business to identify and deliver efficiencies.

Operating profit for the year was £201.8 million (ten months to 31 March 2004: £133.4 million; 2003/04 pro forma: £152.7 million), which reflects an increase in turnover of £53.6 million, offset slightly by a net increase in operating costs of £4.5 million.

Investment

Net capital investment, excluding inter group costs, at NWL, for the year was £208.8 million (ten months to 31 March 2004: £156.7 million; 2003/04 pro forma: £161.6 million). NWL has met its regulatory outputs required to meet quality objectives and delivered the capital efficiencies assumed by Ofwat. Capital maintenance investment has remained in line with the Ofwat forecast. Lower customer demand has resulted in lower investment relating to the supply demand balance and has meant that the regulated business has invested less than the Ofwat forecast for 2000-05.

To safeguard the quality of its water supplies, NWL's investment in new and refurbished assets continued. The new water treatment works at Wearhead in County Durham was commissioned, serving the Wear Valley and Sunderland areas. An extension to the water treatment works at Lound, serving the Lowestoft area in Suffolk, was also completed. Work began at Horsley and Whittle Dene in Northumberland to provide additional treatment facilities to remove minute traces of pesticides occasionally present in the water.

Further progress has been made with the long term project to increase water resources in Essex by enlarging Abberton reservoir. An allowance for the costs of the project during the next five years was made in NWL's final determination. Further details on the scheme and its progress are given in the future development and performance section on page 19.

During the year, capital investment projects were also completed at Marske and Skinningrove on the Cleveland coast. New underground storm water storage tanks were constructed at Marske to protect the quality of the adjacent designated bathing water. At Skinningrove, the new sewage treatment works will improve the quality of the local watercourse and the sea. Preparations were made for the provision of storm water storage tanks at Redcar.

A number of sewerage projects were completed or started in Northumberland. The replacement sewage treatment works at Belford, the new works at Boulmer and the transfer work at Hadston were all completed during the year. Work began on the new sewage treatment works at Seahouses and new pipelines to transfer sewage from Bamburgh and Beadnell to Seahouses. Preparations were also made for new sewage treatment works at Haggerston Castle and at Craster.

Customer performance

NWL continues to provide its customers with excellent levels of service and is still the only water and sewerage company to have achieved a star rating for all aspects of its service standards by Ofwat. However, for the third year running its performance was affected by exceptional adverse weather conditions. Severe summer storms in August 2004 resulted in sewer flooding, and torrential rainfall in January 2005 increased the flow in the River Tyne to such an extent that the river washed away water mains serving Hexham, which is unprecedented, and the town was without water for several days. For further details see the case study on page 25.

The drinking water regulations for both sampling and the provision of information changed for 2004. The sampling regime is now substantially changed, making comparisons with previous years difficult. However, NWL's own monitoring during 2004 demonstrated that its customers in its northern and southern areas continued to receive excellent quality drinking water.

The investment allowed in the Ofwat final determination towards the cost of tackling discoloured water will bring improvements for affected customers over the next five years and should also improve NWL's future score in the Ofwat performance measures. The same is true of the investment allowed to reduce sewer flooding.

In 2004/05, our leakage level targets were agreed with Ofwat at 159.5 megalitres per day (mld) in the northern operating area, and 69.8mld in the south. Both targets were met in the period.

In 2003/04, we responded to 7,065 customer complaints across our northern and southern operating areas. This equates to 3.5 complaints per 1,000 properties, below the industry average of 4.87 complaints per 1,000 properties.

WaterVoice audits the quality of our complaint handling. During this process WaterVoice visits our premises to audit our procedures, track samples of complaint correspondence through our systems and assess the quality of our responses. In 2003/04, 88.3% of all northern complaints and 96% of all southern complaints audited were scored as 'good'.

NWL continued its successful initiative to encourage as many of its customers as possible to use direct debit, administratively the most efficient way to collect payment for bills. Despite the increase in domestic bills, NWL maintained the previous year's collection performance. It was also an active participant in a WaterVoice debt conference, looking at the issue of affordability and the impact bad debts have both on companies and on the customers who pay their bills on time.

Developments were also made in the customer records systems, introducing two new customer systems and linking them to the company's geographical information system. This development allows the better management of responses to customers' calls and also allows customers' records to be viewed in association with maps showing the location of their property and records of incidents and queries. Customer calls, for example reporting discoloured water, are immediately plotted geographically, showing the development and potential spread of any incident. The new system is used to predict actual and potential impacts and allows a much better service to be provided to customers. This innovative development is a significant step forward within the industry and has generated considerable interest with Government and other utilities.

Commercial performance

The number of companies taking advantage of NWL's innovative effluent treatment service at Bran Sands on Teesside was increased with the signing of a 25 year contract to treat effluent from fine chemicals company Degussa.

Following a successful pilot trial, a contract was signed with Lafarge for the use of the sewage sludge pellets, produced by NWL's sludge driers at Bran Sands, as a fuel in the manufacture of cement. The contract reduces NWL's disposal costs and provides a secure and sustainable outlet for the sludge. NWL was also successful in a bid to supply water services to the new racecourse being built at Great Leighs, to the north of Chelmsford.

NWL's non-appointed businesses performed well. Leisure not only reduced costs, but also increased the occupancy of its holiday cabins at Kielder and income from retail sales and fisheries at its reservoirs. An imaginative new offering, 'Winter Wonderland', attracted nearly 4,000 customers to Kielder for a variety of activities before Christmas, a traditionally quiet period. Property Solutions, which provides a range of service and environmental searches, continued to see its income and profitability grow despite the slow down in the property market. Income from third party arrangements which provide insurance, water coolers and gardening products, also continued to grow during the period.

Environmental performance

NWL gained certification to ISO 14001, a framework of control for an Environmental Management System against which the company can be certified by a third party, for the whole of its business in December 2004. This was a significant achievement which builds on the pioneering certification of its sewage treatment and recreation activities.

In 2004, NWL's sewage treatment works continued to perform to the highest levels and all met their consents during the year. Compliance is measured by the EA and reported by Ofwat against standards set by the Urban Waste Water Treatment Directive and the Water Resources Act. In 2004, works achieved 100% compliance.

The environmental impact of this performance is measured by beach and bathing water reports although other factors such as diffuse pollution can affect such performance. In 2005, Encams announced that 16 beaches in the north east would receive seaside awards. In 2004, the last year for which figures were published by the EA, 100% (33) bathing waters in NWL's area passed the EU mandatory standard and 70% (23) passed the guideline standard. In addition, blue flags were awarded to seven beaches.

August 2004 was the wettest August in the UK since 1956, with more than twice the normal average rainfall for that month. This rainfall was widespread, heavy and prolonged, with only eight dry days recorded in some areas. Flooding was experienced in Hartlepool, Darlington and Bishop Auckland. As a result, NWL is unlikely to achieve the highest levels of service in Ofwat's sewer flooding categories when its results for 2004/05 are published.

In 2004, NWL was prosecuted for causing pollution of a burn in Houghton-le-Spring on two occasions in 2003, for which it paid fines totalling £2,000. In January 2005, it was prosecuted on two occasions for a total of four minor pollution incidents, two in Cleveland and two in Durham, with fines totalling £4,270. Although any prosecution is unacceptable, NWL had the fewest prosecutions in the water industry in England and Wales during the year.

Following negotiations last year, NWL's electricity demand since April 2004 has been supplied from green and high efficiency sources such as hydro, wind and high quality combined heat and power. NWL also signed a long term agreement with RWE npower for it to operate and sell the energy from NWL's hydroelectric power station at Kielder Water.

Trends and factors underlying development, performance and position

NWL performed well in Ofwat's unit cost and relative efficiency assessment for 2003/04, published in January 2005. It scored A grades (the highest grade on an A to E scale) for capital maintenance efficiency in both its water service and its sewerage service, and B grades for operating efficiency in its water service and its sewerage service.

A key example of NWL's drive for efficiency is the successful employment of the Six Sigma process improvement technique at its Bran Sands site which has now been extended to other areas of the business. This and other performance improvement measures allowed NWL to beat its cost reduction targets for the year.

International water

Northumbrian Water International (NWI)

NWI is the trading division of NSL responsible for managing the Group's interests in contracts in Scotland, Ireland and Gibraltar. Turnover was £23.1 million in 2004/05 (ten months to 31 March 2004: £17.6 million; 2003/04 pro forma: £20.7 million), reflecting the commissioning and subsequent operation of the Cork plant. Operating profit for the year was £2.3 million (ten months to 31 March 2004: £2.1 million; 2003/04 pro forma: £2.2 million).

In Scotland, the Group is party to two private finance initiative (PFI) 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 continues to perform well. Improvements to the odour treatment facilities are underway with completion of commissioning and performance testing due in early 2006. At Ayrshire, where the Group has a 50% interest in the project company and a 75% interest in the operating company, the three effluent treatment plants have also continued to perform well while the final certificate for the design and construction stage relating to the sludge treatment centre was issued in November 2004.

In the Republic of Ireland, NWI is part of a consortium that designed and built a €70 million waste water treatment plant for Cork City Council. The taking-over certificate was issued by the Council in September 2004 marking the completion of the design and construction phase and handover of the plant to NWI for the 20 year operation and maintenance phase of the contract.

AquaGib Limited, owned by the Group in joint venture with the Government of Gibraltar, continues to operate Gibraltar's dual drinking water and sea water distribution systems under its 30 year contract with the Government of Gibraltar. Potable water charges to customers were increased on 1 April 2005 for the first time since 1986 and the future level of Government subsidy for customers is still under discussion.

Related services companies

The Group's non-water companies' turnover was £87.7 million for the year (ten months to 31 March 2004: £70.2 million; 2003/04 pro forma: £82.1 million) and operating profit was £4.8 million (ten months to 31 March 2004: £3.2 million; 2003/04 pro forma: £3.4 million). The related services companies continue to build their businesses and to expand their client bases.

Entec UK Limited (Entec)

Entec is one of the UK's largest environmental and engineering consultancy companies, employing around 600 people delivering projects to both the Group and a range of external organisations in the public and private sectors. Over the last five years it has grown strongly to reach a turnover of £41.5 million for the year, up 5% on the previous year (ten months to 31 March 2004: £33.8 million), with 77% of revenue now being generated outside the Group.

Services provided include water and industrial engineering, contaminated land remediation, development planning, risk and safety management, energy services, environmental appraisal, environmental management and compliance, sustainable development, water management and waste management consultancy.

Project highlights during the year included a major partnering contract with Scottish Water Solutions, programme and project management services at UKAEA Dounreay, regeneration consultancy to the Telford Millennium Community project, research into affordable housing for the Office of the Deputy Prime Minister, technical advice to Greater Manchester Waste Disposal Authority for Europe's largest waste PFI contract, a flood risk study for the Association of British Insurers and an integral role in a number of NWL's ongoing investment projects including the Wear Valley water treatment works.

Entec was named in an independent poll in Environment Business magazine as the environmental consultancy with the best reputation among customers of the 36 consultancies listed. It was also named as the Royal Town Planning Institute's Planning Consultancy of the Year 2004.

Fastflow Pipeline Services Limited (Fastflow)

Fastflow is the Group's specialist underground asset management business, providing water, sewer and gas network renewal and refurbishment services. During 2004/05 it employed an average of around 220 people.

Turnover was £15.6 million during the year 2004/05, representing a reduction of 3% compared pro forma with 2003/04 (ten months to 31 March 2004: £13.4 million).

Turnover and costs were adversely affected by the cyclical nature of water industry asset management programmes, which resulted in a reduction in workload. The company is well placed for the demands of the next programme, having successfully tendered for Northumbrian Water's 2005-10 water mains rehabilitation contract.

During 2004, Fastflow also extended its capabilities to include gas pipeline work, and completed work to a value of over half a million pounds. This provided valuable experience and another step in its strategy of developing specialist underground asset management skills.

Analytical & Environmental Services Limited (AES)

AES is a leading environmental monitoring company providing high quality monitoring services, analysis and technical consultancy to major industrial groups, environmental regulators and local authorities throughout the UK and Ireland. AES employs over 300 people in eight locations. Although turnover from NWL decreased, total turnover for the year increased marginally to £13.2 million compared to the pro forma figures (ten months to 31 March 2004: £10.9 million) reflecting strong growth in external markets.

AES expanded in Wales after setting up a new office in Cwmbran as a base for its team of air quality scientists and occupational hygienists and will continue to extend its range of services during the coming year by offering a range of health and safety training courses.

AES successfully achieved accreditation for ISO 14001 during the year and MCERTS accreditation for a range of soils analysis. A number of major contracts won were with environment agencies (EA, SEPA and Irish EPA) and in the mineral, retail and pharmaceutical sectors.

International development consultancies

SA Agrer NV (Agrer) and ULG Northumbrian Limited (ULG) provide overseas aid funded project work through a number of funding agencies and a large database of associate consultants.

Agrer

Agrer is based in Belgium, and employs 26 people working on agriculture and rural development, conservation and sustainable management projects. Its turnover for the year was £6.0 million (ten months to 31 March 2004: £3.8 million; 2003/04 pro forma: £4.4 million). Agrer has won contracts with the EU as well as in Mali, the Democratic Republic of Congo and a contract to support the Belgian Federal Justice Department.

ULG

ULG assists governments and local organisations to better manage their natural resources and support rural communities and employs 8 people. It had a successful year and its turnover was £3.4 million (10 months to 31 March 2004: £2.6 million; 2003/04 pro forma: £3.0 million). New projects were won in the Falkland Islands, Kosovo, Kyrgyz Republic, Romania, Tanzania and Uzbekistan, and ULG was awarded Investors in People status.

Northumbrian Water Technical Centre Limited (NWTC)

The Technical Centre brings innovative solutions and productive partnerships to the Group and was merged with the technical department in NWL on 1 April 2005. Its turnover for the year was £0.9 million (ten months to 31 March 2004: £1.0 million; 2003/04 pro forma: £1.3 million).

Future development and performance

Ofwat's review of NWL's price limits set a number of factors in place for the next five years to 2010 and, given the impact of NWL on the Group, it will be a significant influence on the future development, performance and position of the Group. Beyond its regulated business, the Group anticipates modest organic growth in all areas.

Final determination

Financial aspects

The NWL price limits set by Ofwat for the next five years are:

Price limits per year	2005/06	2006/07	2007/08	2008/09	2009/10
% increase above inflation	6.5	3.7	3.2	1.0	0.6

The determination included assumptions on operating and capital efficiencies. They were:

- 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); and
- overall capital enhancement improvements of 14.8% for water and 14.6% for sewerage (for the full five year period).

NWL's Regulatory Capital Value will be:

Regulatory Capital Value at 31 March	2005/06	2006/07	2007/08	2008/09	2009/10
Outturn prices, assuming inflation of 2.5% per year (£ million)	2,628	2,759	2,879	2,983	3,062

Ofwat sets price limits using the industry cost of capital as a target rate of return on investment. For the 2004 review of price limits, a figure of 5.1% real post tax was used. However, for later years in the period, this return proved insufficient for many companies to achieve adequate financial ratios for relevant investment grade rating from ratings agencies. Consequently, upward financeability adjustments to price limits were needed to ensure that the financial ratios will be sufficient. In NWL's case, the financeability adjustment was £20 million (2002/03 prices) over the five year period.

Investment aspects

Over the next five years to 2010, NWL will invest £839 million (2002/03 prices) on further improvements to its services and the environment. This will include capital maintenance as well as further improvements to the quality of drinking water, sewerage assets, discharges to the environment, and levels of service provided to customers.

As outlined in the resources, risks and relationships section on page 20, NWL is increasing its investment in maintaining its above ground sewerage assets, which have been assessed by Ofwat as 'deteriorating'. NWL has invested heavily in the provision of new above ground sewerage assets and has effectively doubled its asset base in this area in the last ten years. Increased capital maintenance investment will achieve and maintain a 'stable' performance.

The extent and impact of flooding from sewers is an issue of concern to NWL, its customers and WaterVoice. The funding allowed for this service improvement will not eradicate the problem, but it will permit the worst cases to be addressed on the basis of a prioritisation scheme agreed with Ofwat and WaterVoice.

NWL will also continue to invest in new and improved sewage treatment works to meet the discharge standards required for the protection of environments designated as 'sensitive' and the requirements of the EU Freshwater Fish Directive. At the same time, NWL is continuing to invest in improvements to unsatisfactory sewage overflows and in the reduction of odours from a number of its sewage treatment works.

NWL has now entered the pre-planning submission stage of the project to enlarge its Abberton reservoir for water supply in Essex. Already ten years in preparation, this major scheme involves changes to existing abstraction licences, the provision of new pipelines, the raising of the reservoir's existing dam by 3.2 metres and the construction of four additional small dams. The planning application is due to be submitted in 2006 and, provided the planning process proceeds smoothly, construction will begin in 2010. Once filled in 2014, the capacity of the enlarged reservoir will be some 60% greater, although with only a modest take-up of surrounding land.

Also during the next five years, NWL will: complete its 20 year mains relining programme and institute a mains flushing programme to further reduce the incidence of discoloured water; invest in further assets at three of its Northumberland water treatment works to provide additional protection against pesticides; and carry out a project to identify whether the management of the upland catchment of the River Tees would be effective in protecting the raw water quality.

Future trends and factors

There is a range of known changes, both short term and longer term, that may have an impact on the future development, performance and position of NWG's subsidiaries in general and NWL in particular. These include:

- the separation of WaterVoice from Ofwat in October 2005 and the replacement of Ofwat with the new Water Services Regulatory Authority, with a board instead of a Director General, in April 2006;
- the operation of the new competition regime in water supply, outlined in the current development and performance section on page 11, which will see the creation of new licences from the autumn of 2005;
- the introduction of new British and European legislation (such as the Traffic Management Bill and Water Framework Directive), the deadlines in existing legislation (such as the lower lead in drinking water requirement in 2013) and proposals for future legislation (such as the proposal for water and sewerage companies to adopt private sewers): some of these could provide new commercial opportunities for Entec and AES;
- the impact of changes in population and industry levels, particularly with the development of the Thames Gateway area, on the demand for and supply of water; and
- the impact of climate change, particularly where it relates to the increased incidence of flooding and changes in rainfall patterns: this, too, could provide commercial opportunities for Entec.

Resources, risks and relationships

Resources

Water resources

There are significant water resource differences between NWL's northern and southern areas. In the north, the massive Kielder Water enables NWL, during periods of drought, to recharge the rivers from which it abstracts, ensuring there is sufficient water to meet its customers' needs. The picture is very different in NWL's southern area, where in a dry year it imports 50% of the water it needs in Essex.

NWL has taken steps in both its operating areas to progressively reduce leakage from its mains such that leakage in both areas is at or below its economic level. In its southern area NWL has also built the unique, award-winning Langford recycling plant that reclaims water that used to be lost to the environment. NWL is also entering the pre-planning submission stages of the major long term project to enlarge its Abberton reservoir in Essex, working closely with the EA and other statutory consultees and stakeholders (further details are given on page 19). In addition, NWL is continuing to encourage customers in both its areas to use water as wisely as possible through a wide-ranging educational and information programme.

In the southern operating area, where water resources are under pressure, NWL actively encourages its customers to opt to have a meter fitted. In addition, NWL was one of the first companies to require a meter to be installed on changes of property ownership and, after a successful trial of this approach, this policy is now being rolled out across the Essex area. In the northern area, which has a more favourable water resource situation, the policy is to respond positively to all requests for optional meters.

Infrastructure

Ofwat measures the performance of water companies' stewardship of their asset base under four categories – water above and below ground and sewerage above and below ground. NWL has been assessed as having a 'stable' rating for the two water and the below ground sewerage assets, but its above ground sewerage assets were determined as 'deteriorating' by Ofwat.

