

# **NORTHUMBRIAN WATER GROUP PLC**

**REPORT AND FINANCIAL STATEMENTS FOR**

**THE YEAR ENDED**

**31 MARCH 2006**

Registered Number 4760441



## Contents

	<b>Page</b>
Chairman's statement	1
Managing Director's statement	3
Corporate responsibility	6
Business review	8
Appendix to the business review	30
Board directors' biographies	32
Directors' report	34
Corporate governance report	39
Directors' remuneration report	46
Directors' responsibilities	55
Report of the Auditors	56
Consolidated income statement	58
Consolidated statement of recognised income and expense	59
Consolidated balance sheet	60
Consolidated cash flow statement	61
Notes to the financial statements	62
Parent Company auditors' report	95
Company balance sheet	97
Notes to the Company financial statements	98
Shareholder information	101

## **Highlights – continuing operations**

- Strong financial and operating performance – a good start to the five year period
- Revenue increase mainly due to the price increase on water and sewerage charges to support the continuing high capital investment programme
- Capital expenditure of £211.9 million in Northumbrian Water Limited – on track to deliver the investment programme of nearly £1 billion to 2010
- Leakage targets and environmental standards either met or exceeded
- Disposal of three non-regulated businesses during the year reinforces the focus on the core water and waste water business
- Financial position further strengthened – funding secured for investment programme to 2010
- Proposed final dividend of 7.04 pence per share, giving a full year ordinary dividend of 10.56 pence per share (2005: 10.00 pence per share)

## **NWG at a glance**

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

NWG owns a number of special purpose companies for specific water and waste water contracts and also provides technical and consultancy services focusing on water and environmental issues.

## **Chairman's statement**

This year marks a new phase in the Group's development. We have sharpened the focus on our core business, disposing of three non-core companies, and have begun a new five year regulatory period. We have made a good start with the delivery of our investment programme in the first year of this new period. Alongside maintaining our extensive asset base, our main targets are to reduce the incidence of sewer flooding and discoloured water. Over the five year period we will invest nearly £1 billion to deliver improvements to our services and the environment.

### **NWG's financial performance**

NWG's revenue from continuing operations was £591.5 million for the year to 31 March 2006 and represents a 9.2% increase on the year to 31 March 2005 (£541.6 million), mainly due to the price increase on water and sewerage charges to support the continuing high capital investment programme.

Profit on ordinary activities before interest from continuing operations for the year was £236.2 million (2005: £196.1 million).

The sale of Fastflow Pipeline Services Limited (FPS), Entec UK Limited (Entec) and ULG Northumbrian Limited (ULG) contributed £14.6 million to the results for the year and is included in the discontinued operations result of £15.4 million (see note 8 for further analysis).

In September 2005, we issued £150 million index linked 2.033% Eurobonds due in 2036. In January 2006, we issued further £60 million index linked 1.6274% Eurobonds due in 2041.

The credit rating of our core business has remained consistent throughout the year at BBB+ stable, Fitch Ratings (Fitch) and Standard & Poors (S&P) and Baa1 stable, Moody's Investors Service (Moody's).

The Board will recommend an ordinary final dividend of 7.04 pence per share for the year ended 31 March 2006 to shareholders at the Annual General Meeting (AGM) on 27 July 2006. Together with the ordinary interim dividend of 3.52 pence per share, the ordinary dividends paid and proposed for the year will be 10.56 pence per share. This represents an increase of 5.6% on the dividend for the previous year. A special dividend of 2.82 pence per share was paid in the year, in respect of the profit on disposal of subsidiaries of £14.6 million.

The ordinary dividends paid and proposed for the year are consistent with the progressive dividend policy announced by the Board in June 2005.

This performance is the result of the skills and effort of everyone within the Group.

I would like to thank the members of the NWG and NWL boards for their contribution not only to the work of the boards but also the very important board committees. They have given wise counsel and support to me as Board Chairman. Their deliberations determine not just what the Group will do, but how that work should be done.

In particular, the Audit Committee and the Remuneration Committee have important delegated responsibilities which help the Board maintain the integrity of the business. The Nomination Committee looks at the overall business and reviews the talents and experience of the boards to ensure there is a strong, complementary range of expertise to undertake the work needed and add value to the business.

In October, we welcomed Ron Lepin to the Board as a non-executive director of NWG. He is a vice president of Ontario Teachers' Pension Plan Board, which has a 25% shareholding in NWG. We also welcomed Alex Scott-Barrett as an independent non-executive director to the board of NWL in November.

In recognition of NWG's increasing focus on its core water and sewerage business through its principal operating subsidiary, NWL, my five non-executive colleagues at NWG joined me on the board of NWL on 1 January 2006.

We have had positive and constructive relationships with our regulators - Ofwat, the Environment Agency (EA) and the Drinking Water Inspectorate (DWI). We will continue to seek to maintain this relationship, based on an understanding of each other's needs and objectives. The value of these relationships lies in mutual respect and regard, and the confidence that our deliberations are rooted in sound science and secure operational procedures.

I continue to be impressed by the commitment and loyalty of our employees both to the business and the communities we serve. They perform well beyond their job descriptions. This dedication is recognised in the many letters and messages of tribute I receive from grateful members of the public. I would like to record my own thanks for the dedication of all our employees.

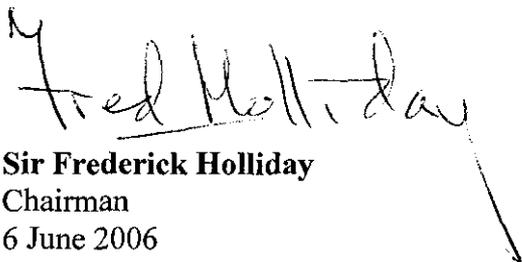
Our strategy has been chosen to guide the business through the challenges ahead, within the boundaries set by the regulators.

The strategy is simple. The job of achieving it is not. Whether we supply water, or clean it, the procedures are complex and the implications of keeping within the narrow bands of our consents are huge. We cannot always manage in the ways we have done in the past. In particular, we need to find new ways of managing as we respond to environmental changes.

This is my final report; I retire at the AGM after 15 years service to the Group and pass the chairmanship to Sir Derek Wanless.

I am leaving a splendid Group in excellent hands. We must learn to live with, and manage, a more highly energised atmosphere, a water cycle driven harder by higher temperatures and more extreme weather events. That stepped-up cycle can be managed to the benefit of both the wider environment and our customers, but it calls for different actions and attitudes. We must learn to retain water as it falls, redistribute it without waste and recycle it wherever possible. To neglect any of those will put not only our gardens and parks at risk, but also the habitats of countless creatures.

I am confident that the Group has the skills and the commitment to meet the challenge.



**Sir Frederick Holliday**  
Chairman  
6 June 2006

## **Managing Director's statement**

This year has seen further development of NWG and highlights include:

- a good start with the delivery of the investment programme of nearly £1 billion over five years to 2010;
- increased focus on the core water and waste water business with the sale of three subsidiaries; and
- continuing high levels of water quality, customer service and environmental standards.

One of the more significant announcements during the year was that Sir Fred Holliday will retire as Chairman at the AGM on 27 July. Sir Fred has guided the Group wisely since he became Chairman in 1993 after first joining the former Northumbrian Water Group plc as a non-executive director in 1991.

He was at the helm for the sale of the former group to Lyonnaise des Eaux, later Suez, in 1995; the mergers of Northumbrian Water, North East Water and Essex & Suffolk Water; and the return to the stock market of the enlarged company in 2003, when Suez decided to reduce its holding.

During that time, NWL has invested £3 billion in the north east and Essex and Suffolk to deliver demonstrable improvements in water quality and the environment.

Sir Fred has consistently provided advice based on the rigorous science of his academic background and, above all, has helped to develop an ethos of commitment in our employees, a commitment to our customers, the communities we serve, the environment and to the business. This ethos is central to the way we conduct our business and to the way we approach corporate responsibility.

His legacy is a Group recognised as providing its customers with high levels of service and which is seen to be an important part of the communities it serves.

We are all grateful to Sir Fred for everything he has brought to the Group and wish him a long and happy retirement.

We welcome Sir Derek Wanless, who joined the Board in December 2003, as incoming Chairman. Under his chairmanship we aim to continue to build on our track record of service delivery, environmental performance and stakeholder value.

Other significant developments during the year were that, in line with our strategy to focus on our core water and waste water operations, the Group disposed of FPS on 8 July 2005, Entec on 5 October 2005 and ULG on 10 April 2006.

Within our investment programme we completed major environmental capital investment projects at Birtley in Tyne and Wear, Hustledown, Sedgfield and Knitsley in County Durham and Hexham and Cramlington in Northumberland. Each of these will improve the quality of local watercourses. We have also replaced or improved 91 unsatisfactory storm water overflows and 591 kilometres of water mains have been renewed or relined.

NWL has also continued to invest in new and refurbished assets to protect drinking water supplies. The water treatment works at Horsley in Northumberland is currently being upgraded to safeguard further the quality of water supplied to the Tyneside area.

We are committed to providing a good service to all our customers. I am pleased to report that the quality of the drinking water supplied by NWL remains among the best in the country. Our own independently commissioned research records that the number of domestic customers believing we provide value for money was the highest for six years and overall levels of customer satisfaction remain high. The results from our surveys of commercial and industrial customers were equally positive. However, we are not complacent and continue to work hard to improve the quality of the service we offer to all our customers.

Ofwat has set tough and challenging efficiency targets for the next five years and NWL is working hard to meet these. NWL has established new consultant and contractor frameworks to improve the delivery of the capital investment programme and has extended the use of the Six Sigma approach across the business. This statistically-based business management tool was piloted at the regional sludge treatment centre at Bran Sands, where it produced excellent results, and it is anticipated that it will prove equally valuable throughout the business.

A highlight of the year was the visit of HRH The Princess Royal to open the Wear Valley water treatment works in Weardale in November. This unique treatment works has been supplying 250,000 customers in parts of Sunderland, Bishop Auckland and the Wear Valley since its commissioning, and has already won 11 awards for design, innovation and environmental achievement. Constructed in an Area of Outstanding Natural Beauty in national parkland, the works was designed to blend into its beautiful surroundings and built in natural stone and slate in the style of a Weardale farmstead.