In the last five years, NWL has invested in sewerage above ground assets at levels over those assessed as being necessary by Ofwat at its last review of price levels. This was a consequence of rigorous prioritisation to obtain the maximum benefit from combined maintenance expenditure in both water and sewerage assets. Investing at the levels set by the regulator would, in NWL's view, have resulted in a substantial deterioration in asset performance, leading to a detrimental impact on the environment. Total maintenance expenditure remained in line with Ofwat allowances.

Environment

Policy and management

The Group has a Sustainable Development Committee that meets at least twice per year. Its function is to establish best practice, to ensure compliance on ethical, economic, environmental and social matters in the context of sustainable development and to evaluate future trends across the Group. This committee interacts with NWL's management team, which formally considers sustainable development matters four times per year.

NWL's Sustainable Development Steering Group develops, monitors and reviews progress against NWL's sustainable development strategy and encourages and facilitates cross-functional decision making for sustainable development. In addition, the Southern and Northern Area Community and Environment Committees guide local delivery and direction of environment, ethics and community issues within NWL.

NWG has an environment policy and a sustainable development policy. The Managing Director is accountable to the Board for these issues. Continual improvement against the policies is monitored through quality and environmental management systems.

Environment policy

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

Sustainable development policy

The Group aims to use resources efficiently and procure materials, goods and commodities on the basis of their environmental, social and economic impacts. At the same time, NWL will work to reduce, where possible, the amount of wastes generated and reuse or recycle by-products. It will also protect and enhance biological diversity, ecological systems and cultural heritage.

People

Employee turnover within NWL and the other Group companies is stable, relative to the sectors in which the subsidiaries operate. An overview of employees' satisfaction with various aspects of NWL and Entec, the two largest employers in the Group, is given in the employees section on page 26.

Workforce profile

The average number of employees in the main business units is as follows:

Group business unit	Average number of employees	%
Northumbrian Water Limited	2,475	65
Northumbrian Water International	134	4
Entec	599	16
Fastflow	222	6
AES	319	8
Other	43	1
Total employees	3,792	100

Financial

The Group has substantial undrawn committed bank facilities available to it in the event that it is unable to raise finance at attractive rates from the markets at a particular time.

Risks and uncertainties

All the subsidiaries within the Group are required to identify, and assess the impact of, risks to their businesses. The Group uses a model that identifies risks under five headings – environmental, external, operational, financial and reputational. 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 risks is assessed. Further details of the Group's treasury risks are contained in note 19 to the financial statements.

Apart from NWL, none of the subsidiaries have 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 46 and 47.

At NWL, measures have been set to enable it to determine whether the risks are significant to the business. The model is reviewed in detail every year and the NWL management team assesses the appropriateness of each risk, its assessment and score in detail. The outcome of this review is considered by the NWG and NWL Audit committees. In addition, the management of significant risks is considered by the NWL board at each of its meetings.

The provisions of the Ofwat interim and final determinations and the measures taken by the Group to strengthen its financial position have removed many of the risks and uncertainties that existed at the time the Group entered the Official List of the London Stock Exchange in September 2003. Those that remain can be classified as follows:

Changes to the regulatory environment and to legislation

Regulation functions in the place of competition in the water industry and regulators encourage high standards and the adoption of industry best practice. As a result, NWL is subject to ever tightening standards, often requiring additional human and financial resources and the provision of new assets and systems. Similarly, British and European legislation changes on a regular basis, and interpretation of existing laws can also change.

Ofwat is required to take account of changes in legal obligations applying to water companies when setting price limits at the five yearly periodic reviews. Where changes having a material financial impact occur between reviews, they may trigger an interim determination, allowing NWL to request a change in prices before the end of the five year period. Less significant unforeseen costs can be 'logged up', so that the costs can be taken into account retrospectively at the next price review.

The Group companies keep themselves informed of actual and likely changes to the regulatory and legislative frameworks, to anticipate, and where possible prepare for, the impact the changes will have. Often, the same legislation that creates additional cost burdens in NWL also creates market opportunities for the other Group companies.

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 dealing with climatic uncertainties, both in terms of the impact of having too little and too much rainfall.

Weather patterns appear to be changing, with increasing incidences of hot, dry summers and heavy rain in winter. However, severe localised storms seem to have become a regular occurrence in August in recent years, causing unwelcome sewer flooding to homes and properties. Although completely outside its control, this has a detrimental impact on NWL's overall performance in the Ofwat service measures.

Excess water also had unexpected results in January 2005, when the twin water mains buried beneath the river bed, serving the Northumberland town of Hexham, were washed away by the swollen River Tyne. Supplies were lost for up to seven days for the town's 6,800 properties. NWL's response to this extreme event is described more fully in the case study on page 25.

Working with Entec, NWL has assessed the possible impact of global warming on not only its own operations but also on those of key industrial and commercial customers. The Group has arranged a conference for September 2005, with the CBI, on the impact of climate change.

In its northern area, because of Kielder Water and the water transfer scheme, NWL has sufficient water reserves and is able to keep its major rivers topped up during periods of drought. However, its southern area is in one of the driest parts of the UK and NWL continues to do everything it can to ensure there is enough water available for customers' needs. NWL has an excellent record of leakage detection and repair in its northern and southern areas and has invested in its innovative, award-winning water recycling plant at Langford. Its plans to enlarge Abberton reservoir in Essex, and to meet the water needs of the next 25 years, are now well advanced (further details are provided on page 19).

Social, environmental and ethical risks

The principal social, environmental or ethical risk considered to be significant to the value of the Group concerns the loss of NWL's ability to use its sewage sludge as a soil conditioner on agricultural land. The potential impact of the risk would be to require NWL (and other water and sewerage companies) to find or develop alternative re-use or disposal routes for its sewage sludge, which could mean higher capital and revenue costs to provide additional sludge processing facilities. However, as reported on page 4, NWL has recently signed a contract with Lafarge for the use of sewage sludge pellets as a fuel replacement in cement manufacture, which will secure the sludge disposal route in the medium term.

Relationships

Reputation

The Group has a strong reputation. It is active in the communities it serves with a number of community programmes, including employee volunteering and sponsorship, which are detailed in the social and community relations section on pages 27 to 29.

NWG has several research programmes which monitor customer satisfaction and reputation and identify areas which need improvement. NWL's customer tracking survey is in its sixth year enabling it to monitor trends; the overall satisfaction level for 2004 was 87.25%, which is a rise of 0.25% from the previous year's results.

Additional research with opinion formers in the north, completed at the beginning of 2004, concluded that their attitudes were largely positive towards NWG, held it in high regard and considered it to be one of the top companies in the region.

The reputation of NWG was further recognised by the number of awards it received during the period.

Stakeholder relations

The Group as a whole has a code of conduct covering its relationships with its customers, employees, suppliers, local communities, shareholders and other investors and the environment. For NWL, key relationships also include those with its regulators.

NWG undertakes regular dialogue with stakeholders, for example, via direct meetings with the business community or their representative groups such as the CBI and Chambers of Commerce. It is an active member of these and other organisations. It also meets with national, regional and local authorities as well as MPs and MEPs and other appropriate organisations to explain ongoing work and issues. This includes attendance at Party Conferences to ensure that it has the opportunity to speak to all representatives. NWL interacts with local communities through public meetings and literature when it needs to explain the impact of work it requires to carry out in their area.

Industry relations

NWL is a committed 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.

Investor relations

Apart from statutory information, investors could request a copy of the Sustainable Development Performance report for last year. As part of its ongoing commitment to corporate governance, NWG has undertaken an independent survey of its largest shareholders to ascertain their views on a range of issues regarding the Company. The overriding conclusion from the report was that shareholders are pleased with the performance of the Company; that the Company is well placed to achieve the operational targets set out in the regulatory review and that the management team has performed very well and is very accessible.

Regulatory

NWL has good working relationships with its three main regulators – Ofwat, EA, DWI – and with WaterVoice. It has also proactively built relationships with other bodies, such as English Nature and the National Trust, with the regional development agencies and local authorities in whose areas it operates, and with environmental and social charities. These relationships were particularly useful during the Ofwat review of price limits; they allowed a full exchange of views and the seeking, and general achievement, of a consensus on the investment needs and priorities.

Key industrial customers

NWL has a unique raw water base and a greater dependency on its key industrial customers than is the case with other UK water companies. As a result, it has well-established relationships with its key industrial and commercial customers, forged through managed accounts. This proactive approach to customers has allowed NWL not only to maintain existing relationships, but also to build its business by providing additional services to existing and new customers. It has also contributed to the attraction of inward investment to the north east of England in the past, by providing the right quality and availability of water, and access to effluent treatment services, that prospective investors find attractive.

Domestic customers

Market surveys consistently show high levels of satisfaction among NWL's domestic customer base. This customer loyalty was severely tested in January 2005 in Hexham, when the water supply to the whole area was interrupted for several days. What could have been a customer relations disaster was avoided because of the efforts of our employees and their speed of response to what was a major emergency, as described in the case study below.

Case Study – the Hexham incident

The effectiveness of our emergency planning and the willingness of our employees to go beyond the call of duty were put to the test earlier this year. Torrential rain swept away two water mains buried beneath the River Tyne and 6,800 properties were without water for up to seven days. We worked around the clock to install a 5.5 km temporary water main in only three days. 342 employees spent some 12,000 hours dealing with the emergency. 325,000 bottles of water were distributed and 121 static water tanks were filled by 15 tankers. To keep customers informed, 28,000 letters were delivered to homes and information was provided in over 280 national and local TV, radio and newspaper reports.

Following the event, we established a fund to support community projects in the Hexham area as a thank you for the patience and understanding of residents during the disruption.

Employees

As the Group operates in a number of different sectors, with their own types of employment, it does not have a formal Group-wide employee policy. Each subsidiary has its own policy, designed to reflect its own situation and to create the workforce it needs to meet its business objectives.

Nevertheless, each subsidiary aims to create a unified company that contains a diverse range of individuals; recruits and retains high calibre employees who are valued for their contribution and able to fulfil their potential; provides opportunities for its employees to develop their skills and capabilities so they are equipped and ready for the challenges they will face; establishes a stimulating and safe working environment in which a sensible work/life balance is promoted and appropriate training is provided; and rewards individual and team contributions, while expecting employees to be committed to, and involved in, the Company's future success.

Recruitment and retention rates within the Group differ from subsidiary to subsidiary, depending on the sector and type of employees concerned. Generally, staff turnover levels are normal compared with the averages for the sector within which each subsidiary operates. For example, turnover in NWL during the year was less than 7%. By comparison, the companies working in the consultancy sector experience a much higher turnover, as consultants tend to be more willing to move jobs. However, Entec's level of staff turnover is less than 16%, much lower than that of its competitors.

The Group companies each have their strategies for retaining staff, including the provision of attractive terms and conditions, family-friendly policies and, in some cases, bonuses. For example, during the course of the year, NWL took steps to introduce a job evaluation system and single salary policy, with a supporting equal pay audit being carried out across the business to harmonise its terms and conditions across its workforce. It will introduce a flexible benefits scheme in 2005/06, including tax-efficient and money-saving opportunities for employees.

Since April 2004, Group employees have been able to invest in NWG shares in a tax-efficient way through the Share Incentive Plan (SIP), which provides a free share for every three purchased. By the end of the year, some 1,143 Group employees were involved in the SIP, owning a total of 944,569 NWG shares (0.18% of issued share capital).

Group companies carry out checks on the morale and motivation of their employees, both informally through the appraisal system and the analysis of absence statistics and more formally through employee attitude surveys. NWL carries out such surveys on an annual basis. They measure employees' attitudes to the company and its image, management, communications, training and development, team spirit, health and safety, customer service and the environment. Of those questioned in 2004, 82% said they enjoyed their job, 74% were proud to work for NWL, 72% were happy with their current position and 62% believed they had the opportunity to learn and grow as an employee.

The results of the 2004 survey showed an increase of 24% in the number of employees believing they were kept well informed about the company's future plans compared with the 2003 results. Increases were also seen in job security (up 16%), belief that the survey would lead to improvements (up 15%) and confidence in the senior management team (up 12%). The results were reported back to employees in a special booklet that identified employees' key issues and the actions the management proposed to take in response.

Entec is the second largest subsidiary in the Group and it carries out its employee satisfaction survey every two years. The results of the survey carried out in May 2004 showed an all-round increase in satisfaction levels since the last survey.

Training and development

All Group companies are committed to the training and development of their employees, for the benefit of the individuals and the companies. The main subsidiaries use annual appraisals to assess and encourage performance, to identify career development possibilities and training needs, and to provide a formal opportunity for feedback and dialogue.

During the year, NWL introduced skills matrices for every role, giving details of training undertaken to date and identifying current and future training needs and priorities, particularly for key technical and health and safety training.

NWL also introduced a new passport system for its employees in operational roles; the passports outline the training and occupational health standards required for the role they undertake. The passports are generated by a new human resources system introduced during the year, called *mydata*, which gives employees and their managers self-service access to data held on them, including employment and training records, qualifications, emergency contacts and pay slip details. It will be further developed during 2005/06 to provide leave and sickness absence records.

To develop its leaders, NWL has three formal training programmes – the graduate development programme (GDP) for newly recruited graduates, the management development programme (MDP) for senior managers and the team leader development programme (TLDP) for junior managers, supervisors and team leaders.

In its four years of operation, 17 graduates have joined the GDP and the majority of those who have completed the programme have gone on to gain a permanent management or technical position within NWL. The MDP and TLDP programmes are centred around the capability framework NWL has developed for its managers and team leaders. Around 150 senior managers have taken part in the MDP programme over the last four years and a further 36 will join it in 2005/06.

The TLDP was introduced during the year; over the next three years around 250 team leaders will take part in the programme. It covers similar areas to the MDP, focusing on leadership skills, individuals' strengths and weaknesses, understanding the needs of others and communication skills. NWL also runs an apprenticeship programme in its maintenance craft area with a view to employing up to three young people each year.

NWL is collaborating with the Learning and Skills Council to equip employees with essential skills for the workplace. The intention is for NWL to create its own accredited learning framework as part of an application for Investors in People in 2006/07.

Working environment

A safe working environment is essential for all Group companies, particularly those that have employees whose roles involve working with hazardous substances or in potentially dangerous situations. All Group companies have health and safety policies and ensure that their employees receive the necessary training to safely carry out their jobs. They also have policies to promote the health and wellbeing of their workforces.

During the year, NWL introduced a new five year health and safety plan, including reductions it wishes to see in the number of reportable accidents year on year. To encourage its employees to be more aware of their own, and their colleagues' safety, it also introduced an initiative whereby the correct reporting of accidents and hazards, the lack of reportable accidents and the encouragement of positive behaviour resulted in monthly cash payments to the charity Mencap. In the first 12 months of operation, the charity has received £20,500. However, NWL had 44 reportable accidents during 2004/05, an increase over 2003/04 figures.

NWL also introduced its *Just culture* framework for the investigation of reportable accidents. This seeks to identify the causes and implications of accidents and to ensure that lessons are learned and safe behaviour and practices are encouraged.

Social and Community Relations

The Group policy is to support the communities in which it operates and in other areas where considered appropriate. Subsidiary companies are permitted to make charitable donations, educational and cultural contributions, gifts in kind and to encourage employee volunteering and fund raising. The level of the support given is appropriate to the size and profitability of the subsidiary and the impact it has on the community in which it operates. All support is provided in accordance with the Group code of conduct.

Group subsidiaries operate in different sectors and with widely varying impacts on their local communities, so each has its own practice so far as the Group policy is applied. For the small subsidiaries, although the scope for social involvement is limited, they variously support charities and employees' fund raising efforts, provide work-place opportunities for school children or university students or provide training for unemployed people. NWL, AES and ULG encourage their employees to take part in community activities through their *Just an hour* programmes, details of which are given below. NWG is a member of Business in the Community's Per Cent Club, donating 2.2% of pre tax profit to the community in terms of cash, facilities used and time given.

Employee involvement runs throughout the Group and, in the north east, John Cuthbert chairs the Business Leaders Group of Business in the Community to help promote responsible involvement by other companies as well as NWG. He also chairs the Regional Skills Partnership, which promotes the proper development and provision of skills in the north east. The Group has also taken the lead nationally in such issues as the provision of 'Affordable Rural Housing'.

This is all part of NWG's responsible business practice and this work has been recognised in different ways. NWG's application to the FTSE4Good UK Index was accepted in September 2004 and NWL completed the Corporate Responsibility Index for Business in the Community for the second year running and moved up to 28th place. In May 2004, NWL was awarded the Business in the Community Award at the North East Business Awards organised by the Trinity Mirror Group and Essex & Suffolk Water received the Essex Countywide Business Award-Community Category 2004, both for their active community involvement.

Because of its size, the community nature of its business and the impact of its capital investment programme, NWL has the greatest social and community involvement in the Group. Its community involvement policy focuses its support on five key areas – economy, social inclusion, environment, education and regional support – building partnerships and providing resources rather than giving grants and sponsorship, with employee volunteering being key to its success.

A key part of the implementation of NWL's policy is its *Just an hour* programme, which allows employees to give at least 12 hours of work time per year to a community or environmental project. During the year, 738 of its employees (29.5% of the workforce) were registered for the programme, of which 427 (58%) actively took part in a project, completing a total of 3,717 hours of voluntary work. This is an increase of 16% on the amount of hours volunteered in 2003/04. AES has also adopted the programme.

Just an hour projects completed during the year include: refurbishing a drop-in centre in Upper Teesdale, planting 2,000 trees in the new nature reserve at Abberton reservoir, making gardens and erecting fencing at Bill Quay Community Farm in Gateshead, holding industry and young enterprise days at schools in Essex and helping primary school pupils in inner city Newcastle with their IT and English skills through an e-pals project.

NWL supports many projects that promote the economic regeneration of the areas it serves, working with organisations such as the regional development agencies, Newcastle Gateshead initiative, Essex Economic Partnership and Kielder Partnership. Each has specific outputs in terms of impact on jobs and investment. During the year, NWL agreed to become water and crew sponsor for the visit of the Tall Ships Race to Newcastle and Gateshead in July 2005. The sponsorship will provide the ships with water and will enable a number of young people to take part in stages of the race.

NWL's social inclusion projects are targeted at improving the health and fitness of its customers. These include: Water for health, a programme to raise the awareness of children, the elderly and families of the importance of drinking sufficient water; the Chance to live initiative, working with the Northern Echo, Durham Primary Healthcare Trust and Wear Valley District Council, to encourage people to be more active; and support to Durham and Essex County Cricket Clubs to encourage more children to actively participate in the sport.

NWL continued its partnerships with the Essex, Durham and Northumberland Wildlife Trusts, Broads Authority and the Davy Down Trust in Essex through which it employs trained people to carry out conservation work and education programmes. It is also one of the main partners in a project to re-introduce red kites to north east England. Two dozen of these magnificent birds of prey were released in 2004 and a similar number will join them in both of the next two years.

Many *Just an hour* projects are educationally based, supporting learning and the development of skills amongst pupils and university students. In addition, NWL works with schools to support their delivery of the national curriculum. During the year, this included 30 presentations to schools, 65 site visits and 10 industry days.

NWL has established funds with the Community Foundations in Tyne & Wear and Northumberland, Essex, Cleveland and Durham. These endowments provide an annual income to support community projects that fit NWL's five support areas. The funds are managed and allocated locally by an employee committee with support and advice from Community Foundation staff. During the year, 57 applications were received by the four committees and a total of £13,649 was given to 44 projects. At the end of the year the four Community Foundation funds held £763,000. NWL is also represented at board level on two of the Foundations.