The visit of the Tall Ships to the river Tyne in July 2005 was a major event both for the people of the north east of England and for the many visitors who came to the region specially. I am very proud that NWL was a major sponsor of the race, providing essential water supplies to the entire Tall Ships' fleet for the second leg of the races from the Tyne to Fredrikstad in Norway. We also supported the young people who acted as crew on two of these ships, The James Cook and Queen Galadriel.

The importance of water to well-being is being recognised increasingly and our 'Water for health' campaign in the regions we serve is one of the leaders in the industry. NWL has launched a series of innovative campaigns. These promote the benefits of water for healthy living to the elderly, to businesses, to families and provide direct support where appropriate, for example, with our 'Chill out' scheme for schools.

Further afield, the Group is part of a consortium that designed and built a €70 million waste water treatment plant for Cork City Council in Ireland which was opened in June 2005. We have now begun the 20 year operation and maintenance contract.

Analytical & Environmental Services Limited (AES) received its best assessment from the United Kingdom Accreditation Service (UKAS). It has won a number of significant contracts during the year, including one with Marks & Spencer to monitor the water systems in half of its stores nationwide.

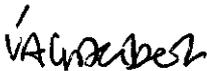
Once again, I would like to take this opportunity to thank all our employees across the Group for their individual contributions to what has been another successful year. They have a genuine commitment to our customers, the communities we serve and the environment.

**Outlook**

NWG will maintain its focus on delivering a solid performance in this regulatory period. We will continue to deliver efficiencies against a backdrop of upward cost pressure from energy prices, abstraction licences and other costs.

In Essex, where water resources are most constrained, we are in a relatively strong position and do not anticipate the need for restrictions. However, we are not complacent and continue to monitor the situation. In the medium term, we will implement our programme to increase security of supply through the Abberton reservoir scheme.

Delivery of our capital investment programme will reinforce our strong operational performance and high level of customer service and water quality.



**John Cuthbert**  
Managing Director  
6 June 2006

## Corporate responsibility

NWG takes seriously its responsibilities as a company, and our corporate responsibility policies underpin all our activities. They are an integral part of the way NWG does business.

NWG is a business with significant resources - notably employees, water and land. We believe it has a responsibility to use all those resources for the benefit not only of customers and shareholders, but also for the wider community.

NWG uses the well-established model based on the triple bottom line i.e. the economy, the environment and society:

- economic bottom line: the impact we have on the economic circumstances of our stakeholders and on economic systems at local, national and global levels;
- environmental bottom line: the impact we have on natural resources and processes, including ecosystems, land, air and water; and
- social bottom line: the impact we have on our stakeholders and the wider social systems.

Our recognised stakeholders include customers, employees, investors, suppliers, Government and the wider local community. NWG tries to balance social, environmental and economic priorities to ensure that, whilst maintaining economic stability, the environment is protected and society is enhanced.

Stakeholders expect a secure supply of water - a basic necessity for health - and they expect us to protect or enhance the environment when we return waste to that environment.

Stakeholders also expect NWG to:

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

The operational, financial and procurement activity is covered by our Code of Conduct and NWL's Sustainable Development and Environment Policies. Other activity is covered in the Corporate Responsibility Programme. This is wide ranging and NWG gives not only money but also time and facilities to help its communities. These activities are mainly targeted to support projects which make the areas served better places in which to live, work or invest. The key elements of the programme include:

- an extensive community involvement programme supporting the work of community foundations and encouraging voluntary time through the 'Just an hour' scheme and funding through 'Cheque it out';
- health and environmental campaigning, including our innovative 'Water for health' initiative;
- educational programmes which range from curriculum support to 'Back to Business' where NWL is a lead partner in a pilot scheme to link schools and businesses;
- environmental partnerships and campaigns where, as well as being a member of many environmental organisations, NWL has developed some key partnerships to help the conservation and biodiversity of our sites, for example, with the Essex Wildlife Trust at Hanningfield; and
- regional support for local community organisations and support for our adopted charity, WaterAid.

NWG has been a member of the Per Cent Club of Business in the Community (BITC) for a number of years. This requires at least 1% of pre-tax profits to be dedicated to the community in cash, time or use of facilities.

NWG continue to be a member of the FTSE4Good Index and NWL was again ranked as a top 100 company in the BITC Corporate Responsibility (CR) Index. The CR Index is a widely recognised benchmark of performance and is underpinned by a rigorous review process. It has been developed to ensure a systematic approach to managing, measuring and reporting upon the impacts that businesses have upon society and the environment.

NWL has also received numerous awards including two 'Big Tick' Awards for Excellence from BITC for integrating responsible business practice into mainstream operations, one for our water treatment works at Wear Valley (Environmental Impact) and the other for our 'Just an hour' scheme (Healthy Communities).

In future, corporate responsibility will be monitored by the recently formed Corporate Responsibility Committee, as set out on page 23.

## **Business review**

The Board of NWG has prepared this review in accordance with Section 234ZZB of the Companies Act 1985. As well as meeting that statutory requirement, the Board has extended the review to deal with other aspects of the Group's business which were addressed in its operating and financial review last year. The Board believes that this additional material will be of benefit to all stakeholders. In preparing the review, the Board has taken account of the Accounting Standards Board's Reporting Statement.

## **Who we are**

### **Northumbrian Water Group plc**

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

### **Water and waste water contracts**

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

### **Related services**

AES provides environmental monitoring services, analysis and technical consultancy to major industrial groups, environmental regulators and local authorities throughout the UK and Ireland.

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

## What we do

### Business strategy

NWG continues to focus on the Group's core competencies of water and waste water management, and aims to deliver value to all stakeholders by being a leading performer in the industry.

Each subsidiary trading company is committed to operating in a way that delivers efficient and effective outputs, to benefit the customers it serves and its fellow companies within the Group. This collaborative approach enables the Group to build on its strengths and to grow organically and in a sustainable way for the future.

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

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

#### Mission

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

To ensure we meet the aspirations set out in this mission, we focus on three strategic priorities.

To maintain an excellent reputation and our main relationships by:

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

To ensure a stable financial profile by:

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

To develop a culture of continuous improvement by:

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

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

## **KPIs**

NWG uses many performance indicators, both financial and non-financial, to monitor its progress. NWL has combined many of them into a balanced scorecard that is used to calculate employees' bonuses.

A small number of these are KPIs. For NWG the KPIs are all financial. Our approach to non-financial KPIs is illustrated using NWL as an example in an appendix on page 31.

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

### *a) Financial performance against KPIs*

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

KPI <sup>(1)</sup>	Target		Performance			
			Current year		Previous year <sup>(2)</sup>	
	NWG	NWL	NWG	NWL	NWG	NWL
Gearing to RCV	<80%	<70% <sup>(3)</sup>	77%	66%	76%	68%
Cash interest cover	>2.5x	>3.0x	2.7x	3.3x	2.7x	3.4x
Cash flow to net debt	>13%	>13%	14%	17%	15%	17%

1. Each KPI is defined in the appendix (see page 30).

2. Figures for the previous year are as at 31 March 2005.

3. Less than 65% for the regulated business of NWL.

Group gearing to Regulated Capital Value (RCV) increased slightly to 77% over the year. Cash interest cover remained stable at 2.7x. More details are given in the financial review section on page 26.

At NWL, gearing decreased to 66% and to 58% for the regulated business within NWL.

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

### *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 paragraph below	
Customer satisfaction		
- overall service	91%	88%
- value for money	83%	74%
Drinking water quality	99.9%	99.9%
Environmental performance	100%	100%

NWL maintained its high level of service, continuing to achieve 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 and perceived value for money.

#### **Financial performance**

An overview of the Group's financial performance is provided in the financial review section on pages 26 to 29.

#### **Our operating environment**

##### **Geography**

NWL operates in two different regions. Northumbrian Water in the north east of England and Essex & Suffolk Water 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 has well developed resources, such as Kielder Water, and these, coupled with above average rainfall in the region, enable it to meet anticipated demand. In addition to its sewerage services, NWL continues to provide expert industrial effluent treatment services through its massive treatment works at Bran Sands on Teesside.

In contrast, 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 too has seen a reduction in demand from heavy industry. This emphasises the importance of the company's well developed plans for resource development to meet additional water demand in a region where water resources are already constrained.

##### **Regulation**

The UK water industry is closely regulated. The standards of service provided by NWL are monitored by three main regulators – Ofwat for levels of customer service, the EA for environmental protection and the DWI for drinking water quality. NWL works closely with these and the other organisations that have an interest in the services it provides.

Many of the standards the UK water industry is required to meet are influenced by European Union (EU) Directives. This is particularly true of environmental standards. The Water Framework Directive (WFD) will become increasingly important in determining priorities for future environmental investment. The EA is responsible, under the WFD, for setting targets for water quality in the regions' rivers and estuaries and establishing a programme of measures to achieve them. We look forward to working closely with the EA and other stakeholders, such as farmers, land managers and The Coal Authority, as these plans are developed. The new Consumer Council for Water (CCWater) also has an important role in representing customer interests and ensuring that affordability is properly taken into account. This is an excellent opportunity to develop a sustainable, coordinated approach to achieving environmental objectives.

Ofwat sets price limits every five years and 2005/06 was the first year of the current price control period. NWL's operating costs in the year were close to Ofwat's assumptions but profits were higher mainly due to greater than expected growth in income. This is partly due to signing new contracts to treat industrial effluent. It is too early to draw conclusions on the prospects for outperformance over the review period. The challenging efficiency targets are made tougher by the spiralling cost of energy. In addition, the rise in direct power costs has also caused a sharp increase in the cost of key treatment chemicals. The company is reviewing options for mitigating the increase in power costs by reducing energy consumption. Reducing the size of NWL's carbon footprint in this way is consistent with our sustainable development goals.

This has been a year of regulatory transition as the provisions of the Water Act 2003 take effect. CCWater represents the water and sewerage consumers in England and Wales and took over from WaterVoice on 1 October 2005. CCWater is independent of both the water industry and Ofwat.

The new Water Services Regulation Authority came into being on 1 April 2006 replacing the Office of Water Services. However, the economic regulator for the water industry will continue to be known as Ofwat. The role of Director General of Water Services is replaced by a board. We are pleased at the continuity provided by Philip Fletcher's appointment as Chair of the new Authority and look forward to the appointment of a Chief Executive.

NWL welcomes Ofwat's new duty to contribute to sustainable development. Many of the key challenges for the water industry including implementation of the WFD, developing long term maintenance strategies, balancing supply and demand, ensuring that bills remain affordable, and managing the effects of climate change, have sustainable development at their core.

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

### **Competition**

Water companies are largely natural monopolies. However, in December 2005 the new Water Supply Licensing regime took effect. This opens the market for the provision of water to large industrial and commercial customers who use at least 50 million litres of water annually at a single site. These customers can now choose to be supplied either by their existing water company or one of the newly licensed suppliers. NWL has been heavily involved in establishing the new framework for competition.

Competition may take one of two forms and, as a consequence, there are now two licences. In the first, the licensee simply buys water wholesale from the local supplier and then retails it to the customer. This requires a 'retail licence'. In the second form, the licensee provides water to be conveyed through the distribution system of the local supplier to the site of its customer. This requires a 'combined licence'.

NWL has introduced an Access Code, following Ofwat guidance, and has produced indicative access prices that cover both retail and combined supply situations. Actual prices, however, have to be calculated on a case-specific basis.

Market activity is in the early stages of development but we expect a gradual increase in competition for non-household customers over the coming years. We believe that the excellent standard of service we provide to our customers places us in a strong competitive position.

Sewerage and trade effluent services are not covered by the new regime.

## **Relationships**

### **Reputation**

The Group continues to have a strong reputation and the Board believes that this is key to the Group's ability to conduct business. Maintaining a good reputation is regarded by the Board as a critical part of sustaining the legitimacy of the business in the eyes of customers and other stakeholders. Reputation sits alongside providing a level of service to customers at a high standard and the two together build trust in the organisation. The Group fulfils its corporate responsibility to the community through its operational and community activities.

NWL monitors opinion on reputation by tracking views through extensive research programmes with our domestic and commercial customers, employees and other stakeholders as well as extensive media monitoring.

### **Stakeholder relations**

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

NWG regularly communicates with its stakeholders, for example, via direct meetings with the business community and its representative groups such as the CBI and Chambers of Commerce. It is an active member of these and other organisations. It also meets 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 communicates with local communities through public meetings and written material when it needs to explain the impact of work it needs 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 commitment to corporate governance, NWG has undertaken an independent survey of the views of its largest shareholders on a range of issues regarding the Company. The overriding conclusion was that these 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 developed a good working relationship with its direct regulators, Ofwat, the EA and the DWI. It works closely with local authorities, which have regulatory powers which affect the company, as well as other regional authorities such as the regional development agencies. It has developed relationships and partnerships with many other organisations which affect, or are affected, by its operations. These include English Nature, the National Trust and the Wildlife Trusts as well as many other environmental and community based organisations.

## **Domestic customers**

NWL keeps its customers informed about its activities via direct communications sent with bills and an annual magazine called 'The Source'. Other information is available on the website and customers who are directly affected by works receive tailored information depending on the activity.

## **Industrial and commercial 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 continues to contribute to attracting inward investment to the north east of England, by providing the right quality and availability of water, and access to effluent treatment services, that prospective investors find attractive.

NWL also provides a regular newsletter for commercial customers alongside a series of workshops to highlight services and other benefits for customers.

## **Employees**

Every company within the Group has developed its own employee policies reflecting the framework set out in the NWG Code of Conduct. These are tailored to specific business objectives and operating environments. Each company aims to recruit and retain the best people, with a diverse range of skills, experience and backgrounds, people who are committed to making the company successful. In return, companies aim to provide opportunities and training for employees to develop their skills and capabilities to equip them to meet the challenges of their role, while rewarding the contributions of both teams and individuals.

## **Social and community relations**

The Group policy is to support the communities in which it operates and all subsidiary companies are encouraged to involve themselves in the areas they serve, although the scope for such involvement by smaller subsidiaries is limited.

NWL's corporate responsibility programme is wide ranging and includes:

- an extensive community involvement programme;
- health and environmental campaigning;
- an educational programme;
- regional support; and
- support for our adopted charity, WaterAid.

These areas have been supported by dedicating our time, money and facilities and have made a real impact within the communities in which we serve. In general terms, activities have been focused on supporting projects aimed at making areas which we serve a better place to live, work and invest in.

Employee volunteering and involvement runs through the Group and the Chairman has participated in the 'Just an hour' scheme along with 30% of employees. Everyone is encouraged to give at least 12 hours of their time at work to a community project or initiative. Last year, 4,000 hours were donated in this way. Employees also benefit from the 'Cheque it out' scheme, which allows them to utilise a special fund to give money to their own community group or project.

The Group also works with the four Community Foundations which serve its area and currently has nearly £870,000 invested primarily in endowment funds, which provide a long term investment for local community projects which benefit from grants derived from the investment income. Committees of employees determine the allocation of these grants based on expert advice received from the Foundations.

The 'Water for health' campaign continues to grow. Supported by significant medical evidence it encourages everyone to drink more water for their health. The initial focus was providing free mains fed water coolers for schools via the 'Chill out' scheme and, to date, £190,000 has been paid into the fund and nearly 250 schools have benefited from water coolers for their pupils. Water cooler trials are being carried out in care homes and prisons within the area, alongside detailed research on the impact of providing more drinking water facilities in such places.

The education programme has focused on the curriculum and competitions to encourage good citizenship and enterprise in schools. The Group is involved with skills development and the Managing Director chairs the Regional Skills Partnership in the north east.

Environmental partnerships play a key part in the management of our sites. The Wildlife Trusts of Northumberland, Durham and Essex as well as the Broads Authority and the Davy Down Trust provide experts to help with conservation and education work, and play a critical role in development at these sites.

WaterAid is our adopted charity and our employee fundraising committee has raised nearly £2 million since 1996 with the help of the Group, customers, employees and other stakeholders. These funds have helped WaterAid provide sustainable water and sanitation solutions together with hygiene education to people in Africa and Asia.

## **How we performed**

### **For our domestic customers**

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

Once again, drinking water and environmental standards have been met or exceeded. The quality of drinking water supplied in both our regions is very high and remains among the best in the country.

The number of properties suffering unplanned interruptions to water supplies returned to normal low levels in 2005/06 after the major interruption caused by unprecedented storms at Hexham in January 2005. The major scheme to replace the two pipes crossing the river Tyne that were washed away is progressing well. The pipe network in Hexham has also been strengthened to improve the security of supplies in the area.

Managing the amount of water lost from our networks is a key priority for NWL. The leakage targets agreed with Ofwat for 2005/06 were 157.5 megalitres per day (Ml/d) in the north and 69.0 Ml/d in the south, and both of these targets have been met. In the south, where resources are scarce, this is, by most comparative measures, amongst the lowest leakage levels in the country. NWL has committed to make further reductions in both the north and the south. This will be achieved by further increasing the coverage and intensity of district metering, further optimisation of pressure management, improved methods for leak detection and better use of new technology, together with our ongoing programme of renewal of old pipes.

NWL has performed very well on Ofwat's new method of measuring customer telephone service which takes into account a combination of all lines busy, calls abandoned and customer satisfaction. The underlying reason for this good performance is that the company has always aimed to answer customer calls in person rather than use automated telephone answering systems.

The number of properties flooded from sewers increased significantly in 2005/06. This was a consequence of an increased number of intense, local storms that affected some of our most densely populated urban areas. For example, a storm on 19 June 2005 was measured as a once in 500 year event.

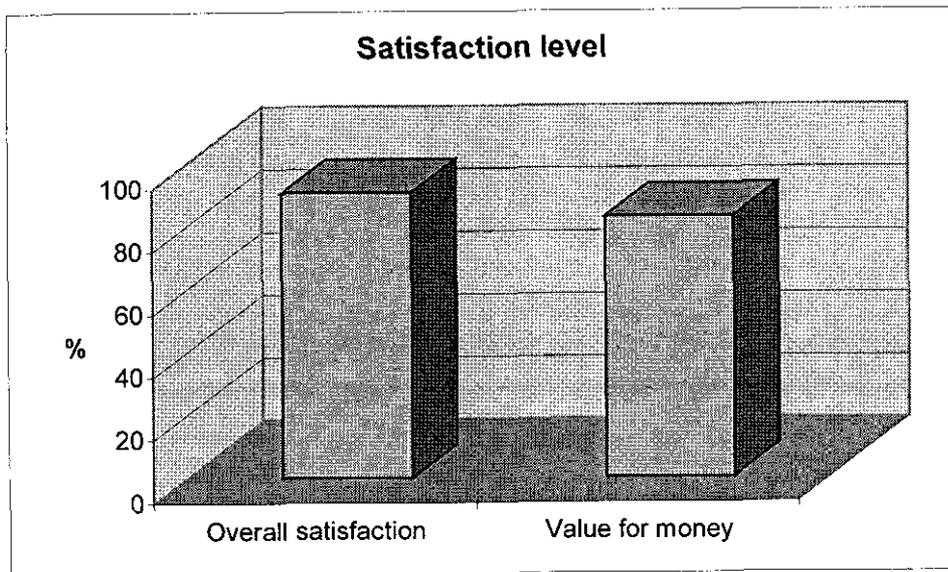
NWL is very aware of the impact flooding has on customers and is working with other stakeholders in the region to attempt to reduce the incidence of flooding and improve the way flooding is dealt with in the immediate and longer term. Regular formal liaison meetings with external bodies, such as local authorities, (most notably Newcastle City, South Tyneside and North Tyneside whose areas were worst affected) the EA and local residents groups, have proven invaluable in ensuring the most up to date information is fed back to the wider community.

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. It also reflects NWL's successful initiative to encourage as many customers as possible to use direct debit. This still proves to be the most efficient way to collect payment for bills.