NWL endeavours to ensure that its operations have as little impact as possible on local communities. However, the nature of its services means that this is not always possible. For example, major capital investment projects can cause some inconvenience because of the transport of materials and occasionally the closure of access to areas involved. Where warranted, NWL establishes funds with the local Community Foundation to support the communities inconvenienced; such a fund was set up in Marske in Cleveland, worth £10,000, in association with NWL's storm water storage tank installation project.

A fund was also established following the Hexham incident, described on page 25. It will support community projects in the Hexham area to recognise the patience and understanding of residents during the week they were without a water supply. The £150,000 Pipeline Fund is administered by the Community Foundation for Tyne & Wear and Northumberland. A further £75,000 was pledged to Tynedale Council for the long term plans to improve a local area.

NWG has supported the international charity, WaterAid since 1981 via direct financial support to the charity and support of a fundraising committee within the Group. Since 1997, the committee has raised over £1.5 million, changing the lives of over 100,000 people in Africa and Asia, who do not have access to clean water and sanitation.

Financial review – current and future

Group financial performance

The Group's turnover was £578.6 million for the year to 31 March 2005 (ten months to 31 March 2004: £442.1 million; 2003/04 pro forma: £520.8 million), largely reflecting NWL's successful application to Ofwat for an IDoK for 2004/05.

Operating profit for the year was £204.7 million (ten months to 31 March 2004: £143.6 million; 2003/04 pro forma: £164.3 million). Operating costs have increased by £4.5 million at NWL; the reasons for the increase at NWL are given on page 12.

Net interest payable was £99.1 million for the year (ten months to 31 March 2004 before exceptionals: £92.8 million; 2003/04 pro forma before exceptionals: £105.3 million) and includes £14.1 million amortisation of debt fair value (ten months and pro forma to 31 March 2004: £5.3 million) and £3.8 million of one-off gains from the cancellation of interest rate hedging and settlement of outstanding tax claims.

The tax charge for the year was £10.4 million (ten months to 31 March 2004: £14.0 million credit; 2003/04 pro forma: £13.5 million credit) comprising corporation tax of £1.5 million (ten months to 31 March 2004: £9.1 million credit; 2003/04 pro forma: £8.8 million credit) and deferred tax of £8.9 million (ten months to 31 March 2004: £4.9 million credit; 2003/04 pro forma: £4.7 million credit).

The corporation tax charge was offset by modest prior year credits compared to 2004 and, unlike 2004, there are no exceptional items. The deferred tax charge was offset by prior year credits but increased by approximately £4.0 million due to a reduction in discount resulting from a decrease in long term gilt yields over the year.

Profit on ordinary activities after tax for the year to 31 March 2005 was £98.4 million (ten months to 31 March 2004: £59.5 million; 2003/04 pro forma: £67.5 million), largely reflecting increased price limits at NWL and the interest credits noted above. Additionally, there were no exceptional costs in the year (ten months and pro forma to 31 March 2004: £8.0 million).

NWG's net debt increased by £11.5 million to £1,881.0 million compared with 31 March 2004. The Group's gearing at 31 March 2005, based on its net debt divided by NWL's RCV at 31 March 2005 of £2,468.3 million, was 76% (73% excluding the unamortised debt fair value). Cash interest cover for the Group is 2.7 times, reflecting the better trading performance. Similarly, the improvements in net cash inflow from operating activities has helped to improve the ratio for cash flow to net debt.

Gearing for NWL's appointed business at 31 March 2005, based on its net debt divided by its RCV at that date was 59% (2004: 59%), whilst cash interest cover improved to 3.4 times.

Financial review statement

Ofwat published its final determination for NWL on 2 December 2004, allowing NWL to raise its price limits by 15% above the rate of inflation over the years 2005-10. This was a significant increase on the draft determination of 7.8%. NWG announced on 15 December 2004 that the NWL board had accepted the review. The final determination includes allowances for increases to base operating expenditure for energy costs and pension contributions, and takes into account the impact of new Inland Revenue tax rules on the business. It also sets the investment programme and outputs that NWL must deliver over the next five years.

Accounting policies

The financial statements have been prepared on the going concern basis under the historical cost convention. The directors have arrived at their decision based on consideration of the Group's net current liabilities in relation to the Group's detailed budget for 2005/06 and the business plan for the period to 31 March 2010.

International Financial Reporting Standards (IFRS)

The Group will publish its results under IFRS for the six months to 30 September 2005 and for the year ending 31 March 2006. The Group does not currently anticipate adopting IFRS at subsidiary level within the Group.

The major differences in accounting policies expected to have an impact on the Group are deferred tax, retirement benefits, fixed asset accounting, business combinations and intangible assets. The adoption of IFRS will have no impact on cash flow or dividends for the Group.

The full impact of the adoption of IFRS on the financial statements will be communicated in a presentation to analysts and investors, planned for September 2005.

Capital structure

The main business is that of the Group's key subsidiary, NWL, which involves the ownership and operation of assets, investment in the maintenance of existing assets and the provision of new ones. As a consequence, the Group has a substantial, and growing, level of debt. In excess of 88% of the Group debt is arranged on a fixed interest basis and has an average maturity of 18 years. The Group seeks to mitigate the risk and exposure it does have to changes in interest rates by matching long term assets with long term liabilities, such as long term bonds.

Since flotation of the Group in May 2003, the Group has taken a number of actions to strengthen the capital structure. The first of these occurred before the current period, in December 2003, when Ofwat responded favourably to an application by NWL to increase its price limits in real terms in 2004/05.

On 12 May 2004, the Group announced the securitisation of NWL's contract with the EA to operate the Kielder Water transfer scheme. The net proceeds of £212.1 million arising from a 30 year bond were used to repay short term acquisition debt of £205.0 million.

The European Investment Bank (EIB) confirmed, on 12 May 2004, its intention to remain as a lender to NWL following the Group's change of ownership.

Ofwat issued a position paper on 12 July 2004, which concluded that NWL had taken adequate measures to demonstrate, both to the regulator and to the capital markets, that it was able to raise finance and to fund investment programmes.

In December 2004, NWL's finance subsidiary issued a £100 million increase to its 2033 Eurobond. The proceeds were used to repay short term working capital facilities, thereby extending the profile of the debt maturity and funding the ongoing capital programme. The all-in cost of this additional issue (5.75%) was similar to the all-in cost of the original £250 million raised in December 2002.

Working capital facilities of £125 million have been arranged for a five year term by NSL in May 2005, to part refinance the NSL bond when it matures in June 2006. The balance required will be covered by available cash at NSL. Similar facilities, with 364 day and five year maturities, were also arranged for NWL, totalling £150 million, to provide additional working capital during the initial phase of the 2005-10 capital investment programme.

Credit rating

Moody's initiated coverage of NWL with a credit rating of Baa1 on 8 April 2004, consistent with the Fitch rating of BBB+ announced on 11 December 2003. S&P's improved its rating outlook for NWL from BBB stable to BBB positive on 16 April 2004 and increased its rating to BBB+ stable on 25 January 2005.

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 short and medium term committed back up facilities, split between a one year and 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 19 to the financial statements. The Group is operating in compliance with its policies.

Cash flows/liquidity

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

The improved credit ratings and the growth in the share price also reflects the growing confidence in the Group, following the actions taken to make itself more financially robust.

As at 31 March 2005, NWG has experienced significant share price growth since its AIM listing in May 2003. The Board believes the actions it has taken to address the short term liquidity concerns of the ratings agencies and the regulatory decisions have all had a part to play in this growth.

Earnings per share and dividends

Basic and diluted earnings per share were 19.1 pence (ten months to 31 March 2004: 11.5 pence; 2003/04 pro forma: 14.4 pence). Earnings per share, adjusted for deferred tax and the amortisation of debt fair value were 18.1 pence (ten months to 31 March 2004: 11.2 pence, before exceptionals, deferred tax and the amortisation of debt fair value; 2003/04 pro forma: 14.2 pence).

A final dividend of 7.13 pence per share for the year ended 31 March 2005 will be recommended by the Board to the AGM on 28 July 2005 and, if approved, will be paid on 16 September 2005 to shareholders on the register at the close of business on 19 August 2005. Together with the interim dividend of 2.87 pence per share, the dividend for the year will be 10.00 pence per share (ten months to 31 March 2004: 6.95 pence per share). This represents an increase of 20% on the dividend for the 2003/04 pro forma trading period. The dividend cover for the year is 1.9 times and 1.8 excluding deferred tax and the amortisation of debt fair value.

The proposed dividend reflects increased confidence following the substantial improvements made to the Group's balance sheet over the last year and the removal of uncertainty following the Ofwat periodic review of prices.

The board of our main subsidiary, NWL, has proposed a dividend policy consistent with the underlying assumptions adopted by Ofwat in its recent final determination.

Looking to the end of the current regulatory period, NWG expects to be able to maintain a progressive dividend policy with real increases of around 3% p.a.

The Board believes this provides shareholders with a sustainable policy consistent with the regulatory environment within which NWL operates and reflects the ongoing benefits at the Group from refinancing. The policy is also consistent with maintaining Group and NWL gearing at around current levels over the medium term (excluding the unamortised fair value adjustment, due to acquisition debt at 23 May 2003).

Pensions

The Group operates a funded defined benefit scheme and a defined contribution pension scheme.

The defined benefit pension scheme provides benefits based on final pensionable remuneration to 2,407 employees across the Group, however, this scheme is now only open to new employees joining NWL. As part of the Ofwat periodic review process, the price increases NWL is allowed to make by the regulator between 2005-10 include an element to cover the anticipated increase in pension contribution rates that will be effective in January 2006.

The defined contribution pension scheme provides defined benefits to 886 employees.

The actuarial valuation as at 31 December 2004 is currently in progress. Employer contribution rates will be reviewed once the results of this valuation are known. The disclosures required by FRS 17 'Retirement benefits' are contained in note 25 to the financial statements.

This operating and financial review was approved by the Board on 7 June 2005 and signed on its behalf by the Managing Director. It will be put to the shareholders for approval at the Company's AGM.



John Cuthbert
Managing Director
7 June 2005

Appendix to the operating and financial 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 the 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: Net cash inflow from operating activities less tax divided by net interest paid (excluding non recurring items, such as hedging gains/losses and issue costs on new borrowings).

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: Net cash inflow from operating activities 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 the 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

Customer service standards

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 against these predetermined standards and other companies.

Source of underlying data: Information collected by the company and submitted to Ofwat annually in June. 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 the tracking of perception of reputation, service and value for money over time.

Source of underlying data: Surveys of 500 customers chosen at random but representative of the customer base as a whole in each of the northern and southern areas, carried out in June and December - total of 2000 customers.

Drinking water quality

Definition and calculation: Compliance with drinking water regulations as monitored by the DWI.

Purpose: To monitor drinking water quality.

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

Environmental performance

Definition and calculation: Percentage of population equivalent served by non-compliant works failing LUT 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 EA and reported on by the latter.

Board directors' biographies

Sir Frederick Holliday Chairman (69)

Sir Fred Holliday had a distinguished academic career, including a period as Vice-Chancellor of Durham University before joining the former Northumbrian Water Group plc as a non-executive director in 1991. He became its Chairman in 1993. He was a director of Shell UK from 1980 to 1989 and Chairman of the Go-Ahead Group plc until October 2002. Sir Fred is a non-executive director of Brewin Dolphin Holdings plc and of Northern 2 VCT plc, and Chairman of Northern Venture Trust plc. He is also Vice-President of the Freshwater Biological Association and the Marine Biological Association.

John Cuthbert Managing Director (52)

John Cuthbert joined the water industry in 1991 and was appointed Managing Director of North East Water in 1993. Following the acquisition of the former Northumbrian Water Group plc by Lyonnaise des Eaux in 1996, 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.

Chris Green Finance Director (50)

Chris Green joined the former Northumbrian Water Group plc in 1990 and was appointed its Finance Director in 1997. He was appointed as Finance Director of Northumbrian Water Limited and oversaw the merger of Northumbrian Water Limited and Essex and Suffolk Water plc in 2000.

Sir Patrick Brown Senior Independent Non-executive Director (65)

Sir Patrick Brown was appointed to the Board in May 2003. 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 a non-executive director of Amey plc and Amey UK plc.

Martin Nègre Independent Non-executive Director (58)

Martin Nègre was appointed to the Board in May 2003. He was, between April 2000 and April 2001, the Chief Executive Officer 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, and a director of Ecofin Water & Power Opportunities plc, a listed investment trust of which he was Chairman for three years. Both funds are focused on utilities.

Sir Derek Wanless Independent Non-executive Director (57)

Sir Derek was appointed to the Board in December 2003. He became a director of National Westminster Bank in 1991 and its Group Chief Executive in 1992. He retired from that position in 1999, since which time he has been involved in reviewing and reporting on the 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 Trustee of the National Endowment for Science, Technology and the Arts (NESTA).

Jenny Williams Independent Non-executive Director (56)

Jenny Williams joined the Board in May 2004. She is Chief Executive of The Gaming Board for Great Britain. In addition to being Head of Water Finance and Flotation at the time of water privatisation, Jenny Williams 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.

Directors' report

The 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 2005.

Activities

The principal activities of the Group during the year were the provision of water, waste water management and related services. A review of the Group's activities for the year is contained in the operating and financial review on pages 6 to 7.

Financial results and dividends

The Company's results and dividends are as follows:

	Year ended 31.3.2005
	£m
Profit after tax and minority interests for the year	98.9
Dividends	(51.8)
Transferred to reserves	47.1

A final dividend payment of 7.13 pence per ordinary share will be recommended by the Board to shareholders at the AGM scheduled for 28 July 2005. If approved, the final dividend will be paid on 16 September 2005 to shareholders whose names appear on the Company's Register of Members at the close of business on 19 August 2005. Together with the interim dividend of 2.87 pence per ordinary share, paid on 4 February 2005, the total dividend for the year will be 10.00 pence per ordinary share.

Post balance sheet events

On 28 April 2005, Suez sold its 25% shareholding in the Company to Ontario Teachers' Pension Plan Board, and Suez's two nominated directors, Christophe Cros and Bernard Guirkingier resigned from the Board.

Substantial shareholdings

As at 7 June 2005, the Company had been notified of the following interests in 3% or more of its issued share capital:

	Number of shares	Percentage of share capital
Ontario Teachers' Pension Plan Board	129,655,961	25.00
Amvescap PLC	98,751,491	19.04
Aviva plc	24,750,000	4.77
Barclays PLC	20,972,652	4.04
FMR Corp and Fidelity International Limited	16,262,510	3.14

Waiver of dividends

Northumbrian Water Share Scheme Trustees Limited, which currently holds 681,296 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 future dividends on the shares it holds. Further details of the LTIP can be found in the directors' remuneration report on pages 51 and 52.

Purchase of the Company's own shares

Authority was given by shareholders at the 2004 AGM to allow the directors to make market purchases of up to 5,186,238 of the Company's own ordinary 10 pence shares at a maximum price per share of 105% of the middle market price. This authority will expire at the 2005 AGM, and shareholder approval will be sought at that meeting to renew the authority for another year. As at 7 June 2005, no market purchases have been made.

Directors

The current directors are Sir Fred Holliday, Sir Patrick Brown, John Cuthbert, Chris Green, Martin Nègre, Sir Derek Wanless and Jenny Williams. All were directors of the Company as at 31 March 2005 and, apart from Jenny Williams who was appointed on 27 May 2004, all served throughout the year.

The following directors who served during the year were nominated for appointment by Suez, which was entitled to nominate two directors to the Company's Board. Following the sale of Suez's shareholding in the Company, Bernard Guirkinger and Christophe Cros, who were directors as at 31 March 2005, resigned from the Board.

Director	Date of appointment	Date of resignation
Jacques Pétry	23 May 2003	27 May 2004
Alan Chaigneau	23 May 2003	17 March 2005
Bernard Guirkinger	27 May 2004	28 April 2005
Christophe Cros	17 March 2005	28 April 2005

In accordance with the Revised Combined Code on Corporate Governance published in 2003 (the Combined Code) and the Company's Articles of Association (the Articles), one third of the Board will retire by rotation and will offer themselves for re-appointment at the forthcoming AGM. Those directors are Sir Patrick Brown and Martin Nègre. The directors' biographies are set out on pages 36 and 37. Information about those directors who are seeking re-appointment at the AGM is also contained in the Notice of Meeting booklet. This booklet includes confirmation by the Chairman, following their performance evaluation, of their continued contribution and commitment to their roles.

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 50 to 57.

Indemnification of directors

The Companies (Audit, Investigations and Community Enterprise) Act 2004 permits companies to extend the indemnification it provides to directors against liabilities for legal costs in certain circumstances, and to fund a director's defence costs as they are incurred. The Company will therefore be asking shareholders at the forthcoming AGM for authority to amend the Articles to indemnify directors to the extent now permitted by company law.

Donations

The Group made charitable donations totalling £92,439 and political donations totalling £10,995 during the year. It is the Company's policy that it does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. However, the definition of donations in the Political Parties, Elections and Referendums Act 2000 (PPERA 2000) is wide and covers activities that form part of the normal relationship between the Group and political organisations. Political expenditure and/or donations up to a total of £40,000 for the Group for the period of two years from the date of the approval were approved by the shareholders at the Extraordinary General Meeting of the Company held on 16 December 2003. Approval will be sought from shareholders at the forthcoming AGM to permit the Group to make political donations as defined in PERA 2000 up to a maximum of £25,000 in the 15 month period commencing on the date of the AGM or until the date of the 2006 AGM, whichever is the sooner. During the year, the Group made political donations, applying the wide definitions from the PERA 2000, as follows:

Name of EU political organisation	Donations for the year
Labour	£9,139
Liberal Democrats	£853
Conservative	£1,003
Total	£10,995

These donations comprise sponsorship of or attendance at dinners and party conferences which are intended to heighten awareness within the political arena of key industry issues and matters affecting the Group. The value of donations made to each party reflects the representation of political parties in NWL's areas of supply rather than the party in Government.

Research and development

NWTC, a subsidiary of the Company, co-ordinated all research and development activities relating to underground assets for the Group, prior to the transfer of its staff and activities to NWL on 1 April 2005. The Company, through NWL, maintains a programme of research and development activities, which are linked to UK business operations. A review of the development of the businesses of NWL and NWTC during the year can be found on pages 12 to 17. During the year, the Group incurred research and development costs of £5 million.

Employees and employment policies

Equal opportunities.

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

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

Training and development

Training and development of employees is important to the achievement of Group goals and policies. Annual appraisals are conducted and training needs are properly assessed throughout the Group. An accelerated development programme for graduates and a management development programme are offered by some subsidiaries.

Communication

Employees receive the Group magazine 'Watermark', which includes articles on Company activities and news from subsidiary companies. Urgent or important information is communicated via a Group-wide 'news flash' facility. Individual Group companies use a range of communication mechanisms, including team briefing, magazines, newsletters, intranet, noticeboards and regular team meetings. NWL won a silver award from the East Anglian region of the Chartered Institute of Public Relations (CIPR) for its internal communication activities in 2004, was runner up in the Utility Industry Achievement Awards 2004 and a finalist in the CIPR North East region's awards for its employee attitude survey feedback. The Group encourages open feedback and protects employees who wish to voice concerns about behaviour or decisions that they believe to be unethical.

Health and safety

The Group 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. The majority of employees are offered membership of a private healthcare scheme.

Employee Share Incentive Plan (SIP)

The directors believe that employee investment strengthens the ties between the Company and the Group's employees by enabling employees to participate more closely in the Company's economic performance. Around 30% of Group employees currently participate in the SIP, which was launched in 2004 and is open to all eligible Group employees. The Company gives one free matching share for every three shares purchased by an employee, which must be kept in the SIP for five years to obtain the full tax benefits. Awards of all shares under the SIP are satisfied using existing ordinary shares purchased on the market, and dividends are paid in cash directly to participants.

Pensions

Information about the pension schemes operated by the Group is contained in note 25 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 thirty 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 2005, was 4 days.

Annual General Meeting

The notice convening the AGM to be held on 28 July 2005 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 has indicated its willingness to continue in office and a resolution proposing its re-appointment 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 2005/06 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.

By order of the Board

Martin Parker

Martin Parker

Company Secretary

7 June 2005

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

Corporate governance report

Introduction and general compliance statement

The Board recognises the importance to the Company and its shareholders of good corporate governance, which it regards as an integral part of the running of the Company. The Board is committed to achieving high standards of corporate governance and undertakes regular reviews of compliance. This report, the directors' report and the directors' remuneration report describe how the Company has applied the principles of the Combined Code. The Board is pleased to report that compliance with the Combined Code has improved since the last annual report, and believes 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, except in the following areas. Prior to 27 May 2004, the Company did not comply with A.3.2 (at least half the board to comprise independent non-executive directors), A.4.1 (composition of the Nomination Committee not compliant) and C.3.1 (composition of the Audit Committee not compliant).

The Company's principal operating subsidiary, NWL, has also endeavoured to maintain its own high standards of corporate governance and to comply with the Combined Code, wherever practicable, during the year.

The Board also seeks to comply with industry best practice as set out in ABI and NAPF guidelines, for example, and has made disclosures in line with those guidelines where appropriate.

The Board

The Board met six times during the year, and held a strategy day in February 2005. A table showing the number of Board and committee meetings held, and attendance by individual directors, can be found at the end of this report. Under the direction of the Chairman, the Company Secretary ensures that the directors receive all necessary information and that relevant information flows effectively between the Board, its committees and senior management. The Company Secretary also co-ordinates the induction process and assists with professional development, as required.

The Board has overall responsibility for determining the Group's strategy and the annual operating budget, setting the broad direction and strategy of the Group and the structure to ensure its continuance and prosperity. The Board monitors and controls the implementation of strategy, policies and plans, and legal and fiduciary obligations. Non-executive directors constructively challenge and help develop proposals on strategy. During the year, the Chairman met with the non-executive directors in the absence of the executive directors to discuss, amongst other business, the performance of the executive directors.

The Company has adopted Company Management Guidelines setting 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, and are circulated to directors of subsidiaries and relevant senior managers within the Group. Terms of reference of the main committees have been approved by the Board. A Standing Committee can take urgent decisions not delegated to a specific committee between Board meetings. All directors receive notice of Standing Committee meetings and are able to participate if they wish. Decisions taken by the Standing Committee are reported at the next meeting of the Board.

The Company recognises its responsibilities towards its stakeholders and to the environment. To help meet those responsibilities, the Board has approved Our Code of Conduct and will endeavour to act in accordance with this Code in all its activities.

Board balance and independence

There are seven directors. Sir Fred Holliday is the non-executive Chairman. 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, Sir Derek Wanless and Jenny Williams. Martin Parker is the Company Secretary. The Company complies with the Combined Code's requirement that half of the directors, excluding the Chairman, are independent non-executive directors. Biographical details of the directors appear on pages 36 and 37 and details of their service contracts in the directors' remuneration report on page 53.

Until 28 April 2005, the Company's former shareholder Suez had two nominated directors on the Board. Further details of these directors and of Suez's shareholding are given in the directors' report on page 39.

The Chairman and Managing Director have clearly defined written responsibilities which have been agreed by the Board. The Chairman is responsible for leadership of the Board and creating the conditions for overall Board and individual director effectiveness, both inside and outside the boardroom. The Managing Director is responsible for running the Company's business.

The Combined Code sets out factors which may be relevant to a board's assessment of the independence of a non-executive director, including whether he or she has been an employee of the group in question in the previous five years, has had a material business relationship with the company in the previous three years in his or her capacity as a director or senior employee of a body which has had a material business relationship with the company, or has cross directorships with other directors through involvement in other companies or bodies.

Martin Nègre was, as an employee of the Suez Group, the Chief Executive Officer of NSL (then named Northumbrian Water Group plc) between April 2000 and April 2001. During that time NSL was wholly owned by Suez. The duration of his connection with NSL was therefore only 12 months. He is also a non-executive director of Ecofin Water & Power Opportunities plc, which held less than 2% of the share capital of the Company as at 31 March 2005. The Board considers that Martin Nègre is independent in character and judgement, and that his past employment and present circumstances are not likely to affect his judgement.

Nomination Committee

The members of the Nomination Committee are Sir Fred Holliday (Chairman), Sir Patrick Brown, John Cuthbert, Martin Nègre, Sir Derek Wanless and Jenny Williams. Prior to 27 May 2004, pending the appointment of further independent non-executive directors, it was felt that all Board members were able to provide a valuable contribution to the nomination process, therefore all directors were members of the Nomination Committee. Since 27 May 2004, the majority of members of the Committee have been independent non-executive directors, in accordance with the Combined Code. Bernard Guirkingier was a member of the Committee until his resignation from the Board on 28 April 2005.

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The Committee reviews succession planning for the Board and will make recommendations to the Board when appropriate. The Committee has now developed its procedure for future appointments and intends to use external recruitment consultants or advertise in order to identify suitable candidates. The Committee's terms of reference are available on the Company's website. All non-executive directors are appointed for a term of three years. In accordance with the Articles, all directors are subject to re-election at least every three years.

Jenny Williams was appointed as an independent non-executive director on 27 May 2004. The Chairman sought advice and suggestions both within and outside the Company, considering career details and references in respect of several candidates for the post, before the whole Board considered the appointment. This process produced a number of suitable candidates making it unnecessary to engage search consultants or advertise the post.

Following the resignation of Jacques Pétry on 27 May 2004, Bernard Guirkinger was nominated as his replacement by Suez and, following Alain Chaigneau's resignation on 17 March 2005, Christophe Cros was nominated as his replacement by Suez. The Nomination Committee considered both appointments. Following the sale of Suez's shareholding in the Company, Bernard Guirkinger and Christophe Cros resigned from the Board.

Information and professional development

All directors are able to access independent professional advice to assist them in the performance of their duties, at the Company's expense, and also have access to the Company Secretary for advice and assistance. The Chairman, with the assistance of the Company Secretary, is reviewing the ongoing training process for directors.

External appointments

The Board has no formal policy on external appointments of directors, but follows the recommendations of the Combined Code. Fees paid in respect of external appointments are retained by the Company. The Nomination Committee ensures, on appointment, that a director has sufficient time to undertake his or her duties. Any new external commitments taken on after appointment are discussed with the Chairman to ensure that no detriment to the performance of the director's present duties for the Company can be foreseen.

Performance evaluation

The Chairman, in consultation with the Company Secretary, takes primary responsibility for the evaluation of the performance of the Board, its committees and individual directors. During the year, a performance evaluation of the Board, of each of its committees and of each director took place. Each director completed a detailed questionnaire, which was used to assist the Chairman in assessing the performance of each director, each committee and the Board against defined criteria. The Chairman then discussed his assessment with the directors and with the Board. As a result of these discussions, the Company has adopted a more formal procedure in relation to the work of the Nomination Committee. Sir Patrick Brown met with the other non-executive directors, without the Chairman or executive directors being present, to evaluate the Chairman's performance.

Remuneration Committee

Details of the work of the Remuneration Committee and of the directors' remuneration are set out in the directors' remuneration report on pages 50 to 57.

Accountability and audit

Audit Committee

The Audit Committee comprises Sir Patrick Brown (Chairman), Sir Derek Wanless and Jenny Williams, who are all independent non-executive directors in accordance with the Combined Code. The Board is satisfied that Sir Derek Wanless has recent significant financial experience. At the start of the year, pending the appointment of an additional independent non-executive director, the members of the Committee were Sir Patrick Brown, Alain Chaigneau and Sir Derek Wanless. Following the appointment to the Board and the Committee of Jenny Williams on 27 May 2004, Alain Chaigneau left the Committee. The Managing Director and Finance Director are invited to Audit Committee meetings with the permission of its Chairman, but have no right of attendance. Alain Chaigneau attended one meeting of the Audit Committee on a similar basis.

The role of the Committee includes monitoring the integrity of the financial statements of the Company, reviewing the Company's internal financial controls, and monitoring and reviewing the effectiveness of the internal audit function and the external auditors. The Committee also monitors the potential impact and management of significant risks on the business using a risk methodology developed by Entec, to meet the recommendations of the Turnbull Report. This methodology sets out and rates all identified risks, including operational, external, financial, environmental, reputational, social and ethical risks. The Committee's terms of reference are available on the Company's website.

The Committee has approved a procedure for the approval of non-audit services to safeguard the objectivity and independence of the external auditors. Certain services are prohibited, for example bookkeeping, financial information systems design and information, and internal audit outsourcing services, whilst others 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. The auditors must also confirm to the Audit Committee, in accordance with SAS610 (Communication of audit matters to those charged with governance), that they have considered their relationship with the Company and that, in their professional judgment, the objectivity of the audit engagement partner and audit staff is not impaired. A breakdown of the cost of audit and non-audit services provided by the auditors is provided in note 3 to the financial statements.

Review of internal control

The Board has overall responsibility for maintaining a sound system of internal control and for reviewing its effectiveness. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the guidelines issued in Internal Control: Guidance for Directors on the Combined Code published by the Institute of Chartered Accountants in England & Wales in 1999. This process has been in place throughout the year and up to the date of approval of the annual report and financial statements 2004/05. 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 Company has reviewed the effectiveness of the Company's system of internal control, outlined below, as follows during the year:

- the Audit Committee and internal auditor have considered the methodology of the annual business risk analysis used; and
- the internal auditor, Group Financial Controller and internal lawyers of the Company have reviewed the effectiveness of the Company's management guidelines and financial controls, which resulted in revised Financial Approval Rules being presented to, and approved by, the Board on 29 July 2004.

Organisational structure

Local boards of directors in the Company's trading subsidiaries (the Subsidiary Boards) are responsible for the operational and financial control of their own businesses. 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 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, the Audit Committee and the Sustainable Development Committee (SDC). 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. To reduce this risk, NWL has entered into a contract to supply a cement manufacturing company with pellets made from the processed sludge, which are used as fuel in a cement kiln. Further details are provided on page 4.

For a number of years, the Subsidiary Boards have performed a full annual business risk analysis using the risk methodology developed by Entec, to meet the recommendations of the Turnbull Report. 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. Its 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 can be found on pages 22 and 23. NWL operates a balanced scorecard system which monitors progress against KPIs and which covers all areas of operation of the business. Performance against these KPIs is used to calculate the annual bonus paid to all NWL employees.

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 Management Guidelines, 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 Company's 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.

Treasury Committee

The Treasury Committee comprises Sir Derek Wanless (Chairman) and Sir Patrick Brown. Prior to his resignation on 17 March 2005, Alain Chaigneau was Chairman of the Committee. He was replaced by Christophe Cros who resigned on 28 April 2005 and did not attend any meetings of the Committee. The Treasury Committee is responsible for reviewing and recommending treasury policies to the Board, as well as monitoring the current economic environment and the likely future financing requirements of the Group. The treasury strategy was developed by the Treasury Committee and approved by the Board.

Sustainable Development Committee

The SDC members include Sir Fred Holliday and John Cuthbert; other members are invited from subsidiaries around the Group. Until his resignation on 28 April 2005, Bernard Guirkinger was also a member of the Committee. The SDC establishes best practice and ensures compliance across the Group on all ethical, environmental, social and economic matters in the context of sustainable development. Further information is provided in the Sustainable Development Performance Report, which is available on request and on the Company's website.

Relations with shareholders

The Company welcomes constructive communication with all its shareholders. The executive directors of the Company maintain regular dialogue with its large institutional investors, as well as giving presentations to analysts at the announcements of its interim and preliminary results. During the year, the executive directors met 40 times with institutional investors, and discussed any issues raised at these meetings with the Chairman and the non-executive directors. Investor feedback from these meetings is presented to the Board to help the non-executive directors develop a better understanding of the views of major shareholders. The Chairman would welcome contact with any shareholders who have matters they wish to discuss. Institutional shareholders have not made any formal requests to meet with non-executive directors.

A letter from the Chairman was sent to all shareholders with the Company's interim report in December 2004, informing shareholders of the services available to them, and inviting feedback on additional shareholder services being considered by the Company. All shareholders are encouraged to contact the Company with queries or suggestions, and can also access the Company's website. The Chairman sends a welcome letter to all new non-corporate shareholders. 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. The Board complies with the Combined Code on the constructive use of the AGM.

Directors' attendance at Board and committee meetings during the year

NAME	AUDIT 26.5.04	BOARD 27.5.04	BOARD 30.7.04	BOARD 1.10.04	AUDIT 24.11.04	TREASURY 24.11.04	REMUNERATION 24.11.04	BOARD 25.11.04	AUDIT 26.1.05	BOARD 3.2.05	REMUNERATION 17.3.05	NOMINATION 17.3.05	TREASURY 17.3.05	BOARD 17.3.05
SIR FRED HOLLIDAY	-	✓	✓	✓	-	-	-	✓	-	✓	-	✓	-	✓
SIR PATRICK BROWN	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
ALAIN CHAIGNEAU Resigned 17.3.05	x	✓	x	x	✓	✓	-	✓	-	x	-	-	x	x
CHRISTOPHE CROS Appointed 17.3.05 Resigned 28.4.05	-	-	-	-	-	-	-	-	-	-	-	-	-	-
JOHN CUTHBERT	✓ -	✓	✓	✓	-	-	✓ -	✓	-	✓	✓ -	✓	-	✓
CHRIS GREEN	✓ -	✓	✓	✓	✓	✓	-	✓	✓ -	✓	-	-	✓ -	✓
BERNARD GUIRKINGER Resigned 28.4.05	-	✓	✓	x	-	-	-	✓	-	✓	-	✓	-	✓
MARTIN NÉGRE	-	✓	✓	✓	-	-	✓	✓	-	✓	✓	✓	-	✓
JACQUES PÉTRY Resigned 27.5.04	-	x	-	-	-	-	-	-	-	-	-	-	-	-
SIR DEREK WANLESS	-	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
JENNY WILLIAMS	-	✓	✓	✓	✓	-	-	✓	✓	✓	-	✓	-	✓
JEAN-LOUIS CHAUSSADE (alternate for B. Guirkingier) Resigned 28.4.05	-	-	-	-	-	-	-	-	-	-	-	-	-	-
MICHEL BOTREL (alternate for A. Chaigneau) Resigned 28.4.05	-	-	-	✓	-	-	-	-	-	✓	-	-	✓	✓

- ✓ Attended
 x Absent
 - Not a member of the Board or relevant committee

Martin Parker

Martin Parker
 Company Secretary
 7 June 2005

Directors' remuneration report

The Remuneration Committee

The Remuneration Committee (the Committee) of the Board recommends to the Board the remuneration and terms of employment of the Chairman of the Company, executive directors and senior management of the Group. Prior to 27 May 2004, Jacques Pétry was a member of the Committee, and the Committee's composition was not compliant with the Combined Code, as only two of its three members were independent non-executive directors. Following Jacques Pétry's resignation from the Board on 27 May 2004, Sir Derek Wanless joined the Committee. Since 27 May 2004, the Committee members have been Martin Nègre (Chairman), Sir Patrick Brown and Sir Derek Wanless, all considered by the Company to be independent non-executive directors. The Committee met twice during the year and all three members attended both meetings. The Committee's terms of reference are available on the Company's website. During the year, the Committee received advice from John Cuthbert (Managing Director) and from The Remuneration Practice, remuneration consultants appointed by the Committee. The Remuneration Practice advised the Committee on salary and bonus levels for the Chairman, the executive directors and senior managers and also advised the executive directors and Chairman on fee levels for non-executive directors. It did not provide other services to the Company during the year. The Committee has undertaken a review of its remuneration consultants, and has appointed New Bridge Street Consultants LLP (NBSC) to advise the Committee with effect from May 2005. NBSC has been instructed to carry out a review of the remuneration packages offered to senior executives and to assist the Committee in maintaining best practice in relation to remuneration. NBSC has not provided any other services to the Company.

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 with the Code. The policy of the Company, which was applied through 2004/05 is to provide remuneration that is sufficient to attract, retain and motivate directors of the quality required to successfully run the Company, and which relates appropriately to remuneration provided by comparable companies. The remuneration policy to be applied in 2005/06 and in subsequent years will be reviewed as part of the work to be undertaken with NBSC.

The remuneration packages of the executive directors and details of the remuneration of non-executive directors are set out below. A significant proportion of executive directors' remuneration links rewards to corporate and individual performance. Major shareholders have been invited, from time to time, to discuss remuneration matters with the Chairman of the Company but no such shareholder has expressed a wish to do so. When considering the remuneration packages of senior executives and directors, the Committee takes into account pay awards to other employees in the Group.

Elements of remuneration

Executive directors: basic salary and benefits

The basic salaries of each director are set out on page 54. The payment of basic salaries is not related to Company performance. Executive directors' basic salaries and benefits are reviewed annually, taking into account market comparators and individual performance. Benefits include membership of a defined benefit pension scheme, car allowance and healthcare.

Non-executive directors: fees and benefits

The Chairman receives an annual fee of £125,000 and benefits in kind, which include the use of a Company car and driver and work related accommodation. The car, driver and accommodation are available to the Company when not used by the Chairman. 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. The fees of non-executive directors are reviewed from time to time, with

advice from the Company's remuneration advisers, to take account of time commitment, inflation and to ensure the level of fees remains fair and competitive. Other than the Chairman, the non-executive directors do not receive benefits in kind. Neither the Chairman nor the other non-executive directors participate in bonus, pension or share incentive schemes operated by the Company.

Annual bonus

During the financial year ended 31 March 2005, the executive directors' annual cash bonus potential was calculated by reference to actual profit before tax (PBT) against budgeted PBT, and could have been reduced if personal targets were not achieved. John Cuthbert's personal targets related to a range of business planning, regulatory and financial matters. Chris Green's personal targets were focused on funding and the maintenance of key financial ratios and measures. The PBT target achieved was exceeded in the 2004/05 financial year and the executive directors met all of their personal targets. As a consequence, bonus payments equal to 40% of the executive directors' basic salaries were approved.

For the 2005/06 and later financial years, the Committee has concluded that, as a principle, the executive directors should have the potential to receive a higher annual bonus payment. Therefore, for substantial out performance of stretching financial and personal targets a discretionary annual bonus of up to 70% of salary may be payable. Details of the measures used and the achievement against targets for 2005/06 will be disclosed in next year's directors' remuneration report.