In 2005/06, NWL responded to 10,241 customer complaints, across our northern and southern operating areas, equivalent to 5.1 complaints for every 1,000 properties we serve. This is higher than previous years and reflects the significant impact of summer storms when an unprecedented number of customers experienced property flooding.

CCWater formally reviews the quality of complaints handling. During this process they visit our premises to audit procedures, track samples of complaints' correspondence through our systems and assess the quality of our responses. In 2005/06, the assessment was that the handling of 96% of all northern and southern complaints were rated as 'good'.

NWL has always monitored levels of customer satisfaction and these have been consistently high. In January 2005, a more extensive and robust research mechanism was introduced. The results are shown below.



This more rigorous approach, produces results which fully represent the opinions of our customer base. Statistics for value for money are at its highest levels for six years.

#### **For our commercial customers**

NWL has continued to develop its commercial business with major companies and, in particular, has successfully negotiated three major water and waste water services contracts, with John Baarda Limited, Biofuels Corporation plc and Corus UK Limited.

NWL's largest commercial customer in the north east is Terra Nitrogen (UK) Limited based in Billingham. Terra Nitrogen has attracted new investment to the region by using its by-products, such as carbon dioxide, electricity and steam, to supply John Baarda which has now created the largest greenhouse complex in the UK. NWL's commercial and network distribution teams worked closely with John Baarda, growers of premium grade tomatoes, to provide long term water and waste water services.

Biofuels has moved into the region and built Europe's largest biodiesel plant at Seal Sands on Teesside, where it produces 250,000 tonnes of biodiesel a year from renewable vegetable crops. NWL has already supplied water services and is now working with Biofuels to provide waste water services. Biofuels is one of a number of businesses in the region to benefit from NWL's cost effective waste water treatment plant at Bran Sands.

Corus has also benefited from these effluent treatment services since 1998. It has now extended its contract with NWL, thus continuing the long term relationship between the two companies.

In addition, the existing arrangement to treat effluent from the PTA production facilities at Wilton was successfully transferred from ICI to Advansa UK Limited, which was then extended to cover additional waste streams. NWL built its first anaerobic treatment facility to carry out this work at Bran Sands and treatment began in February.

The research with this group of customers showed similar results to those for domestic customers with satisfaction levels at 91% and value for money at 85%.

**For our leisure customers**

This is a thriving area of NWL's business, largely focused on our reservoirs, especially Kielder. The year round activities have contributed to increasing both turnover and profitability.

The popularity of the Winter Wonderland event of Christmas activities for the family has grown and this year the number of visitors doubled, with around 13,000 people visiting Kielder over a six week period. A highlight of the summer months was Treibgut, a water based theatrical performance. NWL hosted this internationally acclaimed event as part of NewcastleGateshead's Culture 10 programme and the Source of the Tyne Festival.

Throughout the year, we continued to attract a diverse range of customers, from fishermen to lodge guests, who enjoyed being as energetic or relaxed as they chose in this rich and varied landscape.

We carry out regular surveys of our customers and 94% rated our customer service in this area as good or excellent.

We take part in a number of community and partnership based initiatives in this part of north Northumberland and are members of the Kielder Partnership which is currently planning to build on the existing activities and facilities with further major developments in the area.

**For our municipal customers**

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

At Ayrshire, the Group acquired Degrémont Limited's interest in the project and operating companies on 23 December 2005, taking the Group's interest to 75% in the project company and 100% in the operating company. The three effluent treatment plants continue to perform satisfactorily.

In Ireland, the Group is part of a contractual consortium that designed and built a €70 million waste water treatment plant for Cork City Council. Under the consortium agreement, the Group has full responsibility for the operation and maintenance of the plant.

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

**For customers of our related services companies**

AES' business grew by over 25% in the last year in the Occupational Hygiene, Contaminated Land, Ambient Air, and Drinking Water sectors.

The company also received its best ever annual audit results from UKAS in March 2006 and received a commendable third Investors in People assessment.

During the year, AES secured significant contracts to provide analytical services to Water Services Northern Ireland and strengthened its relationship with Marks & Spencer where it now has a contract to monitor water systems at half of its stores across the country. It also won a major contract for British Energy's Hartlepool Nuclear Power Station and continues to be one of the National Grid's four approved laboratories for the analysis of contaminated soils.

Agrer has successfully completed several important projects in Central Africa and the former USSR and continues to win new contracts in developing countries sponsored by the main funding agencies.

### **Meeting quality standards**

NWL upgraded its environmental certification to the new 2004 version of ISO 14001 (known as ISO 14001:2004) in December 2005. This rigorous, independently audited certification continues to cover all areas of our business, including operational sites and office-based teams.

For the second year running, all sewage treatment works, of which there are over 400 (160 with numeric consents), met the standards set by the EA. This is a significant achievement as the number of parameters tested for increases, and the standards in the consents become more stringent. The EA monitors performance against standards set by both the Urban Waste Water Treatment Directive and the Water Resources Act. Ofwat uses some of this information in comparing the operating performance of the various water companies.

Pollution incidents continue to be a focus of attention within the business and were reduced for the second year running.

NWL is a major consumer of energy within its water and waste water processes and is already accredited under the Carbon Trust's Energy Efficiency Accreditation Scheme. Energy costs have risen substantially over the past two years increasing the importance of reducing overall energy use. NWL monitors power consumption closely and audits energy and pump efficiency to identify areas where new plant operating procedures and efficiency improvement measures will reduce consumption.

NWL also recognises the need to reduce its use of energy generated from fossil fuel sources. It currently meets its energy needs from a mix of internal renewable generators installed at water and waste water facilities and, since 2004, from external supplies generated from green and high efficiency sources such as hydro, wind and high quality combined heat and power.

NWL has recently 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. This agreement has increased the efficiency of the plant and will also improve its future reliability.

### **Investment achievements 2005/06**

NWL made a good start with the new investment programme and expenditure is broadly in line with the requirements set out in the regulatory settlement.

Good progress has been made on work to improve our water treatment works at Chigwell, Whittle Dene, Horsley and Warkworth to prevent pesticides from farming entering water supplies.

Over 591km of water mains have been renewed or relined (renovated) to reduce iron in water supplies.

Eight sewage discharges have been improved as part of the National Environment Programme, including Hustledown and Seahouses, and 91 combined sewer overflows have been improved to enhance the aesthetic quality of rivers and streams. Substantial work is also being carried out at Redcar to improve further the quality of the bathing water.

Investment schemes to improve the sewerage system have removed 99 properties from our register for properties at risk of flooding from sewers.

NWL has now entered the pre-planning submission stage of the major project to enlarge its Abberton reservoir for water supply in Essex. Ten years have already been spent carefully preparing this major scheme which involves changes to existing abstraction licences, providing new pipelines, raising the reservoir's existing dam by 3.2 metres and constructing 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 increased by some 60% and it will be an important part of our plans to secure water supplies for our customers in one of Britain's driest regions.

#### **For our employees**

Throughout the Group we have 3,045 employees, from continuing operations, working as set out below:

<b>Group business unit</b>	<b>Average number of employees</b>	<b>%</b>
Northumbrian Water Limited	2,540	83
Water and waste water contracts	150	5
Related services	355	12
<b>Total employees</b>	<b>3,045</b>	<b>100</b>

Recruitment and retention rates within the Group vary from subsidiary to subsidiary, depending on the sector and type of employees concerned. Generally, employee turnover levels are in line with the average for the sector within which each subsidiary operates. For example, turnover in NWL during the year was less than 7%.

We have introduced health screening for all employees, whether it is critical for their job or not, and provide all employees with access to private medical insurance cover for work related conditions. NWL has continued to reduce the level of sickness absence which is now down to 3.1%.

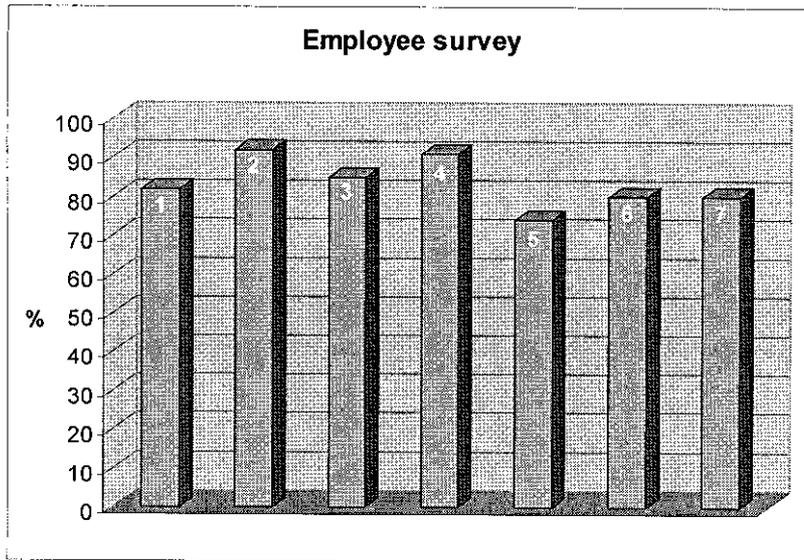
Since April 2004, Group employees have been able to invest in NWG shares in a tax efficient way through the Share Incentive Plan (SIP), which provides a free share for every three purchased. By the end of 2005/06, some 1,016 Group employees were investors in the SIP, owning a total of 1,335,065 NWG shares (0.25% of issued share capital).

Employees also have access to 'mybenefits' which provides a range of money saving benefits including tax efficient childcare vouchers and discounted store vouchers. Currently 17% of employees participate in the scheme.

Internal communication throughout the Group is supported by annual roadshows, a briefing and magazine every two months, weekly newsletters and newsflashes as appropriate. These are under review, with the planned introduction of an updated intranet and touch screen facilities in those areas where access to computers is limited.

Group companies use informal and formal measures such as the appraisal system, analysis of statistics and employee attitude surveys to engage with employees and understand their needs, morale and motivation.

NWL's commitment to monitoring and measuring employee attitudes has continued with a thorough survey conducted in the summer of 2005. A total of 49% of employees completed a detailed questionnaire examining their views on their job satisfaction, on the company, its image, management, communications, training and development, team spirit, health and safety, customer service and environmental protection.