Long Term Incentive Plan (LTIP)

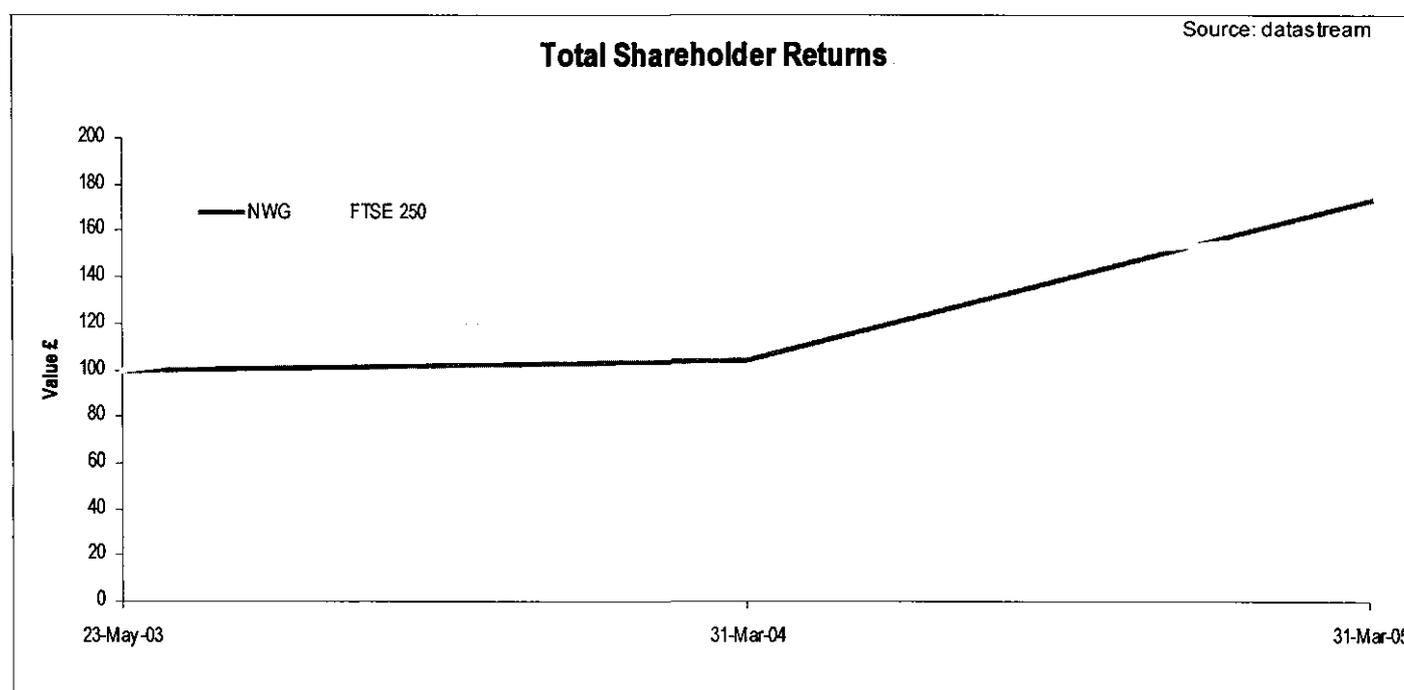
Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company. Details of the levels of award and performance conditions are shown in the table below, and LTIP awards made to directors are shown in the table on page 56.

SUMMARY OF LTIP	
Maximum award	75% of salary permitted.
Performance conditions against Total Shareholder Return (TSR)	<p>Comparison of TSR with 2 comparator groups over 3 years:</p> <p>group (1) - 70% of award depends on performance against this group. 30% vests at median performance with sliding scale increase to 100% when top of group.</p> <p>group (2) - 30% of award depends on performance against this group. 30% vests when TSR equals the index, sliding scale increase to 100% when TSR is at least 6% above the index.</p> <p>Where the Company's performance is below the median performance of the comparator group, none of that element of the award will vest.</p>
Composition of comparator groups	<p>group (1) – listed water companies: AWG plc, Bristol Water plc, East Surrey Holdings plc(see note below), Kelda Group plc, Pennon Group plc, Severn Trent plc and United Utilities plc</p> <p>group (2) - FTSE 250 Total Return Index, excluding investment trusts</p>
Note:	The Board has noted the proposed acquisition of East Surrey Holdings plc by Kellen Acquisitions Limited. If the proposed acquisition proceeds, the Board will take independent advice on the impact on the composition of the comparator group and the calculation of TSR.

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 Board 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. An independent firm of chartered accountants will be engaged to calculate the TSR and to assess the extent to which the performance conditions have been met, so that the process is rigorous and transparent.

Performance graph

The following graph 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 2005, 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 2005, 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.

Employee Share Incentive Plan (SIP)

The Company SIP is open to all eligible employees. Further details of the SIP are set out in the directors' report on page 41. During the year all executive directors had the opportunity to participate in the SIP, and their interests in shares purchased under the SIP are shown in the table on page 57.

Service contracts

Details of the employment contracts of the directors who served during the year are set out below:

	Contract start date	Unexpired term ⁽¹⁾	Notice period by either side	Contract end date
Executive Directors				
John Cuthbert ⁽²⁾	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
Chris Green ⁽²⁾	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
Non-executive Directors				
Sir Fred Holliday ⁽³⁾	23 May 2003	16 months	None	AGM 2006
Sir Patrick Brown ⁽³⁾	12 May 2003	13 months	None	11 May 2006
Alain Chaigneau ^(3,4)	23 May 2003	N/A	None	Resigned 17 March 2005
Christophe Cros ^(3,4)	17 March 2005	N/A	None	Resigned 28 April 2005
Bernard Guirkinge ^(3,4)	27 May 2004	N/A	None	Resigned 28 April 2005
Martin Nègre ⁽³⁾	12 May 2003	13 months	None	11 May 2006
Jacques Pétry ^(3,4)	23 May 2003	N/A	None	Resigned 27 May 2004
Sir Derek Wanless ⁽³⁾	1 December 2003	20 months	6 months	30 November 2006
Jenny Williams ⁽³⁾	27 May 2004	26 months	6 months	26 May 2007

Notes:

1. Calculated as at 31 March 2005 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.
4. Suez nominated directors.

All directors are subject to appointment by shareholders at the first general meeting after their appointment and to re-appointment thereafter at intervals of no more than three years. Sir Patrick Brown and Martin Nègre are retiring by rotation and will seek re-appointment at the AGM. The unexpired terms of the directors' contracts are set out in the table above. Further details of the directors seeking re-appointment are provided on page 39.

Terms and conditions of appointment of non-executive directors are available for inspection at the Company's registered offices 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

John Cuthbert is a non-executive director of One NorthEast, a regional development agency. His gross fee for this position is £8,150 p.a., which is paid to, and retained by, the Company. The Board's position on external appointments is described in the corporate governance report on page 45.

Directors' emoluments (audited information)

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 £ 000	Bonus ⁽¹⁾ £ 000	Total for the year ended 31 March 2005 £ 000	Total for the ten months to 31 March 2004 £ 000
Executive Directors						
John Cuthbert	-	250	8	100	358	273
Chris Green	-	165	9	66	240	190
Non-executive Directors						
Sir Fred Holliday	125	-	20	-	145	130
Sir Patrick Brown ⁽²⁾	38	-	-	-	38	26
Alain Chaigneau ^(3,4)	29	-	-	-	29	26
Christophe Cros ^(3,5)	1	-	-	-	1	-
Bernard Guirkingier ^(3,6)	25	-	-	-	25	-
Martin Nègre ⁽⁷⁾	35	-	-	-	35	26
Jacques Pétry ^(3,8)	5	-	-	-	5	26
Sir Derek Wanless ⁽⁹⁾	30	-	-	-	30	10
Jenny Williams ⁽¹⁰⁾	25	-	-	-	25	-
Total remuneration	313	415	37	166	931	707

Notes:

1. The annual bonus is payable in June 2005, for performance during the period ended 31 March 2005.
2. Includes additional fee paid as Chairman of the Audit Committee.
3. The fees of these directors were paid to Suez.
4. Resigned on 17 March 2005.
5. Appointed on 17 March 2005 and resigned on 28 April 2005.
6. Appointed on 27 May 2004 and resigned on 28 April 2005.
7. Includes additional fee paid as Chairman of the Remuneration Committee.
8. Resigned on 27 May 2004.
9. Appointed on 1 December 2003.
10. Appointed on 27 May 2004.

Directors' pensions and pension benefits (audited information)

The main features of the Northumbrian Water Pension Scheme are set out in note 25 to the financial statements. The Committee will review its pensions policy in the light of the introduction of the new pension rules in April 2006, but does not intend to compensate participants for changes to the personal income tax regime.

The accrued defined benefit pensions and corresponding transfer values for the executive directors are as follows:

	Accrued pension at 31 March 2004	Accrued pension at 31 March 2005	Increase in accrued pension	Increase in accrued pension net of inflation	Transfer value of net increase in accrued pension	Transfer value of accrued pension at 1 April 2004	Transfer value of accrued pension at 31 March 2005	Total change in transfer value less directors' contributions
	£ 000	£ 000	£ 000	£ 000	£ 000	£ 000	£ 000	£ 000
John Cuthbert	91.8	108.7	16.9	14.0	173.5	1,232.0	1,523.0	278.5
Chris Green	49.8	59.8	10.0	8.4	98.9	615.0	771.0	146.4

Notes:

1. Accrued pensions shown are the amounts that would be paid annually on retirement based on service to the end of the year, or date of leaving, or retirement, if earlier.
2. Voluntary contributions paid by the directors and resulting benefits are not shown.
3. The change in transfer value includes the effect of 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 total contribution paid by the Company during the year was £25,575.

Directors' interests in shares and debentures (audited information)

The directors had the following beneficial or family interests in the ordinary 10 pence shares of the Company as at 31 March 2005:

	Number of shares held at the start of the year or subsequent date of appointment	Number of shares held as at 31 March 2005 ⁽¹⁾
Sir Patrick Brown	43,000	43,000
John Cuthbert	80,000	100,000
Chris Green ⁽²⁾	50,000	65,000
Sir Fred Holliday	8,700	8,700
Martin Nègre ⁽³⁾	100,000	190,000
Sir Derek Wanless	30,000	30,000
Jenny Williams ⁽⁴⁾	-	6,000

Notes:

1. There have been no changes in any of the above interests from the end of the year to 7 June 2005.
2. These shares are beneficially owned by Mrs Geraldine Green.
3. 20,000 of these shares are beneficially owned by Mrs Linda Nègre.
4. Appointed on 27 May 2004.

The directors had the following beneficial or family interests in debentures of NSL, a subsidiary of the Company, as at 31 March 2005:

	Class of debentures	Amount of debentures held at the start of the year or subsequent date of appointment	Amount of debentures held as at 31 March 2005 ⁽¹⁾
John Cuthbert	8.625% bonds 28.6.2006	40,000	40,000
Chris Green ⁽²⁾	8.625% bonds 28.6.2006	25,000	25,000

Notes:

1. There have been no changes in any of the above interests from the end of the year to 7 June 2005.
2. These debentures are beneficially owned by Mrs Geraldine Green.

Directors' interests in LTIP awards (audited information)

As at 31 March 2005, 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:

	Awards held at the start of the year ⁽¹⁾ or subsequent date of appointment	Awarded during the year ⁽²⁾	Awards vested/lapsed during the period	Awards held as at 31 March 2005 ⁽³⁾
John Cuthbert	85,603	67,001	-	152,604
Chris Green	56,618	44,221	-	100,839

Notes:

1. Awards were made on 27 January 2004. The market value of the shares on the date of the award was 113.5 pence per share. The three year performance period runs from 1 October 2003 to 30 September 2006.
2. Awards were made on 22 December 2004. The market value of the shares on the date of the award was 174.5 pence per share. The three year performance period runs from 1 October 2004 to 30 September 2007.
3. There have been no changes to any of the above interests in awards under the LTIP from the end of the year to 7 June 2005.
4. The cost of conditional awards is charged to the profit and loss account over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £113,482 was charged to the profit and loss account.
5. Details of the performance conditions are shown on page 51.

Ordinary 10 pence shares required to fulfil LTIP awards that have vested will 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 Richard Allan (a director of NWL). The Trustees are regarded for the purpose of the Companies Act 1985 as being interested in the shares of the Trust, which at 31 March 2005 held a total of 681,296 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.

Directors' interests in shares under the Share Incentive Plan (audited information)

The directors who held office as at 31 March 2005 had the following interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP⁽¹⁾.

	Number of SIP shares held at the start of the year or subsequent date of appointment	Number of SIP shares held as at 31 March 2005 ⁽²⁾	Number of SIP shares held as at 7 June 2005 ⁽²⁾
John Cuthbert	-	1,716	2,780
Chris Green	-	1,716	2,780

Notes:

1. A summary of the SIP can be found in the directors' report on page 41.
2. This figure includes the shares paid for by the participant and the free shares granted by the Company.

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

7 June 2005

Directors' responsibilities

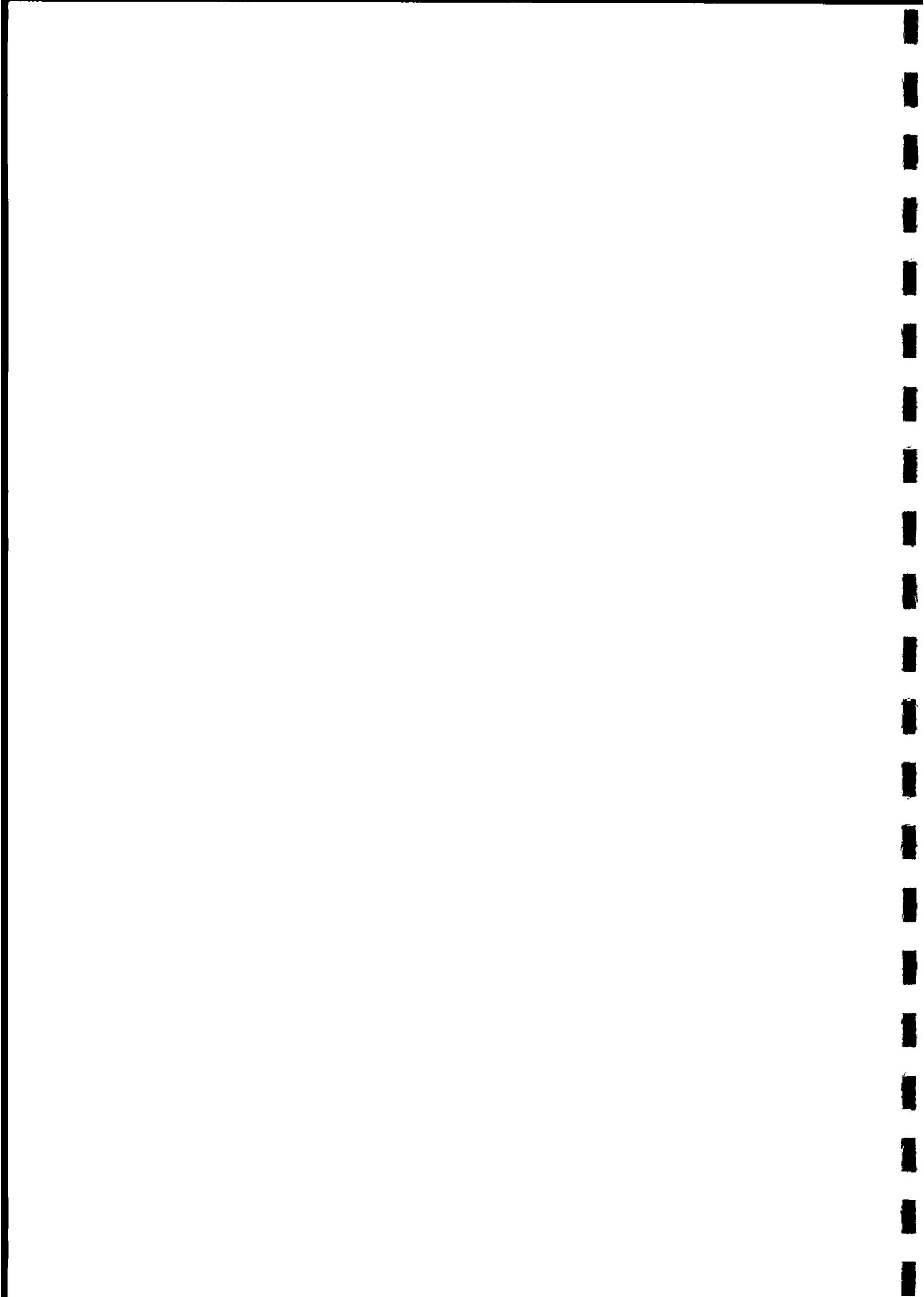
Statement of directors' responsibilities

Company law requires the directors to prepare financial statements that give a true and fair view of the state of affairs of the Company and of the Group as at the end of each accounting period and of the profit or loss of the Group for that accounting period.

In preparing the financial statements, the directors are required to:

- select appropriate accounting policies and apply them consistently;
- state whether applicable United Kingdom law and accounting standards have been followed subject to any material departures disclosed and explained in the financial statements; and
- make judgements and estimates that are reasonable and prudent.

The directors are responsible for ensuring that the Company keeps sufficient accounting records to disclose with reasonable accuracy at any time the financial position of the Group 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.



Report of the Auditors

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

We have audited the group's financial statements for the year ended 31 March 2005 which comprise the Consolidated Profit and Loss Account, Consolidated Statement of Total Recognised Gains and Losses, Consolidated Balance Sheet, Company Balance Sheet, Consolidated Cash Flow Statement, Notes to the Consolidated Cash Flow Statement and the related notes 1 to 29. These financial statements have been prepared on the basis of the accounting policies set out therein. We have also audited 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 are responsible for preparing the Annual Report, including the financial statements which are required to be prepared in accordance with applicable United Kingdom law and accounting standards as set out in the Statement of Directors' Responsibilities in relation to the financial statements. The directors are also responsible for preparing the Directors' Remuneration Report.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements, United Kingdom Auditing Standards and the Listing Rules of the Financial Services Authority.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the 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 if, in our opinion, the Directors' Report is not consistent with the financial statements, if 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 or the Listing Rules regarding directors' remuneration and transactions with the Group is not disclosed.

We review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC 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 financial statements. This other information comprises Highlights 2004/05, Chairman's statement, Managing Director's review, Operating and financial review, Appendix to operating and financial review, Board directors' biographies, Directors' report, 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 financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

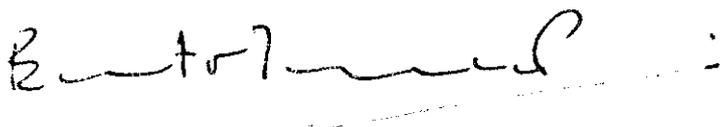
We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the 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 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 financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- the financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 March 2005 and of the profit of the Group for the year then ended; and
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985.



Ernst & Young LLP
Registered Auditor, Newcastle upon Tyne
7 June 2005

Northumbrian Water Group plc

Consolidated profit and loss account

For the year ended 31 March 2005

	Notes	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Turnover: Group and share of joint ventures		585.5	448.6
Less share of joint ventures' turnover		(6.9)	(6.5)
Group turnover	2	578.6	442.1
Operating costs			
- operating costs before exceptional costs	3	(373.9)	(296.3)
- exceptional costs	3	-	(2.2)
Operating profit	2/3	204.7	143.6
Share of associated undertakings' operating profit		2.2	2.5
Share of joint ventures' operating profit		1.0	1.0
Total operating profit: Group and share of joint ventures and associates		207.9	147.1
Interest payable and similar charges			
- net interest payable and similar charges	4	(99.1)	(92.8)
- exceptional amortisation of financing costs	4	-	(8.8)
Profit on ordinary activities before taxation	2	108.8	45.5
Tax on profit on ordinary activities			
- current taxation	6	(1.3)	9.4
- deferred taxation	6	(8.9)	4.9
- share of associates' and joint ventures' tax	6	(0.2)	(0.3)
Profit on ordinary activities after taxation		98.4	59.5
Minority interests		0.5	(0.1)
Profit attributable to shareholders		98.9	59.4
Dividends paid and proposed	7	(51.8)	(36.0)
Retained profit for the financial year	23	47.1	23.4
Basic earnings per share	8	19.1p	11.5p
Adjusted earnings per share	8	18.1p	11.2p
Diluted earnings per share	8	19.1p	11.5p
Dividend per share		10.00p	6.95p

All the above results relate to continuing activities.

Consolidated statement of total recognised gains and losses

For the year ended 31 March 2005

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Profit for the financial year		
Group	98.8	58.7
Associates	(0.4)	-
Joint ventures	0.5	0.7
Profit for the financial year attributable to the members of the parent company	98.9	59.4
Exchange differences	0.4	-
Total recognised gains and losses relating to the year	99.3	59.4

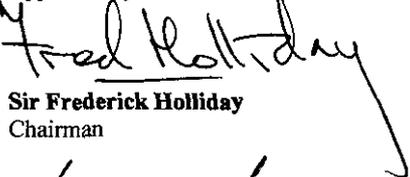
Northumbrian Water Group plc

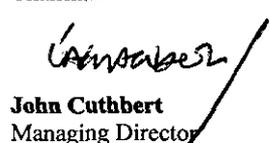
Balance sheets

As at 31 March 2005

	Notes	Group		Company	
		31.3.2005 £m	31.3.2004 £m	31.3.2005 £m	31.3.2004 £m
Fixed assets					
Intangible assets	9	64.3	64.4	-	-
Tangible assets	10	2,806.6	2,692.8	-	-
Investments in joint ventures: share of gross assets		12.1	12.5	-	-
share of gross liabilities		(8.5)	(9.1)	-	-
	11	3.6	3.4	-	-
Investments in associates	11	1.4	1.8	-	-
Other investments	11	0.4	0.4	1,022.7	1,022.7
		2,876.3	2,762.8	1,022.7	1,022.7
Current assets					
Stocks	12	4.5	4.8	-	-
Debtors: receivable within one year	13	121.9	118.1	53.9	50.2
Debtors: receivable after more than one year	13	13.0	14.3	-	-
Cash at bank and short term deposits	14	118.0	44.8	47.3	4.4
		257.4	182.0	101.2	54.6
Creditors: amounts falling due within one year	15	(280.6)	(247.5)	(85.9)	(47.2)
Net current (liabilities)/assets		(23.2)	(65.5)	15.3	7.4
Total assets less current liabilities		2,853.1	2,697.3	1,038.0	1,030.1
Creditors: amounts falling due after more than one year	16	(1,946.3)	(1,866.4)	(490.0)	(490.0)
Provisions for liabilities and charges	20	(172.9)	(165.1)	-	-
Accruals and deferred income	21	(164.5)	(142.8)	-	-
		(2,283.7)	(2,174.3)	(490.0)	(490.0)
Net assets		569.4	523.0	548.0	540.1
Capital and reserves					
Called up share capital	22	51.9	51.9	51.9	51.9
Share premium account	23	446.3	446.3	446.3	446.3
Other reserve	23	(0.9)	(0.5)	(0.9)	(0.5)
Profit and loss account	23	71.0	23.4	50.7	42.4
Equity shareholders' funds	24	568.3	521.1	548.0	540.1
Minority equity interest		1.1	1.9	-	-
Total capital and reserves		569.4	523.0	548.0	540.1

Approved by the Board on 7 June 2005 and signed on its behalf by:


Sir Frederick Holliday
 Chairman


John Cuthbert
 Managing Director

Northumbrian Water Group plc

Consolidated cash flow statement

For the year ended 31 March 2005

	Notes	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Net cash inflow from operating activities	a	283.4	218.5
Dividends received from joint ventures		0.3	-
Net cash inflow from dividends received from joint ventures		0.3	-
Returns on investments and servicing of finance			
Interest received		14.4	7.1
Interest paid		(112.0)	(107.5)
Issue costs on new borrowings		(11.7)	-
Interest paid on hire purchase contracts and finance leases		(1.6)	(0.6)
Dividends paid to minority interests		(0.1)	(0.9)
Net cash outflow from returns on investments and servicing of finance		(111.0)	(101.9)
Taxation			
Taxation received		6.7	-
Net cash inflow from taxation		6.7	-
Capital expenditure and financial investments			
Purchase of tangible fixed assets		(197.1)	(163.5)
Proceeds on disposal of tangible fixed assets		2.7	0.6
Capital grants received		21.3	14.5
Net cash outflow from capital expenditure and financial investments		(173.1)	(148.4)
Acquisitions and disposals			
Acquisition of subsidiaries		-	(893.0)
Net cash acquired with subsidiaries		-	104.1
Acquisition of division		-	(0.3)
Net cash outflow from acquisitions and disposals		-	(789.2)
Equity dividends paid		(38.9)	(12.0)
Cash outflow before management of liquid resources and financing		(32.6)	(833.0)
Management of liquid resources			
Purchase of short term deposits		(1,174.4)	(1,554.8)
Disposal of short term deposits		1,154.7	1,848.4
Net cash (outflow)/inflow from management of liquid resources		(19.7)	293.6
Financing			
Issue of new shares		-	368.5
Purchase of own shares		(0.4)	(0.5)
Loans received		348.2	536.0
Loans repaid		(253.7)	(348.9)
Payment of principal under hire purchase contracts and finance leases	b	(4.0)	(2.4)
Net cash inflow from financing		90.1	552.7
Increase in cash in the year		37.8	13.3
Reconciliation of net debt			
Increase in cash in the year		37.8	13.3
Cash inflow from increase in net debt and lease financing		(90.5)	(184.7)
Cash outflow/(inflow) from management of liquid resources		19.7	(293.6)
Issue costs on new borrowings		11.7	-
Increase in net debt resulting from cash flows	b	(21.3)	(465.0)
Other non-cash items		14.9	5.3
Inception of new finance lease contracts	b	(5.1)	(5.2)
Increase in net debt in the year		(11.5)	(464.9)
Net borrowings at start of the year		(1,869.5)	-
Loans and finance leases acquired with subsidiaries net of short term deposits		-	(1,404.6)
Net debt at end of the year	b	(1,881.0)	(1,869.5)

Net debt is the sum of all borrowings net of cash and short term deposits.

Northumbrian Water Group plc

Notes to the consolidated cash flow statement

For the year ended 31 March 2005

(a) Net cash inflow from operating activities

	Notes	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Operating profit	2	204.7	143.6
Depreciation of tangible fixed assets	3/10	92.6	72.9
Loss/(profit) on disposal of tangible fixed assets		1.3	(0.5)
Amortisation of capital grants	21	(3.9)	(3.2)
Amortisation of goodwill	9	0.1	-
Other non-cash movements		0.1	-
Movement in provisions		(1.1)	(1.5)
Decrease in stocks		0.3	1.2
(Increase)/decrease in debtors		(9.2)	15.5
Decrease in creditors		(1.5)	(9.5)
Net cash inflow from operating activities		283.4	218.5

(b) Analysis of net debt

	As at 1.4.2004 £m	Cash flow £m	Other non-cash changes £m	As at 31.3.2005 £m
Cash at bank	30.4	53.5	-	83.9
Bank overdrafts	(17.1)	(15.7)	-	(32.8)
	13.3	37.8	-	51.1
Loan debtors due within one year	3.8	-	0.8	4.6
Loans due after one year	(1,795.7)	(82.8)	9.8	(1,868.7)
Loans due within one year	(44.4)	-	4.3	(40.1)
Finance leases	(60.9)	4.0	(5.1)	(62.0)
	(1,883.9)	(41.0)	9.8	(1,915.1)
Short term deposits	14.4	19.7	-	34.1
Net debt	(1,869.5)	(21.3)	9.8	(1,881.0)

(c) Analysis of cash balances

	As at 1.4.2004 £m	Trading for the year £m	As at 31.3.2005 £m
Cash at bank and short term deposits	44.8	73.2	118.0
Less short term deposits with maturity dates greater than one day	(14.4)	(19.7)	(34.1)
	30.4	53.5	83.9
Bank overdrafts	(17.1)	(15.7)	(32.8)
	13.3	37.8	51.1

Notes to the financial statements

1 Accounting policies

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 Group's financial statements. These have been applied consistently throughout the current period.

(a) Basis of accounting

The financial statements have been prepared under the historical cost convention. As stated in the directors' report on page 42, the financial statements have been prepared on the going concern basis. The directors have arrived at their decision based on consideration of the Group's net current liabilities in relation to the Group's detailed budget for 2005/06 and the business plan for the period to 31 March 2010.

(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 FRS 5 'Reporting the Substance of Transactions', the accounts of two companies are consolidated as quasi-subidiaries.

(c) Associated undertakings and joint ventures

The Group's share of profits less losses of associated undertakings and joint ventures is included in the consolidated profit and loss account and the Group's share of their net assets/liabilities is included in the consolidated balance sheet. Joint ventures are accounted for using the gross equity method. Goodwill arising on the acquisition of associates and joint ventures is accounted for in accordance with the accounting policy set out below.

(d) Intangible fixed assets

Goodwill arising on the acquisition of subsidiary undertakings, businesses, associates and joint ventures, representing the excess of the fair value of the consideration given over the fair value of the identifiable assets and liabilities acquired, is capitalised and written off on a straight line basis over its useful economic life up to a maximum of 20 years. Provision is made for any impairment.

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 capped so as not to create negative goodwill on acquisition, 23 May 2003. 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 FRS 11.

(e) Turnover

Turnover, which excludes value added tax, represents the income receivable in the ordinary course of business for goods and services provided.

(f) Tangible fixed assets and depreciation

Tangible fixed assets, 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):

i) Infrastructure assets

Infrastructure assets comprise a network of physical overground and underground systems. Expenditure on infrastructure assets relating to increases in capacity or enhancements to the network and on maintaining the operating capability of the network, in accordance with defined standards of service, is treated as additions which are included at cost. Costs include internal and external costs to bring the asset into use. The Section 19 quality programme addresses water discolouration problems caused by iron pipes, either through relining these pipes or replacing them where relining is not possible. 'Overlap' expenditure represents the extra cost of replacing pipes rather than relining them where their structural condition is insufficient to withstand the relining process. Such expenditure is classified as capital in nature and is included under infrastructure assets in the fixed asset note. The depreciation charge for infrastructure assets is the estimated average amount of expenditure required to maintain the operating capability of the network, which is based on independently certified asset management plans, adjusted to reflect differences between estimated and actual expenditure over each five year regulatory period.

ii) Other assets

Other assets are included at cost less accumulated depreciation and any provision for impairment. 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; fixtures, fittings, tools and equipment, 4-10 years. Where the remaining useful economic life of the asset is estimated to be greater than 50 years, an impairment review is performed at the end of each reporting period to ensure that the carrying amount can be supported.

iii) Assets in the course of construction

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

(g) Grants and contributions

Revenue grants are credited to the profit and loss account in the period to which they relate. Capital grants and contributions relating to tangible fixed assets are treated as deferred income and amortised in the profit and loss account over the expected useful economic lives of the qualifying assets. Specifically, in the case of infrastructure assets, the expected useful economic lives have been determined by reference to the physical replacement cycle of those assets.

(h) Fixed asset investments

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

(i) Hire purchase and leasing

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

(j) Stocks

Stores are stated at cost less any provisions necessary to recognise damage and obsolescence. Work in progress and finished goods are valued at the lower of cost and net realisable value. Cost includes labour, materials, transport and an element of overheads.

(k) Long term contracts

Profit on long term contracts is taken as the work is carried out if the final outcome can be assessed with reasonable certainty. The profit included is calculated on a prudent basis to reflect the proportion of the work carried out at the year end, by recording turnover and related costs (as defined in Stocks above) as contract activity progresses. Turnover is calculated as that proportion of total contract value which costs incurred to date bear to total expected costs for that contract. Revenues derived from variations on contracts are recognised only when they have been accepted by the customer. Full provision is made for losses on all contracts in the year in which they are first foreseen.

(l) Pension costs

The cost of providing pension benefits is charged to the profit and loss account so as to spread the cost over the expected average service lives of employees. Differences between the amounts funded and amounts charged to the profit and loss account are treated as prepayments or provisions in the balance sheet. Pension surpluses/deficits arising on acquisition are recognised as an asset/liability on the balance sheet, in accordance with FRS 7.

(m) Taxation

The charge for corporation tax is based on the profit for the period 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 Group has decided to adopt 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.

(n) Research and development

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

(o) Foreign currencies

Assets and liabilities of subsidiaries 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 and associates companies, and from the translation of the results of those companies at average rate, are taken to reserves. All other foreign exchange differences are taken to the profit and loss account in the period in which they arise.

(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. Amounts payable or receivable in respect of these derivatives are recognised over the period of the contracts as adjustments to net interest payable in the profit and loss account. Forward exchange contracts are valued at the period end rates of exchange. Resultant gains and losses are offset against foreign exchange gains or losses on the related borrowings or, where the instrument is used to hedge a committed future transaction, are deferred until the transaction occurs. When interest rate swaps and underlying debt are terminated together, the net gain or loss is taken to the profit and loss account as interest payable. When interest rate swaps are terminated but the underlying debt is retained then the gain/loss is deferred and is amortised to interest payable over the remaining life of the underlying debt.

(q) Liquid resources

Liquid resources comprise external deposits.

(r) Share-based compensation arrangements

In accordance with UITF 17 'employee share schemes', the costs of long term incentive awards to executive directors and senior managers in accordance with the Company's long term incentive plan (see the directors' remuneration report) are expensed on a straight line basis over the period in which performance is measured. The amount to be expensed is based upon an estimate of the probability that the performance criteria will be met. In accordance with UITF 38 'Accounting for ESOP trusts', until such time as the Company's own shares held by the trust vest unconditionally in employees, the consideration paid for the shares will be deducted from shareholders' funds.

(s) Debt

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. Finance costs (including issue costs) are taken to the profit and loss account over the term of the debt at a constant rate on the carrying amount. The carrying amount is increased by the finance costs and reduced by payments made in respect of the accounting period. Debt acquired at acquisition is restated to its fair value. The adjustment arising on acquisition is amortised to the profit and loss account on the basis of the maturity profile of each instrument.

2 Segmental analysis

(a) Analysis by class of business and by geographical origin

	UK water		Water international		Related services		Total Year to		Period to 31.3.2004 £m
	31.3.2005	31.3.2004	31.3.2005	31.3.2004	31.3.2005	31.3.2004	31.3.2005	31.3.2004	
	£m	£m	£m	£m	£m	£m	£m	£m	
Turnover:									
UK	508.2	386.2	13.1	10.8	81.7	65.4	603.0	462.4	
Rest of Europe	-	-	10.0	6.8	6.0	2.8	16.0	9.6	
Rest of World	-	-	-	-	-	2.0	-	2.0	
Total turnover	508.2	386.2	23.1	17.6	87.7	70.2	619.0	474.0	
Inter segment	-	-	(0.7)	(0.5)	(39.7)	(31.4)	(40.4)	(31.9)	
External turnover	508.2	386.2	22.4	17.1	48.0	38.8	578.6	442.1	
Operating profit:									
UK	201.8	133.4	1.8	1.7	4.1	2.7	207.7	137.8	
Rest of Europe	-	-	0.5	0.4	0.6	0.5	1.1	0.9	
Rest of World	-	-	-	-	0.1	-	0.1	-	
	201.8	133.4	2.3	2.1	4.8	3.2	208.9	138.7	
Central unallocated costs and provisions							(4.2)	4.9	
Group operating profit							204.7	143.6	
Share of associates' operating profit							2.2	2.5	
Share of joint ventures' operating profit							1.0	1.0	
Exceptional amortisation of financing costs							-	(8.8)	
Net interest payable and similar charges							(99.1)	(92.8)	
Profit on ordinary activities before taxation							108.8	45.5	

Central unallocated costs and provisions includes those costs that relate to the performance of the Company's functions and other consolidation adjustments.

2004 includes one-off fair value adjustments of £3.2 million to restate balances at their estimated recoverable value and an accounting policy alignment adjustment of £6.0 million. These adjustments have been reversed at consolidation as they have also been adjusted in UK water.

(b) Analysis of external turnover by geographical destination

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
UK	557.0	427.0
Rest of Europe, Middle East and Far East	20.7	14.4
Rest of World	0.9	0.7
External turnover	578.6	442.1

(c) Net assets

	UK water		Water international		Related services		Total	
	31.3.2005	31.3.2004	31.3.2005	31.3.2004	31.3.2005	31.3.2004	31.3.2005	31.3.2004
	£m	£m	£m	£m	£m	£m	£m	£m
Subsidiary undertakings	2,379.6	2,300.9	50.9	53.1	(26.1)	(23.9)	2,404.4	2,330.1
Share of associates' and joint ventures' net assets	-	-	-	-	5.0	5.2	5.0	5.2
Net operating assets							2,409.4	2,335.3
Unallocated net liabilities							(1,840.0)	(1,812.3)
Net assets							569.4	523.0
UK							558.9	512.9
Rest of Europe							10.5	10.1
Net assets							569.4	523.0

Net operating assets comprise tangible fixed assets, stocks, debtors and creditors which relate to segmental operating activities. Unallocated net liabilities comprise other fixed asset investments, current investments, cash and short term deposits, borrowings, current taxation balances, dividends and other common assets and liabilities.

3 (a) Operating costs

	Year to 31.3.2005	Period to 31.3.2004
	£m	£m
This is stated after charging/(crediting):		
Materials and consumables	26.8	22.4
Manpower costs (see note 5)	118.8	93.3
Own work capitalised	(31.0)	(24.7)
Depreciation of tangible fixed assets (see note 10)	92.6	72.9
Other operating costs	166.7	134.6
Total operating costs	373.9	298.5

Own work capitalised includes both employment and other costs charged to capital schemes.

The exceptional operating costs in 2004 comprise additional severance costs of £1.1 million and the costs associated with the uplift to the main market of £1.1 million.

(b) Operating profit

	Year to 31.3.2005	Period to 31.3.2004
	£m	£m
This is stated after charging/(crediting):		
Auditors' remuneration:		
audit *	0.3	0.2
non-audit services	0.2	0.5
Depreciation of tangible fixed assets: (see note 10)		
owned	89.7	69.7
under hire purchase contracts and finance leases	2.9	3.2
Amortisation of goodwill (see note 9)	0.1	-
Loss/(profit) on disposal of tangible fixed assets	1.3	(0.5)
Amortisation of capital grants (see note 21)	(3.9)	(3.2)
Operating leases:		
plant and machinery	0.9	0.2
other	1.9	2.3
Costs of research and development	5.0	4.1

* £80,000 of this relates to the Company (2004: £50,000).

The non-audit services in March 2005 were principally for advice on International Financial Reporting Standards and tax consultancy work.

The non-audit services in March 2004 were principally for the admission to the Official List of the London Stock Exchange.

4 Net interest payable and similar charges

	Year to 31.3.2005	Period to 31.3.2004
	£m	£m
Interest payable on debentures, bank and other loans and overdrafts	115.3	96.6
Exceptional amortisation of financing costs	-	8.8
Amortisation of discount, fees, loan issue costs and other financing items	(13.9)	(5.2)
Interest payable on hire purchase contracts and finance leases	3.0	2.0
Group interest payable	104.4	102.2
Share of associates' interest payable	2.7	2.3
Share of joint ventures' interest payable	0.2	0.2
Total interest payable	107.3	104.7
Interest receivable	(8.2)	(3.1)
Net interest payable	99.1	101.6
Disclosed as:		
Net interest payable: Group	96.2	99.1
associates	2.7	2.3
joint ventures	0.2	0.2
	99.1	101.6

Exceptional financing costs in 2004 of £8.8 million were in respect of the debt required for the acquisition. These costs were fully written off in 2004.

5 Employee information

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

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Wages and salaries	99.8	78.7
Social security costs	9.2	7.0
Other pension costs	9.8	7.6
Total employment costs	118.8	93.3

Total employment costs were charged as follows:

Capital schemes and infrastructure renewals	30.4	23.8
Manpower costs	88.4	69.5
	118.8	93.3

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

	Year to 31.3.2005 Number	Period to 31.3.2004 Number
UK water	2,475	2,406
Water international	134	119
Related services	1,183	1,156
	3,792	3,681

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 Tax on profit on ordinary activities

(a) Analysis of tax charge/(credit) for the financial year

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Current tax:		
UK corporation tax on profits for the year at 30%	3.0	1.4
Adjustment in respect of prior periods	(1.8)	(10.9)
UK corporation tax	1.2	(9.5)
Overseas tax	0.1	0.1
Total current tax charge/(credit) (see note 6b)	1.3	(9.4)

UK corporation tax on profits for the period to 31 March 2004 includes a £2.3 million tax credit in respect of exceptional costs.