	%
1 Enjoy job	82
2 Felt they were doing a good job and adding value	92
3 Received enough training to carry out their job safely	85
4 Environmentally aware	91
5 Proud to work for NWL	74
6 NWL has a good image	80
7 Encourages employee involvement in the community	80

The results were reported back through a summary report circulated to all employees and were also discussed with the representative bodies and at a series of roadshows to which all employees were invited. A full copy of the survey results was also published on our information management system. Management agreed to address and report back on key issues raised in the survey.

### Training and development

All Group companies are committed to training and developing their employees, to benefit both the employee and the company. They use an annual appraisal system to monitor development and identify career development opportunities and training needs. Companies and employees use the appraisal as a formal way to provide feedback and discussion.

During the year, 36 senior managers took part in the fifth management development programme and 90% of senior managers have now taken part. This concludes what has proved to be a very successful programme and future management development options are currently being reviewed. A total of 174 team leaders have now completed the team leader development programme, which was introduced in September 2004. A further 96 team leaders are taking part during 2006/07, by which time 90% of NWL's team leaders will have completed the programme.

Building upon the achievements of last year, NWL has made significant progress in refining the human resources system to provide further management information. Through 'mydata', managers now have the ability to view full training history for each of their team members and also have access to an on-line training calendar and course catalogue, enabling a proactive approach to planning and tracking learning and development.

For the year 2005/06, NWL have incorporated training and development into the business planning phase as part of departmental recruitment and 'people plans'. This enables NWL to target professional development and enhances career and succession planning.

NWL successfully completed essential skills in the workplace programmes and is now ready to begin development of the NWL accredited learning framework with relevant partners and national learning providers.

### Working environment

A safe working environment is essential for all Group companies. This is particularly important when employees work with hazardous substances or in potentially dangerous situations. The Group is committed to improving the health and safety at work of all our employees.

All Group companies have health and safety policies and ensure their employees receive the necessary training to carry out their jobs safely. They also have policies to promote the health and well-being of their employees.

NWL continues to use its 'Just culture' framework to investigate reportable accidents. The framework identifies the causes and implications of accidents, ensures that lessons are learned and encourages safe behaviour and practices.

NWL has completed the second year of a five year health and safety plan, which contains targets to reduce the number of reportable accidents. As an incentive for employees to be more aware of their own and their colleagues' safety, the company introduced an initiative linking the correct reporting of accidents and hazards, positive behaviour and the lack of reportable accidents, to monthly cash payments to the charity Mencap.

This year the number of lost time reportable accidents fell by over 50%, which exceeded the 2006/07 target in the five year plan. All employees are actively encouraged to report hazards and near misses and the number of health and safety issues reported has increased as a result of that effort. This resulted in a total of £68,740 being raised for Mencap, up from £20,500 last year, as we reduce accidents by identifying hazards earlier.

## **Risks and resources**

All subsidiaries within the Group identify and assess the impact of risks to their business. The Group uses a model that identifies risks under five headings – environment, external, operations, finance and reputation. For each risk the unmanaged and managed likelihood and consequence are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed. NWL has set measures to enable it to determine whether the risks are significant to the business. The NWL management team reviews the model in detail every year to ensure that the inclusion and assessment of each risk is still appropriate. The NWG and NWL Audit Committees consider the outcome of this review. In addition, the NWL board considers the management of significant risks at each of its meetings.

Apart from NWL, none of the subsidiaries has risks considered to be significant to the Group's short and long term value. The NWG Board considers social, environmental and ethical risks as outlined in the corporate governance report on page 43. Details of the Group's treasury risks are contained in note 22 to the financial statements.

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

Regulation acts as a proxy for comprehensive competition in the water industry and regulators encourage high standards and efficient operation in the adoption of industry best practice. As a result, NWL is subject to ever tightening standards, often requiring additional human and financial resources and new assets and systems. Similarly, UK and EU legislation changes on a regular basis and the interpretation of existing laws can also change.

Ofwat is required to take account of changes in legal obligations applying to water companies when it sets price limits at the five yearly periodic reviews. Where changes having a material financial impact occur between reviews, NWL or Ofwat may request an interim determination for a price change 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 actively monitor actual and potential changes to the regulatory and legislative frameworks to anticipate and, where possible, prepare for the impact the changes will have. The same legislation that creates additional cost burdens in NWL may also create market opportunities for AES.

### **Changes to weather patterns and their impact**

The Group's main business, the provision of water and sewerage services, is closely linked to the water cycle and is, therefore, influenced by the vagaries of the British weather. NWL is skilled and experienced in managing climatic uncertainties, both in terms of the impact of having too little and too much rainfall. Although completely outside its control, this has a detrimental impact on NWL's overall performance in the Ofwat evaluation of service measures. NWL has assessed the possible impact of global warming on both its own operations and those of key industrial and commercial customers.

Weather patterns appear to be changing, with increasing incidences of hot, dry summers and heavy rain in winter. However, severe and irregular localised storms seem to have become more frequent in recent years, causing unwelcome sewer flooding to homes and properties. Unlike 2004, this year has seen below average rainfall punctuated by some very heavy rainstorms in the summer. Widespread flooding on Tyneside was caused by an extreme storm on the afternoon of 19 June 2005 when over 70mm of rain fell in three hours. Other heavy storms on 30 June, 13 August and 31 August 2005 also caused severe flooding to properties.

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

The principal social, environmental or ethical risk considered to be significant to the value of the Group is the possibility of the removal of the opportunity to use sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, NWL (and other water and sewerage companies) would need to find or develop alternative ways to re-use or dispose of its sewage sludge. This could mean higher capital and revenue costs to provide additional sludge processing facilities. However, NWL's existing contract with Lafarge to use sewage sludge pellets as a fuel replacement in cement manufacture, gives NWL a viable alternative way of disposing of sludge in the medium term.

### **Water resources**

NWL has sufficient water reserves in its northern area, largely due to Kielder Water and the ability to top up its major rivers during periods of drought. Its southern area is in one of the driest parts of the UK and rainfall has been low since November 2004. In Suffolk, both groundwater and river levels are at about average for the time of year. The situation in Essex is currently less challenging than that facing water companies further south and NWL continues to ensure there is enough water available for customers' needs.

Over the years, NWL has carefully designed its systems in Essex to take account of the limited availability of water in summer. Consequently, our reservoirs are full at the time of preparing this report. The Langford Recycling Scheme was commissioned some two years ago to improve the security of water supply. This scheme is designed to treat up to 40 Ml/d of water during the summer months. The resource position is further enhanced by our industry-leading work to manage demand and control leakage. Customer responses to our long standing programmes to encourage the wise use of water have also helped to reduce demand.

In the medium term, there is an identified need to improve the security of supply and augment resources in the Essex area. Our plan to raise Abberton reservoir is described on page 20.

### **Policy and management**

NWG has replaced the Sustainable Development Committee with a new Corporate Responsibility Committee which has a wider remit. The new committee comprises directors, management team members and senior managers and has been established to review policies and to agree targets and the framework for activity in this important area. Specialist working groups will be charged with investigating and advising on specific environmental, workplace, marketplace and community projects. Area Corporate Responsibility Committees, covering our northern and southern operational areas, will support the Committee by monitoring the delivery of the corporate responsibility strategy in their areas as well as raising awareness of corporate responsibility activity and initiatives.

During the year, a review of NWG's approach to sustainable development resulted in the creation of a new Corporate Responsibility Team. This team will develop, monitor and champion NWG's corporate responsibility strategy and encourage and facilitate cross-functional decision making for responsible business practice.

NWL has an environment policy and a sustainable development policy and the Managing Director is personally accountable to the NWL board for both of these.

### **Environment policy**

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

### **Sustainable development policy**

NWL 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 re-use or recycle by-products. It will also protect and enhance biological diversity, ecological systems and cultural heritage.

### **Driving the business forward**

Ofwat's review of NWL's price limits in its final determination in 2004 sets the framework for the 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**

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).

### **Financial aspects**

Price limits allowed in 2005/06 increased by 6.5% before inflation and for the next four years are:

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

NWL's Regulatory Capital Value, as advised by Ofwat, at 31 March 2006 was £2,624 million and for the next four years will be:

Regulatory Capital Value at 31 March	2006/07	2007/08	2008/09	2009/10
Outturn prices, assuming inflation of 2.5% per year (£ million)	2,755	2,875	2,979	3,058

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 what were considered to be 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 would be sufficient. In NWL's case, the financeability adjustment was £20 million (in 2002/03 prices) most of which comes into effect in 2008/09 and 2009/10.

Financial performance for the appointed business has been broadly in line with Ofwat's assumptions this year, but the cost of power and abstraction charges are both rising significantly above the rate of inflation. In this context, Ofwat's efficiency assumptions for future operating costs will be challenging.

### **Investment aspects**

Over the five years to 2010, NWL will invest around £1 billion. This will include maintenance of its existing assets 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 on page 19, NWL is increasing its investment to maintain its above ground sewerage assets. These 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.

NWL is working hard to minimise the effect of the increasing number of localised heavy summer storms.

The extent and impact of flooding from sewers is a concern to NWL, its customers and CCWater. The allowance in price limits for this service improvement will not eradicate the problem, but it will mean that the worst cases can be addressed on the basis of priorities agreed with Ofwat and CCWater.

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 reducing odours from a number of its sewage treatment works.

The planning application to enlarge Abberton reservoir in Essex is due to be submitted in 2006 (see page 20) and, provided the planning process proceeds smoothly, construction will begin in 2010. When it is filled in 2014, the capacity of the enlarged reservoir will be some 60% greater than it is today.

NWL has almost completed its 20 year mains rehabilitation programme and has now started its mains flushing programme to reduce the incidence of discoloured water. NWL's investment programme, at three of its Northumberland water treatment works, to provide additional protection against pesticides is well underway and it has started 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 introduction of new UK and EU legislation (such as the Traffic Management Bill and WFD), 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);
- 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.