Deferred tax:		
Origination and reversal of timing differences in the year	26.7	17.9
Adjustment in respect of prior periods	(7.6)	(1.3)
	19.1	16.6
Increase in discount	(10.2)	(21.5)
Total deferred tax charge/(credit) (see note 20)	8.9	(4.9)

Origination and reversal of timing differences for the period to 31 March 2004 includes a £0.7 million tax credit in respect of exceptional costs.

Share of associates' tax (credit)/charge	(0.1)	0.2
Share of joint ventures' tax charge	0.3	0.1
Share of associates' and joint ventures' tax charge	0.2	0.3
Tax charge/(credit) on profit on ordinary activities	10.4	(14.0)

(b) Factors affecting the tax charge/(credit) for the financial year

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Profit on ordinary activities before taxation	108.8	45.5
Profit on ordinary activities multiplied by standard rate of UK corporation tax (30%)	32.6	13.7
Effects of:		
Expenses not deductible for tax purposes	0.3	6.1
Depreciation in respect of non-qualifying items	1.1	1.2
Overseas tax losses not recognised	0.2	0.3
Capital allowances in excess of depreciation	(27.1)	(20.4)
Other timing differences	(0.6)	2.2
UK tax losses carried forward	0.6	-
Amortisation of SSAP 24 pension asset	0.4	0.3
Non taxable amortisation of financing items	(4.2)	(1.6)
Share of associates' and joint ventures' tax	(0.2)	(0.3)
Adjustment to tax charge in respect of prior periods	(1.8)	(10.9)
Total current tax charge/(credit) (see note 6a)	1.3	(9.4)

(c) Factors that may affect future tax charges

The Group expects to continue to incur high levels of capital expenditure and, accordingly, it expects to be able to claim capital allowances in excess of depreciation at a similar level to the current period.

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

7 Dividends

	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Interim paid of 2.87 pence (2004: 2.32 pence) per 10 pence ordinary share	14.9	12.0
Final proposed of 7.13 pence (2004: 4.63 pence) per 10 pence ordinary share	36.9	24.0
	51.8	36.0

8 Earnings per share

Basic and diluted earnings per share (EPS) are calculated by dividing the profit attributable to shareholders by the weighted average number of ordinary shares in issue during the period.

	Earnings 31.3.2005 £m	Weighted average number of shares 31.3.2005 million	Earnings per share 31.3.2005 pence	Earnings 31.3.2004 £m	Weighted average number of shares 31.3.2004 million	Earnings per share 31.3.2004 pence
Basic and diluted EPS	98.9	518.6	19.1	59.4	518.6	11.5

Adjusted EPS is considered by the directors to give a better indication of the Group's underlying performance and is calculated as follows:

Basic EPS	98.9	518.6	19.1	59.4	518.6	11.5
Deferred tax	8.9		1.7	(4.9)		(1.0)
Amortisation of debt fair value	(14.1)		(2.7)	(5.3)		(1.0)
Exceptional current tax	-		-	(2.3)		(0.4)
Exceptional operating costs	-		-	2.2		0.4
Exceptional amortisation of financing costs	-		-	8.8		1.7
Adjusted EPS	93.7	518.6	18.1	57.9	518.6	11.2

9 Intangible assets

	Goodwill £m	Other £m	Total £m
Cost at 1 April 2004 and 31 March 2005	0.2	64.2	64.4
Amortisation:			
Charge for the year	(0.1)	-	(0.1)
At 31 March 2005	(0.1)	-	(0.1)
Net book value at 31 March 2005	0.1	64.2	64.3
Net book value at 31 March 2004	0.2	64.2	64.4

Goodwill is being amortised over its useful economic life, which is four years.

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.

10 Tangible fixed assets

Group	Freehold land and buildings £m	Short leasehold land and buildings £m	Infra- structure 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 2004	89.0	5.2	1,313.0	1,563.4	159.6	85.4	3,215.6
Additions	-	-	0.1	0.6	1.3	208.4	210.4
Schemes commissioned	0.4	-	92.4	124.5	7.5	(224.8)	-
Reclassifications	(1.3)	(0.2)	5.9	10.7	(15.1)	-	-
Disposals	(0.5)	-	(22.0)	(5.3)	(3.1)	-	(30.9)
At 31 March 2005	87.6	5.0	1,389.4	1,693.9	150.2	69.0	3,395.1
Depreciation:							
At 1 April 2004	25.4	2.7	51.3	349.3	94.1	-	522.8
Charge for the year	1.6	0.3	29.9	56.2	4.6	-	92.6
Reclassifications	0.2	(0.1)	-	-	(0.1)	-	-
Disposals	-	-	(22.0)	(2.0)	(2.9)	-	(26.9)
At 31 March 2005	27.2	2.9	59.2	403.5	95.7	-	588.5
Net book value at 31 March 2005	60.4	2.1	1,330.2	1,290.4	54.5	69.0	2,806.6
Net book value at 31 March 2004	63.6	2.5	1,261.7	1,214.1	65.5	85.4	2,692.8

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 tangible fixed assets held under hire purchase contracts and finance leases was as follows:

	31.3.2005 £m	31.3.2004 £m
Infrastructure assets	2.2	2.2
Operational structures, plant and machinery	25.9	25.7
Fixtures, fittings, tools and equipment	0.3	0.7
	28.4	28.6

11 Fixed asset investments

(a) Group

	Joint ventures £m	Associated undertakings £m	Other investments £m	Total £m
At 1 April 2004	3.4	1.8	0.4	5.6
Share of profits	0.5	(0.4)	-	0.1
Dividends received	(0.3)	-	-	(0.3)
At 31 March 2005	3.6	1.4	0.4	5.4

All fixed asset investments are unlisted.

(b) Company

	Interests in subsidiaries £m
At 1 April 2004 and 31 March 2005	1,022.7

(c) The Group's interests in principal trading associates at 31 March 2005 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 and Company %	Business activity
Ayr Environmental Services Limited	Scotland	Ordinary shares of £1	50	Waste water services

(d) Joint ventures

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

(e) The Group's interests in principal subsidiaries at 31 March 2005 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 and Company %	Business activity
Northumbrian Water Limited	England and Wales	Ordinary shares of £1	100	Water and sewerage services
AquaGib Limited	Gibraltar	Ordinary shares of £1	67	Water and sewerage services
Entec UK Limited	England and Wales	Ordinary shares of £1	100	Environmental and engineering consultancy
Northumbrian Water Technical Centre Limited	England and Wales	Ordinary shares of £1	100	Research and development
Northumbrian Services Limited	England and Wales	Ordinary shares of £1	100	Holding of investments and loans
Analytical & Environmental Services Limited	England and Wales	Ordinary shares of £1	100	Analytical laboratory and scientific services
Fastflow Pipeline Services Limited	England and Wales	Ordinary shares of £1	100	Infrastructure replacement and rehabilitation
Caledonian Environmental Services plc	Scotland	Ordinary shares of £1	75	Waste water services
ULG Northumbrian Limited	England and Wales	Ordinary shares of £1	100	Aid-funded project work
SA Agrer NV	Belgium	Ordinary shares of £1	100	Aid-funded project work
Northumbrian Water Finance plc	England and Wales	Ordinary shares of £1	100	Holding of finance instruments

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.

12 Stocks

	Group	
	31.3.2005	31.3.2004
	£m	£m
Stores	3.4	3.7
Work in progress	1.1	1.1
	4.5	4.8

13 Debtors

	Group	Group	Company	Company
	31.3.2005	31.3.2004	31.3.2005	31.3.2004
	£m	£m	£m	£m
Amounts receivable within one year:				
Trade debtors	67.3	60.9	0.1	-
Amounts owed by subsidiary undertakings	-	-	49.3	49.2
Amounts owed by associate undertakings	4.6	3.8	-	-
Amounts owed by joint venture undertakings	1.0	0.8	-	-
Other debtors	7.4	9.4	-	0.2
Taxation	-	7.7	-	-
Deferred tax	-	-	4.0	0.3
Prepayments and accrued income	41.6	35.5	0.5	0.5
	121.9	118.1	53.9	50.2
Amounts receivable after more than one year:				
SSAP 24 pension asset	13.0	14.3	-	-

Trade debtors are shown net of bills paid in advance. In the Company, amounts owed by subsidiary undertakings includes amounts receivable for the provisional surrender of tax losses amounting to £4.7 million (2004: £2.7 million). The deferred tax asset in the Company relates wholly to other timing differences.

14 Cash at bank and short term deposits

	Group	Group	Company	Company
	31.3.2005	31.3.2004	31.3.2005	31.3.2004
	£m	£m	£m	£m
Cash at bank	83.9	30.4	47.3	3.0
Short term deposits	34.1	14.4	-	1.4
	118.0	44.8	47.3	4.4

15 Creditors: amounts falling due within one year

	Group	Group	Company	Company
	31.3.2005	31.3.2004	31.3.2005	31.3.2004
	£m	£m	£m	£m
Bank loans and overdrafts (see note 17) (principal £57.6 million, 2004: £55.2 million)	69.4	61.5	-	-
Obligations under hire purchase contracts and finance leases (see note 18)	4.5	3.6	-	-
Trade creditors	18.2	20.9	-	-
Amounts owed to subsidiary undertakings	-	-	48.9	23.0
Other creditors	17.1	19.4	-	-
Taxation	1.2	-	-	-
Amounts payable to associates for tax losses	-	3.6	-	-
Amounts payable to other companies for tax losses	-	1.7	-	-
Other tax and social security	3.6	4.4	-	-
Dividends payable: equity shareholders	36.9	24.0	36.9	24.0
Accruals and deferred income	129.7	108.4	0.1	0.2
	280.6	247.5	85.9	47.2

16 Creditors: amounts falling due after more than one year

	Group 31.3.2005 £m	Group 31.3.2004 £m	Company 31.3.2005 £m	Company 31.3.2004 £m
Loans (see note 17) (principal £1,812.9 million, 2004: £1,705.2 million)	1,872.2	1,795.7	-	-
Amounts owed to subsidiary undertakings (see note 17)	-	-	490.0	490.0
Obligations under hire purchase contracts and finance leases (see note 18) (principal £57.3 million, 2004: £57.3 million)	57.5	57.3	-	-
Amounts payable to associates for tax losses	4.4	-	-	-
Other creditors	12.2	13.4	-	-
	1,946.3	1,866.4	490.0	490.0

At 31 March 2005, the Group had no interest swap arrangements (2004: £15.0 million).

The difference between the principal value of £1,870.2 million (2004: £1,762.5 million) and the carrying value of £1,929.7 million (2004: £1,853.0 million) are unamortised issue costs of £15.7 million (2004: £4.3 million) and a credit of £75.2 million (2004: £94.8 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

17 Loans

	Group 31.3.2005 £m	Group 31.3.2004 £m	Company 31.3.2005 £m	Company 31.3.2004 £m
Loans are repayable as follows:				
Less than one year (principal £24.8 million, 2004: £38.1 million)	36.6	44.4	-	-
Between one and two years (principal £219.1 million, 2004: £229.3 million)	226.3	235.6	-	-
Between two and five years (principal £138.2 million, 2004: £345.4 million)	154.9	364.4	-	-
In more than five years (principal £1,455.6 million, 2004: £1,130.5 million)	1,491.0	1,195.7	490.0	490.0
	1,908.8	1,840.1	490.0	490.0
Disclosed as due:				
Within one year:				
Bank loans and overdrafts (principal £51.9 million, 2004: £50.2 million)	54.4	56.5	-	-
Debentures (principal £5.7 million, 2004: £5.0 million)	5.7	5.0	-	-
Eurobonds (principal £0 million, 2004: £0 million)	9.3	-	-	-
Less bank overdrafts (principal £32.8 million, 2004: £17.1 million)	(32.8)	(17.1)	-	-
After one year:				
Loans (principal £310.2 million, 2004: £534.4 million)	322.7	552.7	-	-
Eurobond – due 28 June 2006 bearing interest rate of 8.625% (principal £189.6 million, 2004: £200.0 million)	190.9	211.2	-	-
Eurobond – due 11 October 2017 bearing interest rate of 6.0% (principal £300.0 million, 2004: £300.0 million)	313.3	314.8	-	-
Eurobond – due 6 February 2023 bearing interest rate of 6.875% (principal £350.0 million, 2004: £350.0 million)	398.8	401.2	-	-
Eurobond – due 29 April 2033 bearing interest rate of 5.625% (principal £350.0 million, 2004: £250.0 million)	345.3	247.9	-	-
Eurobond – due 23 January 2034 bearing interest rate of 5.87526% (principal £248.0 million, 2004: £0 million)	239.3	-	-	-
Eurobond – due 31 March 2037 bearing interest rate of 6.627% (principal £61.6 million, 2004: £61.6 million)	58.4	58.3	-	-
Debentures (principal £3.5 million, 2004: £9.2 million)	3.5	9.6	-	-
Amounts owed to subsidiary undertakings	-	-	490.0	490.0
	1,908.8	1,840.1	490.0	490.0

The difference between the principal value of £1,837.7 million (2004: £1,743.3 million) and the carrying value of £1,908.8 million (2004: £1,840.1 million) are unamortised issue costs of £15.7 million (2004: £4.3 million) and a credit of £86.8 million (2004: £101.1 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

Loans to the Group from third parties, any part of which falls due for repayment in five years or more and which are repayable by instalments, amount to £486.4 million (2004: £257.0 million) and bear rates of interest in the range of 5.24% to 8.55% (2004: 5.05% to 8.55%). £16.3 million (2004: £18.8 million) of these loans bear interest rates linked to LIBOR.

Loans to the Group from third parties repayable otherwise than by instalments which fall due for repayment after more than five years amount to £1,110.5 million (2004: £1,101.6 million) and bear rates of interest in the range of 5.25% to 6.99% (2004: 3.5% to 11.75%). Of these loans, £120.5 million (2004: £120.5 million) bears interest rates linked to LIBOR.

The aggregate amount of Group loans, any part of which falls due for repayment in five years or more, is £1,593.2 million (2004: £1,274.0 million).

Included in the loans are debenture stocks as follows:

- (a) £3.6 million (2004: £8.6 million) originally issued by North East Water plc and secured by a floating charge on the assets of Northumbrian Water Limited;
- (b) £5.6 million (2004: £5.6 million) originally issued by Essex and Suffolk Water plc and secured by a floating charge on the assets of Northumbrian Water Limited.

18 Obligations under hire purchase contracts and finance leases

	Group	
	31.3.2005	31.3.2004
	£m	£m
Amounts due:		
In less than one year	4.5	3.6
Between one and two years	4.0	4.0
Between two and five years	12.3	10.4
In more than five years	62.3	66.1
Gross obligations	83.1	84.1
Less finance charges allocated to future periods	(21.1)	(23.2)
	62.0	60.9
Disclosed as due:		
Within one year	4.5	3.6
After more than one year	57.5	57.3
	62.0	60.9

The aggregate gross amount of obligations under hire purchase contracts and finance leases, any part of which falls due for repayment in five years or more, is £82.5 million (2004: £82.9 million).

19 Derivatives and 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 2005, the Group had £90.0 million available in standby committed bank facilities.

(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 2005, 88% (2004: 78%) of the Group's borrowings were at fixed rates of interest.

(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 affect on the Group's pre-tax profits.

(h) Interest rate risk profile of financial assets and financial liabilities

The interest rates and currency profile of the Group's net debt at 31 March 2005 were:

	Total net borrowings £m	Variable rate net borrowings £m	Fixed rate net borrowings		
			Borrowings £m	Weighted average interest rate %	Weighted average period for which rate is fixed years
Sterling borrowings:					
Loans (principal £329.3 million)	344.3	153.1	191.2	6.39	10.6
Eurobonds (principal £1,499.2 million)	1,555.3	-	1,555.3	6.49	19.4
Debentures (principal £9.2 million)	9.2	-	9.2	8.67	4.3
Finance leases (principal £61.8 million)	62.0	54.3	7.7	7.82	4.4
Overdrafts	32.8	32.8	-	-	-
	2,003.6	240.2	1,763.4	6.50	18.3
Cash and short term deposits	(118.0)	(118.0)	-	-	-
Sterling loans receivable	(4.6)	(4.6)	-	-	-
Net debt at 31 March 2005	1,881.0	117.6	1,763.4		

The difference between the principal value of £1,899.5 million and the carrying value of £1,970.8 million are unamortised issue costs of £15.7 million and a credit of £87.0 million in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

In addition there are provisions due after more than one year of £5.2 million (2004: £6.3 million), on which no interest is payable.

The interest rates and currency profile of the Group's net debt at 31 March 2004 were:

	Total net borrowings £m	Variable rate net borrowings £m	Fixed rate net borrowings		
			Borrowings £m	Weighted average interest rate %	Weighted average period for which rate is fixed years
Sterling borrowings:					
Loans (principal £567.5 million)	587.0	360.9	226.1	6.41	10.3
Eurobonds (principal £1,161.6 million)	1,238.4	-	1,238.4	6.64	17.5
Debentures (principal £14.2 million)	14.7	-	14.7	9.84	3.2
Finance leases (principal £60.9 million)	60.9	53.0	7.9	7.55	5.0
Overdrafts	17.1	17.1	-	-	-
	1,918.1	431.0	1,487.1	6.65	16.2
Cash and short term deposits	(44.8)	(44.8)	-	-	-
Sterling loans receivable	(3.8)	(3.8)	-	-	-
Net debt at 31 March 2004	1,869.5	382.4	1,487.1		

As permitted by FRS 13, short term debtors and creditors have been excluded from the disclosures, other than the currency disclosures.

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

Included in the debentures above are £2.1 million (2004: £2.1 million) of irredeemable debentures that have been excluded from the calculation of the weighted average maturity and fixed periods.

The difference between the principal value of £1,804.2 million and the carrying value of £1,901.0 million are unamortised issue costs of £4.3 million and a credit of £101.1 million in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

(i) Currency exposures

At 31 March 2005, after taking into account the effects of forward foreign exchange contracts, the Group had no currency exposures (2004: £nil).

(j) Borrowing facilities

The Group has various undrawn committed borrowing facilities. The facilities available at 31 March 2005, in respect of which all conditions precedent have been met, are as follows:

	31.3.2005 £m	31.3.2004 £m
Expiring in one year or less	90.0	-
Expiring in more than one year but not more than two years	-	90.0
At 31 March 2005	90.0	90.0

(k) 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 2005 is set out below:

	Book value £m	Fair value £m
Primary financial instruments held or issued to finance the Group's operations:		
Short term financial liabilities and current portion of long term borrowings (principal £62.1 million)	73.9	63.7
Long term borrowings (principal £1,870.2 million)	1,929.7	1,961.9
Financial assets	(122.6)	(122.6)
At 31 March 2005	1,881.0	1,903.0

The difference between the principal value of £1,932.3 million and the carrying value of £2,003.6 million are unamortised issue costs of £15.7 million and a credit of £87.0 million in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

A comparison by category of book values and fair values of the Group's financial assets and liabilities as at 31 March 2004 is set out below:

	Book value £m	Fair value £m
Primary financial instruments held or issued to finance the Group's operations:		
Short term financial liabilities and current portion of long term borrowings (principal £58.8 million)	65.1	61.5
Long term borrowings (principal £1,762.5 million)	1,853.0	1,825.1
Financial assets	(48.6)	(48.6)
Derivative financial instruments held to manage the interest rate and currency profile:		
Interest rate swaps	-	(3.4)
At 31 March 2004	1,869.5	1,834.6

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 £1,492.7 million (2004: £1,113.2 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 £1,821.3 million and the carrying value of £1,918.1 million are unamortised issue costs of £4.3 million and a credit of £101.1 million in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

(l) Gains and losses on hedges

The Group enters into forward foreign currency contracts to eliminate the currency exposures that arise on sales denominated in foreign currencies immediately those sales are transacted. It also uses interest rate swaps to manage its interest rate profile. Changes in the fair value of instruments used as hedges are not recognised in the financial statements until the hedged position matures.

An analysis of these unrecognised gains and losses as at 31 March 2005 is as follows:

	Gains £m	Losses £m	Total net gains/(losses) £m
Unrecognised gains and losses on hedges at 1 April 2004	3.4	-	3.4
Gains and losses arising in previous years that were recognised to March 2005	(3.4)	-	(3.4)
Gains and losses arising before 1 April 2004 that were not recognised to March 2005	-	-	-
Unrecognised gains and losses on hedges at 31 March 2005	-	-	-

An analysis of these unrecognised gains and losses as at 31 March 2004 is as follows:

	Gains £m	Losses £m	Total net gains/(losses) £m
Unrecognised gains and losses on hedges at 23 May 2003	1.4	0.7	0.7
Gains and losses arising in previous years that were recognised to March 2004	(0.6)	0.4	(0.2)
Gains and losses arising before 23 May 2003 that were not recognised to March 2004	0.8	0.3	0.5
Gains and losses arising to March 2004 that were not recognised to March 2004	2.6	(0.3)	2.9
Unrecognised gains and losses on hedges at 31 March 2004	3.4	-	3.4
Of which:			
Gains and losses expected to be recognised in 2004/05	3.4	-	3.4
Gains and losses expected to be recognised in 2005/06 or later	-	-	-

20 Provisions for liabilities and charges

	Group			
	Reorganisation and restructuring provision £m	Deferred taxation £m	Other £m	Total £m
At 1 April 2004	4.7	158.8	1.6	165.1
(Credited)/charged to the profit and loss account	(0.1)	8.9	(0.2)	8.6
Utilised during the year	(0.8)	-	-	(0.8)
At 31 March 2005	3.8	167.7	1.4	172.9

The reorganisation and restructuring provision represents outstanding severance and pension contributions of £0.8 million (2004: £1.5 million) in respect of costs of restructuring programmes within the Group and £3.0 million (2004: £3.2 million) relating to discretionary pension liabilities. The former representing the best estimate of amounts payable, principally in the next 24 months.

Other provisions relate to dilapidations in respect of leasehold properties which will be payable as individual leases expire over a period of up to 12 years.

The provision for deferred tax comprises:

	Group	
	31.3.2005	31.3.2004
	£m	£m
Accelerated capital allowances	506.5	483.7
Losses carried forward	(2.6)	(2.3)
SSAP 24 pension asset	3.9	4.3
Other timing differences	(59.2)	(56.2)
Undiscounted provision for deferred tax	448.6	429.5
Discount	(280.9)	(270.7)
	167.7	158.8

In addition, there are tax losses of approximately £10.8 million (2004: £10.4 million) available to be carried forward and set against future profits arising in territories outside the United Kingdom.

21 Accruals and deferred income

	Group		
	Capital grants and contributions	Interest rate swaps	Total
	£m	£m	£m
At 1 April 2004	142.8	-	142.8
Additions	21.3	4.3	25.6
Amortisation for the year (see note 3)	(3.9)	-	(3.9)
At 31 March 2005	160.2	4.3	164.5

22 Called up share capital

The share capital of the Company and Group is shown below:

	31.3.2005	31.3.2004
	£m	£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 681,296 (2004: 440,000) 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 page 51. As at 31 March 2005, the share price of the ordinary 10 pence shares in the Company was 176.25 pence (2004: 111.25 pence).

23 Reserves

Group	Own shares	Share premium account	Profit and loss account
	£m	£m	£m
At 1 April 2004	(0.5)	446.3	23.4
Purchase of own shares for the LTIP	(0.4)	-	-
Amortisation of LTIP awards	-	-	0.1
Exchange differences	-	-	0.4
Retained profit for the financial year	-	-	47.1
At 31 March 2005	(0.9)	446.3	71.0
Company			
At 1 April 2004	(0.5)	446.3	42.4
Purchase of own shares for the LTIP	(0.4)	-	-
Amortisation of LTIP awards	-	-	0.1
Retained profit for the financial year	-	-	8.2
At 31 March 2005	(0.9)	446.3	50.7

As permitted by Section 230 of the Companies Act 1985, the Company's profit and loss account has not been included in these financial statements. Its profit for the financial year was £60.0 million (2004: £78.4 million).

24 Reconciliation of movement in equity shareholders' funds

	Group		Company	
	Year to 31.3.2005 £m	Period to 31.3.2004 £m	Year to 31.3.2005 £m	Period to 31.3.2004 £m
Profit for the financial year	98.9	59.4	60.0	78.4
Dividends	(51.8)	(36.0)	(51.8)	(36.0)
Retained profit for the financial year	47.1	23.4	8.2	42.4
Exchange differences	0.4	-	-	-
Purchase of own shares for the LTIP	(0.4)	(0.5)	(0.4)	(0.5)
Amortisation of LTIP awards	0.1	-	0.1	-
Issue of shares (net of expenses)	-	498.2	-	498.2
Increase in equity shareholders' funds	47.2	521.1	7.9	540.1
Opening equity shareholders' funds	521.1	-	540.1	-
Closing equity shareholders' funds	568.3	521.1	548.0	540.1

25 Pensions

The Group operates a funded defined benefit pension scheme, providing benefits based on final pensionable remuneration to 2,407 employees. The scheme, named the Northumbrian Water Pension Scheme, comprises four unitised sub-funds – WPS Section, Northumbrian Water Section (North), Northumbrian Water Section (South) and the MIS Section.

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

The most recent actuarial valuation of the scheme was at 31 December 2001. At that date the market value of assets amounted to £441.0 million in aggregate (excluding MIS which was transferred into the scheme on 1 April 2002 and was valued at approximately £20.0 million). The 2001 valuation disclosed that the combined value of the assets represented 109% of the value of the accrued liabilities. NSL contributed a further £15.0 million to the scheme on 2 January 2003.

The following table sets out the agreed contributions based on the 31 December 2001 valuations for WPS, North and South sub-funds. The contributions for the MIS sub-fund were agreed based on the 31 March 2001 valuation.

	Section			
	WPS %	North %	South %	MIS %
Members' contributions	6	5	5	5/6
Employers' contributions	15.5	10.5	Nil	6/7.2

The MIS employer contributions increased to 21%/20.7% of pensionable earnings for 5%/6% members respectively from July 2003, following advice from the actuary. In addition, the Company has agreed to pay £0.3 million p.a. for ten years starting on 1 January 2005.

The employer contribution rate was assessed, at the December 2001 valuation, using the Projected Unit Method and the following actuarial assumptions:

	Group %
Investment return:	
Pre retirement	6.1
Post retirement	5.7
Pay increases	3.5
Pension increases	2.5
Price inflation	2.5

The actuarial valuation as at 31 December 2004 is currently in progress. An independent qualified actuary performs the actuarial valuation. Employer contribution rates will be reviewed once the results of this valuation are known.

During the year, the Group made contributions amounting to £8.5 million to the defined benefit pension scheme and the Northumbrian Water Group Personal Pension Plan, which provides defined contribution benefits to 886 employees, £7.5 million of which related to the defined benefit pension scheme. The SSAP 24 charge for the year was £9.8 million (2004: £7.6 million).

Additional disclosures regarding the Group's defined benefit scheme are required under the transitional provisions of FRS 17 'Retirement benefits' and these are set out below.

A qualified actuary, using revised assumptions that are consistent with the requirements of FRS 17, has updated the actuarial valuation described above at 31 December 2001. Investments have been valued, for this purpose, at fair value.

FRS 17 actuarial assumptions:

	Group	
	31.3.2005	31.3.2004
	%	%
Pay increases	3.9	4.0
Pension increases	2.9	3.0
Price inflation	2.9	3.0
Discount rate	5.4	5.5

The fair value of the assets in the scheme, 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	31.3.2005 £m	Long term expected rate of return	31.3.2004 £m
	31.3.2005 %		31.3.2004 %	
Equities	6.7	373.9	6.8	335.4
Corporate bonds	5.4	39.7	5.5	37.7
Government bonds	4.7	45.2	4.8	41.8
Property	5.7	55.5	5.8	47.5
Cash	4.7	12.3	4.0	12.7
Total fair value of assets		526.6		475.1
Present value of scheme liabilities		(600.2)		(565.7)
Deficit in the scheme		(73.6)		(90.6)
Related deferred tax asset		22.1		27.2
Net pension liability		(51.5)		(63.4)

Analysis of the amount that would have been charged to operating profit under FRS 17:

	31.3.2005 £m	31.3.2004 £m
Current service cost	11.8	10.6
Curtailments and settlements	1.2	0.5
	13.0	11.1

Analysis of the amount that would have been credited to net finance income under FRS 17:

	31.3.2005 £m	31.3.2004 £m
Expected return on pension scheme assets	29.9	22.2
Interest on pension scheme liabilities	(31.1)	(23.5)
	(1.2)	(1.3)

Analysis of the actuarial gain that would have been recognised in the statement of total recognised gains and losses:

	31.3.2005 £m	31.3.2004 £m
Actual return less expected return on pension scheme assets	28.5	30.4
Experience gains and losses arising on the scheme liabilities	(4.4)	8.0
Changes in assumptions underlying the present value of the scheme liabilities	-	(0.8)
	24.1	37.6

Analysis of movement in deficit during the year:

	31.3.2005 £m	31.3.2004 £m
Deficit in scheme at 1 April	(90.6)	(121.5)
Current service cost	(11.8)	(10.6)
Total other finance income	0.5	1.0
Actuarial gain	24.1	37.6
Impact of curtailments and settlements	(1.2)	(0.5)
Other	(0.9)	(0.6)
Net return	(1.2)	(1.3)
Contributions	7.5	5.3
Deficit at 31 March	(73.6)	(90.6)

History of experience gains and losses:

	31.3.2005	31.3.2004
Difference between the expected and actual return on scheme assets:		
Amount (£m)	28.5	30.4
Percentage of scheme assets	5.4%	6.4%

Experience gains and losses on scheme liabilities:

Amount (£m)	(4.4)	8.0
Percentage of the present value of scheme liabilities	(0.7%)	1.4%

Total actuarial gain recognised in the statement of total recognised gains and losses:

Amount (£m)	24.1	37.6
Percentage of the present value of scheme liabilities	4.0%	6.7%

Reconciliation of net assets and reserves under FRS 17:

Net assets – Group:

	31.3.2005 £m	31.3.2004 £m
Net assets in balance sheet	569.4	523.0
SSAP 24 balance	(13.0)	(14.3)
Related deferred tax	3.9	4.3
Net assets excluding defined benefit assets/(liabilities)	560.3	513.0
FRS 17 net pension liability	(51.5)	(63.4)
Net assets including defined benefit assets/(liabilities)	508.8	449.6

Reserves – Group:

	31.3.2005 £m	31.3.2004 £m
Profit and loss account in balance sheet	71.0	23.4
SSAP 24 balance	(13.0)	(14.3)
Related deferred tax	3.9	4.3
Profit and loss account excluding amounts relating to defined benefit assets/(liabilities)	61.9	13.4
FRS 17 net pension liability	(51.5)	(63.4)
Profit and loss account including defined benefit assets/(liabilities)	10.4	(50.0)

26 Financial commitments

(a) Capital expenditure

	Group	
	31.3.2005 £m	31.3.2004 £m
Expenditure contracted for	82.4	53.3

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.

(b) Lease commitments

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

	Land and buildings £m	Other £m	31.3.2005 £m	31.3.2004 £m
Leases which expire:				
Within one year	0.3	0.9	1.2	0.7
Within two to five years	0.2	1.9	2.1	1.6
After five years	1.0	-	1.0	0.8
	1.5	2.8	4.3	3.1

27 Commitments – Company

The Company has issued letters of continuing support to subsidiary companies with net current liabilities amounting to £139.1 million (2003/04: £193.9 million). These subsidiary companies are expected to meet their working capital requirements from operating cash flows.

28 Financial review statement

The Group has disclosed the comparative pro forma figures for the acquired group, NSL, for the year ending 31 March 2004. This includes eight weeks of pre-acquisition trading results and the accounting effect of the acquisition on 23 May 2003.

	Year to 31.3.2005 £m	Year to 31.3.2004 (pro forma)		
		Before exceptional items £m	Exceptional items £m	Total £m
Turnover: Group and share of joint ventures	585.5	528.3	-	528.3
Less share of joint ventures' turnover	(6.9)	(7.5)	-	(7.5)
Group turnover	578.6	520.8	-	520.8
Operating costs				
- operating costs before exceptional costs	(373.9)	(354.3)	-	(354.3)
- exceptional costs	-	-	(2.2)	(2.2)
Operating profit	204.7	166.5	(2.2)	164.3
Share of associated undertakings' operating profit	2.2	2.5	-	2.5
Share of joint ventures' operating profit	1.0	1.3	-	1.3
Total operating profit: Group and share of joint ventures and associates	207.9	170.3	(2.2)	168.1
Interest payable and similar charges				
- net interest payable and similar charges	(99.1)	(105.3)	-	(105.3)
- exceptional amortisation of financing costs	-	-	(8.8)	(8.8)
Profit on ordinary activities before taxation	108.8	65.0	(11.0)	54.0
Tax on profit on ordinary activities				
- current taxation	(1.3)	6.6	2.3	8.9
- deferred taxation	(8.9)	4.0	0.7	4.7
- share of associates' and joint ventures' tax	(0.2)	(0.1)	-	(0.1)
Profit on ordinary activities after taxation	98.4	75.5	(8.0)	67.5
Minority interests	0.5	(0.6)	-	(0.6)
Profit attributable to shareholders	98.9	74.9	(8.0)	66.9
Dividends paid and proposed	(51.8)	(36.0)	-	(36.0)
Retained profit for the financial year	47.1	38.9	(8.0)	30.9
Basic earnings per share	19.1p			14.4p
Adjusted earnings per share	18.1p			14.2p
Diluted earnings per share	19.1p			14.4p
Dividend per share	10.00p			8.34p

The Group has also presented the comparative pro forma cash flow figures for the acquired group, NSL, for the year ending 31 March 2004. This includes eight weeks of pre-acquisition cash flows and the accounting effect of the acquisition on 23 May 2003.

	Year to 31.3.2005 £m	Year to 31.3.2004 £m Pro forma
Net cash inflow from operating activities	283.4	255.4
Dividends received from joint ventures	0.3	-
Net cash inflow from dividends received from joint ventures	0.3	-
Returns on investments and servicing of finance		
Net cash outflow from returns on investments and servicing of finance	(111.0)	(102.5)
Taxation		
Taxation received	6.7	-
Net cash inflow from taxation	6.7	-
Capital expenditure and financial investments		
Purchase of tangible fixed assets	(197.1)	(194.2)
Proceeds on disposal of tangible fixed assets	2.7	0.8
Capital grants received	21.3	15.8
Net cash outflow from capital expenditure and financial investments	(173.1)	(177.6)
Acquisitions and disposals		
Acquisition of subsidiaries	-	(893.0)
Net cash acquired with subsidiaries	-	16.1
Acquisition of division	-	(0.3)
Net cash outflow from acquisitions and disposals	-	(877.2)
Equity dividends paid	(38.9)	(43.2)
Cash outflow before management of liquid resources	(32.6)	(945.1)
Management of liquid resources		
Net cash (outflow)/inflow from management of liquid resources	(19.7)	408.0
Financing		
Issue of new shares	-	368.5
Purchase of own shares	(0.4)	(0.5)
Loans received	348.2	536.0
Loans repaid	(253.7)	(349.6)
Payment of principal under hire purchase contracts and finance leases	(4.0)	(4.0)
Net cash inflow from financing	90.1	550.4
Increase in cash in the year	37.8	13.3
Reconciliation of net debt		
Increase in cash in the year	37.8	13.3
Cash inflow from increase in net debt and lease financing	(90.5)	(182.4)
Cash outflow/(inflow) from management of liquid resources	19.7	(408.0)
Issue costs on new borrowings	11.7	-
Increase in net debt resulting from cash flows	(21.3)	(577.1)
Other non-cash items	14.9	5.3
Inception of new finance lease contracts	(5.1)	(5.5)
Increase in net debt in the year	(11.5)	(577.3)
Net borrowings at start of the year	(1,869.5)	-
Loans and finance leases acquired with subsidiaries net of short term deposits	-	(1,292.2)
Net debt at end of the year	(1,881.0)	(1,869.5)

29 Quasi-subidiaries

As noted under accounting policy 1(a), under FRS 5 two companies are consolidated as quasi-subidiaries. The principal quasi-subidiary is Bakethin Holdings Limited, the shares in which are owned by Bakethin Charitable Trust. The other quasi-subidiary 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 bonds. On 12 May 2004, Bakethin Finance plc issued £248 million of guaranteed secured bonds. The bonds are due to mature in 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 accounts of the quasi-subidiaries are as follows:

Profit and loss account:

	31.3.2005
	£m
Interest receivable	13.2
Interest payable	(13.2)
Retained profit	-

Balance sheet:

	31.3.2005
	£m
Investments	239.3
Net current assets	1.6
Creditors: amounts falling due after more than one year	(240.9)
Net assets	-

Cash flow statement:

	31.3.2005
	£m
Return on investments and servicing of finance	(0.4)
Cash outflow from loan granted to Reiver Finance Limited	(248.0)
Financing	
Cash inflow from guaranteed secured bonds	248.0
Cash inflow from loan	1.5
Increase in cash	1.1

SHAREHOLDER INFORMATION

For queries about your shares please contact

Capita Registrars at:

The Registry
34 Beckenham Road
Beckenham
Kent, BR3 4TU

Tel: 0870 162 3100
From overseas: +44 20 8639 2157
Fax: 020 8639 2342
E-mail: ssd@capitaregistrars.com
Web: www.capitaregistrars.com

For general shareholder queries please contact

Secretariat on:

Tel: 0191 301 6704/0191 301 6701
Fax: 0191 301 6705
E-mail: shareholders@nwl.co.uk

To request financial statements and other company literature please contact

Communications on:

Tel: 0191 301 6734
E-mail: shareholders@nwl.co.uk

Annual General Meeting

The Notice of Meeting, information about the Annual General Meeting to be held on 28 July 2005 and the proxy voting card are enclosed with these financial statements. Shareholder questions and special needs requests should be addressed to:

Secretariat
Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham, DH1 5FJ
Tel: 0191 301 6701
Fax: 0191 301 6705
E-mail: shareholders@nwl.co.uk

Company Secretary & registered office

Martin Parker
Company Secretary
Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham, DH1 5FJ

Sustainable Development Performance Report

Copies of the Northumbrian Water Group plc Sustainable Development Performance Report 2004/05 can be requested from:

Environment Department
Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham, DH1 5FJ
E-mail: environment@nwl.co.uk
Tel: 0191 301 6758
Fax: 0191 301 6578

Financial calendar

2005

28 July	AGM
17 August	Ex-dividend date
19 August	Record date
16 September	Final dividend payment
7 December	Interim results announcement
21 December	Ex-dividend date
23 December	Record date

2006

3 February	Interim dividend payment
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Group websites

www.nwg.co.uk
www.nwl.co.uk
www.eswater.co.uk
www.entecuk.com
www.aes-labs.co.uk
www.ulgnorthumbrian.com
www.agrer.com

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