## **Financial review**

### **NWG's financial performance**

Revenue from continuing operations was £591.5 million for the year to 31 March 2006 (2005: £541.6 million). This increase is mainly due to the price increase on water and sewerage charges to support the continuing high capital investment programme agreed as part of the recent regulatory price review.

Profit on ordinary activities before interest from continuing operations for the year was £236.2 million (2005: £196.1 million). Operating costs increased by £9.8 million (3%) to £355.3 million. At NWL, operating costs have increased from £310.5 million to £320.9 million, principally reflecting additional depreciation charges from the commissioning of new assets, the impact of inflation plus increases in market prices for power. These increases have been partially offset by efficiency savings. Operating costs for the appointed business in 2005/06 are in line with those estimated in the 2004 final determination.

The net interest charge from continuing operations was £106.0 million (2005: £99.9 million) and includes a credit of £13.0 million (2005: £14.1 million) in respect of the amortisation of the debt fair value.

Profit on ordinary activities before tax for the year was £130.3 million (2005: £96.3 million). The tax charge of £39.3 million (2005: £20.1 million) reflects increased profitability and changes in tax rules on capitalised maintenance expenditure. The effective tax rate for the year to 31 March 2006 is 30% (2005: 21%).

The sale of subsidiaries contributed £14.6 million to the results for the year and this is included in the profit from discontinued operations of £15.4 million (see note 8 for further analysis).

The Group's gearing has remained stable with net debt increasing by £129.4 million to £2,010.4 million over the year. Cash interest cover for the Group at 2.7x is unchanged from last year (see page 10 for further analysis).

### **Accounting policies**

NWG is required to report its consolidated financial results under International Financial Reporting Standards (IFRS) from 1 April 2005. This is the first year that the Group has presented its financial statements under IFRS and the comparatives have been restated. The consolidated financial statements have been prepared in accordance with IFRS as adopted for use in the EU and as applied in accordance with the provisions of the Companies Act 1985.

The Group issued explanatory reconciliations detailing how the transition from UK GAAP to IFRS affected the results for the year to 31 March 2005, which were published on 28 November 2005. These reconciliations, including the impact on net assets at the date of transition, 1 April 2004, are attached in the note to the financial statements (see note 30).

### **Sale of subsidiaries**

In line with the strategy to focus on the core water and waste water business, and following the receipt of several expressions of interest, the Group disposed of FPS on 8 July 2005, Entec on 5 October 2005 and ULG on 10 April 2006.

FPS, which provides infrastructure replacement and rehabilitation services, was sold to a management buy-in for a cash consideration of £0.8 million.

The total consideration for the sale of Entec, which provides environmental and engineering consultancy services, to its management was £30.0 million, satisfied by £29.0 million in cash and £1.0 million of loan notes.

ULG provides overseas aid funded project work through a number of funding agencies and was sold, to PMTC International Limited, for a consideration equal to its net assets of £26,642.

In the results for the year to 31 March 2006, the Group profit on the disposal of Entec and FPS was £14.0 million and £0.6 million respectively. No tax arises on either disposal due to the availability of the substantial shareholdings exemption. A payment of £11.0 million was made into the defined benefit scheme to meet the Section 75 liabilities of both FPS and Entec.

There was no profit or loss on the sale of ULG and no defined benefit scheme liability.

### **Capital structure**

In September 2005, Northumbrian Water Finance plc (NWF), the finance subsidiary of NWL, issued £150 million index linked 2.033% Eurobonds due in 2036. The proceeds were used to repay short term loans and fund the continuing capital programme. This was the Group's first index linked debt issue and NWL will benefit from the cash flow advantage from this type of debt.

In November 2005, the EIB entered into a new £100 million facility with NWL. This offers NWL attractive funding and will be drawn on an index linked basis mid 2006, with a ten year maturity.

On 20 April 2005, NWL effectively completed the early redemption of six debenture stocks amounting to £3.7 million. On 6 September 2005, NWL gave formal notice of redemption to the holders of the 11.2% redeemable debenture stock (£3.5 million) and the 12% redeemable debenture stock (£2.0 million) and both were redeemed at par on 31 December 2005.

On 31 January 2006, NWF issued further £60 million index linked 1.6274% Eurobonds due in 2041.

On 31 March 2006, the bondholders of the £350 million 6.875% Eurobonds due in 2023 agreed to the substitution of NWF as issuer, in place of Northumbrian Services Limited (NSL), with the retention of the guarantee from NWL.

On 28 June 2006, the Group will redeem the remaining £172 million 8.625% Eurobonds utilising five year committed bank facilities of £125 million, with the balance to be paid from existing cash resources.

NWL has agreed the terms of two issues of index linked Eurobonds amounting to £200 million with a real coupon of c.1.75% and an average maturity of 45 years. Subject to the finalisation and terms of customary documentation, these index linked Eurobonds are expected to be issued in mid June 2006. This will take advantage of the current low cost of funds and secure sufficient resources to meet the needs of the capital investment programme until 2010. When issued, the Group's debt portfolio will comprise c.75% on a fixed interest rate basis and average maturity will extend to about 20 years.

### **Credit rating**

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

### **Treasury policies and objectives**

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

It also invests any surplus funds the Group may have, based on its forecast requirements and in accordance with the Group's treasury policy. On occasions, derivatives are used as part of this process, but the Group's policies prohibit their use for speculation. Full details are provided in note 22 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 in order to maintain general liquidity.

### **Earnings per share and dividends**

Basic and diluted earnings per share were 20.55 pence (2005: 14.94 pence) and 20.52 pence (2005: 14.92 pence) respectively. Earnings per share from continuing operations, adjusted for IAS 39, deferred tax and the amortisation of debt fair value were 19.62 pence (2005: 16.44 pence).

A final dividend of 7.04 pence per share for the year ended 31 March 2006 will be recommended by the Board to shareholders at the AGM on 27 July 2006 and, if approved, will be paid on 15 September 2006 to shareholders on the register at the close of business on 18 August 2006. Together with the ordinary interim dividend of 3.52 pence per share, the ordinary dividends paid and proposed for the year will be 10.56 pence per share (2005: 10 pence per share). This represents an increase of 5.6% on the dividend for the previous year and is consistent with the Board's decision to maintain a progressive dividend policy with real increases of around 3% p.a. 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.

A special dividend of 2.82 pence per share was paid in the year, in respect of the profit on disposal of subsidiaries of £14.6 million.

The dividend cover, including the special dividend, for the year is 1.5x, and 1.7x excluding deferred tax and the amortisation of debt fair value. The ordinary dividend cover from continuing operations for the year is 1.7x, and 1.9x excluding deferred tax and the amortisation of debt fair value.

### **Pensions**

The Group operates a defined benefit pension scheme providing benefits based on pensionable remuneration. The scheme remains open to existing members and to new employees of NWL. As at 31 March 2006, there were 2,351 active members.

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

The deficit under IAS 19 at 31 March 2006, was £3.7 million (2005: £76.4 million).

The Group also operates a defined contribution scheme and, as at 31 March 2006, there were 258 contributing members.

Further details of both schemes are disclosed in note 27 to the financial statements.

This business review was approved by the Board on 6 June 2006 and signed on its behalf by the Managing Director.



**John Cuthbert**  
Managing Director  
6 June 2006

## Appendix to the business review

### Group financial KPIs

#### Gearing to RCV

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

**Purpose:** The RCV generates most of the revenue stream of the Group and 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 flows from operating activities less tax divided by net interest paid.

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

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

#### Cash flow to net debt

**Definition and calculation:** Net cash flows 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 (300 north, 200 south) chosen at random, but representative of the customer base, carried out each quarter – a total of 2,000 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 (70)

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 1998 and Chairman of the Go-Ahead Group plc until October 2002. He was Chairman of Brewin Dolphin Holdings plc from 2001 to 2005. Sir Fred is a non-executive director 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. Sir Fred will retire from the NWG and NWL Boards at the close of NWG's AGM on 27 July 2006.

### **John Cuthbert** Managing Director (53)

John Cuthbert joined the water industry in 1991 and was appointed Managing Director of North East Water plc in 1993. Following the acquisition of the former Northumbrian Water Group plc by Lyonnaise des Eaux in 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 (51)

Chris Green joined the former Northumbrian Water Group plc in 1990 and was appointed its Finance Director in 1997. Chris 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 (66)

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 non-executive Chairman of Amey plc and Amey UK plc.

### **Ron Lepin** Non-executive Director (40)

Ron Lepin was appointed to the Board on 24 October 2005. He began his career at a Toronto law firm, Torys. In 1997, he joined a privatisation and project finance group at PricewaterhouseCoopers where he advised a number of foreign and domestic governments and companies on privatisations and project finance transactions. Ron joined Ontario Teachers' Pension Plan Board in 2002 and, since March 2003, has been Vice President of their Infrastructure division. Ontario Teachers' Pension Plan Board holds 25% of the issued share capital of Northumbrian Water Group plc and he is, therefore, not regarded as an independent director.

### **Martin Nègre** Independent Non-executive Director (59)

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 London listed investment trust of which he was Chairman for three years. Both funds are focused on utilities. In 2005, he was appointed a director of Promethean plc, an AIM-listed investment company.

**Sir Derek Wanless** Independent Non-executive Director (58)

Sir Derek Wanless was appointed to the Board in December 2003. Sir Derek will take over as Chairman of NWG and NWL following Sir Fred's retirement in July 2006. He became a director of National Westminster Bank in 1991 and its Group Chief Executive in 1992. He retired from this position in 1999. In 2002 and 2004, he reviewed and reported on trends affecting health services for the UK Government. Sir Derek is currently a non-executive director of Northern Rock plc, Vice Chairman of the Statistics Commission and a Trustee of the National Endowment for Science, Technology and the Arts (NESTA).

**Jenny Williams** Independent Non-executive Director (57)

Jenny Williams joined the Board in May 2004. She is a Commissioner and Chief Executive of the Gambling Commission. In addition to being Head of Water Finance and Flotation at the time of water privatisation, Jenny 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.

**Martin Parker** Company Secretary (46)

Martin Parker graduated in law in 1980 and was admitted as a solicitor in 1983, when he joined Harbottle & Lewis. He moved in-house with Northern Engineering Industries plc in 1987 and joined Northumbrian Water in 1990, concentrating on acquisitions, overseas projects and contracts with industrial customers. He was appointed Head of Group Legal Services in 1998, Company Secretary and Head of Legal Affairs for Northumbrian Water Limited in 2000 and Company Secretary of Northumbrian Water Group plc in May 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 2006.

### 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 included in the business review on pages 8 to 29.

### Financial results and dividends

The Company's results and dividends are as follows:

	<b>Year to 31.3.2006</b>
	<b>£m</b>
Profit for the year from continuing operations	91.0
Dividends paid (special – 2.82 pence per share)	14.6
Dividends paid (ordinary – 3.52 pence per share)	18.2
Dividends proposed (ordinary – 7.04 pence per share)	36.5

A final dividend payment of 7.04 pence per ordinary share will be recommended by the Board to shareholders at the AGM scheduled for 27 July 2006. If approved, the final dividend will be paid on 15 September 2006 to shareholders whose names appear on the Company's Register of Members at the close of business on 18 August 2006. Together with the interim and special dividends of 3.52 pence and 2.82 pence per ordinary share respectively, paid on 3 February 2006, the total dividend for the year will be 13.38 pence per ordinary share.

### Substantial shareholdings

As at 6 June 2006, the Company had been notified of the following interests in 3% or more of its issued share capital:

	<b>Number of shares</b>	<b>Percentage of share capital</b>
Ontario Teachers' Pension Plan Board	129,655,961	25.00
Amvescap PLC	77,892,700	15.01
Barclays PLC	27,410,323	5.29

### Waiver of dividends

Northumbrian Water Share Scheme Trustees Limited, which currently holds 976,668 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 47 and 49.

### **Purchase of the Company's own shares**

Authority was given by shareholders at the 2005 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. As at 6 June 2006, no market purchases have been made. This authority will expire at the 2006 AGM and the directors are not seeking to renew it.

### **Directors**

The current directors are Sir Fred Holliday, Sir Patrick Brown, John Cuthbert, Chris Green, Ron Lepin, Martin Nègre, Sir Derek Wanless and Jenny Williams. All were directors of the Company as at 31 March 2006 and, apart from Ron Lepin who was appointed on 24 October 2005, served throughout the year.

At 1 April 2005, Bernard Guirkinger and Christophe Cros were Suez nominated directors but resigned on 28 April 2005 following the sale of Suez's shareholding in the Company.

Sir Fred Holliday will retire from the boards of NWG and NWL following the AGM on 27 July 2006, and will be succeeded as Chairman of both boards by Sir Derek Wanless.

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), two directors will retire by rotation and offer themselves for re-appointment at the forthcoming AGM. Those directors are John Cuthbert and Chris Green. In addition, Ron Lepin, having been appointed to the Board since the 2005 AGM, will offer himself for re-appointment at the AGM. The directors' biographies are set out on pages 32 and 33. Information about those directors who are seeking appointment or re-appointment at the AGM is also contained in the Notice of Meeting booklet. This booklet includes confirmation by the Chairman, following his evaluation of their performance, 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 46 to 54.

### **Indemnification of directors**

The Company has in place directors' & officers' insurance and, on 28 November 2005, the Company entered into a deed of indemnity to grant the directors further protection against liability to third parties. The deed, together with directors' service contracts, will be available for inspection by shareholders at the AGM, or on application to the Company Secretary.

### **Donations**

The Group made charitable donations totalling £122,761 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 Company and political organisations. Political expenditure and/or donations up to a total of £25,000 for the Group, for the period from 28 July 2005 until the date of the 2006 AGM, were approved by the shareholders at the AGM held on 28 July 2005. 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 £20,000 from 27 July 2006 until the date of the 2007 AGM. During the year, the Group made political donations, applying the wide definitions from the PERA 2000, as follows:

<b>Name of EU political organisation</b>	<b>Donations for the year</b>
Labour	£5,570
Liberal Democrats	£968
Conservative	£1,177
<b>Total</b>	<b>£7,715</b>

These payments covered attendance of employees and guests at regional breakfast meetings and dinners and at a party conference fringe event, which gave employees opportunities to engage with stakeholder groups and 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**

The Company, through NWL, maintains a programme of research and development activities which are linked to UK business operations. This includes the provision of technical solutions to operations for water and waste water management and develops partnerships with academic and research organisations. During the year, the Group incurred research and development costs of £2.3 million.

### **Employees and employment policies**

#### *Equal opportunities.*

The Group operates an equal opportunity policy, incorporated into Our Code of Conduct (available on the Company's website). 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. A graduate development programme and team leader and management development programmes are offered by some subsidiaries.

#### *Communication*

Employees receive the Group magazine 'Watermark', which includes articles on 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. In 2005, NWL won awards from Communicators in Business for its internal communications magazines. The Group encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be unethical. All methods of internal communications for the Group will be reviewed and updated during 2006/07.

### *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. A third 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 27 to the financial statements.

### **Treasury policies**

Details of the Group's treasury policies are contained in note 22 to the financial statements.

### **Creditors**

The Company's policy is to agree payment terms with suppliers and to pay on time according to those agreed terms. In the absence of alternative agreement, the policy is to make payment not more than 30 days after receipt of a valid invoice. The ratio, expressed in days, between the amount invoiced to the Company by its suppliers during the year and the amount owed to its trade creditors at 31 March 2006, was 5 days.

### **Annual General Meeting**

The notice convening the AGM to be held on 27 July 2006 was sent to shareholders with this report, together with an explanation of the business to be conducted at the meeting, and a form of proxy.

### **Auditors**

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

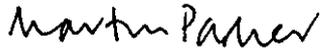
### **Financial statements preparation and going concern**

The directors consider that it is appropriate to prepare the financial statements for the financial year on a going concern basis. The directors have arrived at their decision based on consideration of the Company's detailed budget for 2006/07 and the business plan for the period to 31 March 2010. Their analysis included a review of the capital expenditure and investment plans, the anticipated funding requirements and facilities available, and the reasonableness of the underlying assumptions of both the budget and business plan.

**Directors' declaration**

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

By order of the Board



**Martin Parker**

Company Secretary

6 June 2006

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 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 area of board performance evaluation (A.6.1 and D.1.1). The Board explains why it has not followed A.6.1 and D.1.1 later in this report.

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 has also taken account of best practice on reporting, for example, ABI and NAPF guidelines, in preparing this report.

### The Board

The Board sets and implements the Company's strategy and ensures compliance with agreed policies and legal and fiduciary obligations. The Board's decision to sharpen the focus on the core business underpinned the appointment of NWG non-executive directors Sir Derek Wanless, Sir Patrick Brown, Ron Lepin, Martin Nègre and Jenny Williams to the NWL board on 1 January 2006. This ensures that all members of the NWG Board are fully familiar with NWL's operational priorities and participate in its regulatory and strategic positioning.

The Board met five times during the year and held an additional strategy meeting in January 2006. Attendance at meetings was good throughout the year, with all current NWG directors recording 100% attendance at Board and appropriate committee meetings. The Company Secretary, Martin Parker, ensures that directors are kept informed and that information flows effectively within the Group. An intranet site has been created to give the Board easy access to minutes and papers from Board and committee meetings. The Chairman ensures that important issues are given enough time at meetings and that all directors can express their views. This enables full and vigorous discussion of key items.

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

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 Board meeting.

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

### **Board balance and independence**

There are eight directors. Sir Fred Holliday is the non-executive Chairman. His other significant appointments are as Chairman of Northern Venture Trust plc and as a non-executive director of Northern 2 VCT plc. The executive directors are John Cuthbert (Managing Director) and Chris Green (Finance Director). Sir Patrick Brown is the Senior Independent Non-executive Director and the other independent non-executive directors are Martin Nègre, Sir Derek Wanless and Jenny Williams. Ron Lepin is also a non-executive director, but is not independent as he is Vice President, Infrastructure, of Ontario Teachers' Pension Plan Board, which holds 25% of the issued share capital of the Company.

Sir Fred will retire from the Board on 27 July 2006 and will be succeeded as Chairman by Sir Derek Wanless, who is also a non-executive director of Northern Rock plc. 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 32 and 33 and details of their service contracts are in the directors' remuneration report on page 50.

As at 1 April 2005, the Company's former shareholder, Suez, had two nominated directors on the Board, but they both resigned on 28 April 2005 following Suez's sale of its 25% stake in the Company.

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 and the duration of his connection with NSL was only 12 months. He is also a non-executive director of Ecofin Water & Power Opportunities plc, which held less than 1.5% of the share capital of the Company as at 31 March 2006. 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. He has demonstrated this consistently since joining the Board in 2003.

### **Information and professional development**

All directors have access to independent professional advice to assist them in the performance of their duties, at the Company's expense, and to the Company Secretary for advice and assistance. The Chairman, with the assistance of the Company Secretary, monitors the induction and training requirements of directors.

### **Performance evaluation**

A full evaluation of the performance of the Board, its committees and of individual directors was conducted in January 2005 and the Board proposes to carry out a formal appraisal during the 2006/07 financial year and regularly thereafter. Except as explained below, there was no formal performance appraisal of the Board and committees during the year. The Chairman considered that the withdrawal of the Suez appointed directors, the appointment of Ron Lepin, the appointment of the NWG non-executives to the NWL board and the announcement of his own retirement required a period of adaptation and that a formal performance assessment in the context of such changes would be unlikely to be worthwhile. The Chairman did, however, assess the performance of the directors seeking appointment or re-appointment at the AGM and further details are provided in the notice of the AGM.

### **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 of executive directors are generally retained by the Company, except in the case of John Cuthbert's appointment as an associate director of County Durham Development Company Limited, where his fee is donated to a charitable foundation in the north east of England. The Nomination Committee ensures, on appointment, that a director has sufficient time to undertake his or her duties. External commitments taken on after appointment are discussed with the Chairman to avoid detriment to the performance of the director's duties for the Company.

### **Board committees**

The Board has established Audit, Nomination, Remuneration and Treasury Committees to assist it in the performance of its duties. The Board sets the terms of reference of the committees and receives regular reports from the Chairmen of these committees at board meetings. The terms of reference of the Audit, Nomination and Remuneration Committees are available on the Company's website or from the Company Secretary. The membership of these committees complies with the Combined Code.

### **Remuneration Committee**

The work of the Remuneration Committee and details of the directors' remuneration are set out in the directors' remuneration report on pages 46 to 54.

### **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. Bernard Guirkingner was a member of the Committee until his resignation from the Board on 28 April 2005, but there were no meetings between the start of the year and the date of his resignation.

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's general policy is to use external recruitment consultants or to advertise in order to identify suitable candidates. From 1 April 2006, all non-executive directors will be appointed for a term of one year. In accordance with the Articles, all directors are subject to re-election at the AGM at least every three years.

The Nomination Committee met three times during the year and all members attended all meetings, apart from Sir Fred Holliday who attended two meetings. During the year the Committee considered:

- the appointment of Ron Lepin to the NWG Board;
- the appointment of a successor to Sir Fred Holliday, who will retire as Chairman of both the NWG and NWL boards on 27 July 2006;
- the appointment of a non-executive director to the NWL board following Richard Allan's retirement;
- the appointment of the NWG non-executive directors to the NWL board; and
- the renewal of appointments of non-executive directors on the NWG and NWL boards whose contracts for service expired during the year.

Ron Lepin was the senior executive at Ontario Teachers' Pension Plan Board who managed the purchase of Suez's 25% interest in NWG. Following that purchase, Mr Lepin met Sir Fred Holliday, John Cuthbert and Chris Green and, on 27 July 2005, he met the NWG and NWL boards and described his own professional background and experience, as well as Ontario Teachers' Pension Plan Board's investment strategy. Following discussions between the NWG and NWL boards, consultation with several substantial shareholders and a recommendation by the Nomination Committee, Mr Lepin was invited to join the NWG Board on 24 October 2005.

## **Accountability and audit**

### **Audit Committee**

The Audit Committee comprises Sir Patrick Brown (Chairman), Sir Derek Wanless and Jenny Williams, who have all served throughout the year and who have attended all meetings of the Committee. The Board is satisfied that Sir Derek Wanless has recent significant financial experience. The Managing Director and Finance Director are invited to Audit Committee meetings with the permission of its Chairman, but have no right of attendance. Sir Patrick meets regularly with the Internal Audit Manager.

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

- monitoring the integrity of the financial statements of the Company;
- reviewing the Company's internal financial controls;
- monitoring and reviewing the effectiveness of the internal audit function;
- monitoring and reviewing the performance of the external auditors; and
- monitoring the potential impact and management of significant risks on the business using a risk methodology which meets 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.

Given the importance of NWL to the Group's business, the Committee works closely with the Audit Committee of NWL. In particular, both committees regularly review NWL's debt recovery strategy and performance.

### **Non-audit services**

The Committee has approved a procedure for the approval of non-audit services to safeguard the objectivity and independence of the external auditors. 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 judgement, 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 4 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. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the Turnbull Report. This process has been in place throughout the year and up to the date of approval of the annual report and financial statements 2005/06. 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 Internal Audit team manages a process whereby all of the financial controls within the Company are identified and certified by the relevant manager as having operated for the full year. As part of a programme of work (which is agreed with the Audit Committee), these controls are tested throughout the year. A report detailing any areas of concern is produced after each audit. As part of the same process all of the key business risks are identified. Each risk is assessed on an unmanaged basis, the controls which are in place to mitigate the risks are detailed and the risk is then re-assessed after these controls.

Internal Audit's findings and recommendations are presented to the Audit Committee along with agreed actions. The relative significance of each of the findings is given and the more significant issues are discussed in greater detail. Internal Audit updates progress against any agreed actions until the control weakness is resolved.

### **Organisational structure**

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

The NWL management team manages the major business of the Group and consists of John Cuthbert (Managing Director), Chris Green (Finance Director), Graham Neave (Operations Director and on NWL board), Ceri Jones (Regulation & Compliance Director and on NWL board), John Devall (Water & Networks (South) Director), Ian Donald (Customer Services Director), Diane Morton (HR Director), Colin Price (Technical Director) and Henry Wilson (Waste Water & Networks (North) Director). The NWL management team meets monthly to consider and discuss progress against annual and monthly financial and operational targets and to prepare the business plan for consideration and approval by the NWL board.

The Board is able to monitor the impact of social, environment and ethical matters on the Group's business, to assess the impact of significant risks on the business, and to evaluate methods of managing these risks through reports it receives from the Subsidiary Boards and the Audit Committee. The only environmental risk considered to be significant by the Board is the potential loss of the use of agricultural land for processed sewage treatment sludge disposal. 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 23.

For a number of years, the Subsidiary Boards have performed a full annual business risk analysis, 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. The NWL management team considers significant risks in a structured way every two months, assessing the likelihood and potential impact of the relevant risks both before and after risk management measures have been put in place. Further details about how risks and uncertainties facing the Group are assessed and managed are included in the business review on pages 22 to 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, consisting of Sir Derek Wanless (Chairman) and Sir Patrick Brown, met once during the year, and both members were present. Christophe Cros was a member of the Committee between 17 March 2005 until his resignation from the Board on 28 April 2005 but there were no meetings of the Committee during that period.

The Treasury Committee's role is to:

- review and recommend treasury policies to the Board; and
- monitor the current economic environment and the likely future financing requirements of the Group.

Treasury policies were last approved by the Board on 26 May 2005.

### **Relations with shareholders**

The Company welcomes constructive communication with all its shareholders. The executive directors of the Company maintain regular contact 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 77 times with institutional investors and discussed any issues raised at these meetings with the rest of the Board. Investor feedback reports from these meetings, prepared by the Company's advisers, are also considered at Board meetings to update the non-executive directors on the views of major shareholders. The Board believes that these methods of investor feedback provide the Senior Independent Non-Executive Director and the other non-executive directors with a balanced understanding of the issues and concerns of major shareholders. The Chairman continues to welcome contact with any shareholders who have matters they wish to discuss. The Company has not received any requests from institutional shareholders to meet with non-executive directors.

All shareholders are encouraged to contact the Company with queries or suggestions. Shareholder feedback on last year's annual report has been taken into account in the preparation of the report and financial statements for this year. The Chairman sends a welcome letter to all new non-corporate shareholders, which includes information on services available to shareholders. Shareholder information is also available on the Company's website. During the year, the Company launched a programme to encourage shareholders to receive electronic communications from the Company and to manage their shareholdings online.

**AGM**

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



**Martin Parker**  
Company Secretary  
6 June 2006

## Directors' remuneration report

### **The Remuneration Committee**

The Remuneration Committee of the Board (the Committee) determines the remuneration and terms of employment of the Chairman of the Company, executive directors and senior management of the Group in accordance with a remuneration policy approved by the Board. The Committee members are Martin Nègre (Chairman), Sir Patrick Brown and Sir Derek Wanless, all considered by the Company to be independent non-executive directors. The Committee met four times during the year with 100% attendance by all three members. The Committee's terms of reference are available on the Company's website. The Committee received advice during the year from its appointed remuneration consultants who, until May 2005, were The Remuneration Practice, and, since May 2005, are New Bridge Street Consultants LLP (NBSC), and also from John Cuthbert (Managing Director). NBSC has carried out a full review exercise in respect of the remuneration packages offered to senior executives and will continue to assist the Committee in maintaining best practice in relation to remuneration. Neither The Remuneration Practice nor NBSC 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 2005/06, is to provide remuneration that is sufficient to attract, retain and motivate directors of the quality required to run the Company successfully. That being said, the Committee's paramount principle is to pay fairly. The Committee is aware of the risk of remuneration being ratcheted up as a result of benchmarking exercises and confirms that this has not happened.

The policy conclusions of the Committee following the review by NBSC were:

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

The implementation of this remuneration policy is described below.

The Committee is always available to engage with major stakeholders and their representatives to discuss remuneration matters. During the year the Committee received no such approaches.

Consistent with its fair pay policy, when considering the remuneration packages of senior executives and directors, the Committee takes into account pay awards to other employees in the Group.

## Elements of remuneration

### Executive directors: basic salary and benefits

The basic salaries paid to each director during the year are set out on page 51. Basic salary is the only pensionable element of the executive directors' remuneration package. The NBSC review revealed that the Managing Director's basic salary is less than the median paid to his counterparts at other quoted water companies. Notwithstanding this, and at his own suggestion, the Managing Director has not been awarded a salary increase in 2006. A salary increase was awarded to the Finance Director in order to bring his salary closer to 75% of the Managing Director's salary, which is considered to be an appropriate relativity.

Benefits provided to the executive directors 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

For the 2005/06 and later financial years, the Committee has concluded that the annual bonus plan should reflect the interests of all of the Company's stakeholders. Maximum annual bonuses for the executive directors in 2005/06 are 70% of salary, which are apportioned as follows:

Stakeholder	Bonus Metric	Maximum bonus available as a % of salary
Shareholders	PBT	40%
Customers	Overall Performance Assessment (OPA) rating	5%
Employees	Percentage lost time through sickness	5%
	Bespoke personal targets	20%
Total		70%

John Cuthbert's personal targets related principally to business strategy, investor relations, succession planning and remuneration strategy, as well as a range of financial matters. Chris Green's personal targets were focused mainly on funding, the maintenance of key financial ratios and measures and the implementation of IFRS.

Taking account of performance against personal targets and the OPA, PBT and lost time performance, bonuses equal to 44.5% and 48.25% of basic salary were approved for payment to John Cuthbert and Chris Green, respectively.

### 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 on page 48, and LTIP awards made to directors are shown in the table on page 53.

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

<b>SUMMARY OF LTIP</b>	
LTIP awards made 27 January 2004 and 22 December 2004	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth 40% of salary.
Performance conditions	Comparison of TSR with 2 comparator groups over 3 years: (1) 70% of award depends on the Company's TSR performance against other listed water companies: AWG plc, Bristol Water plc, East Surrey Holdings plc, Kelda Group plc, Pennon Group plc, Severn Trent plc and United Utilities plc; and (2) 30% of award depends on the Company's TSR performance against the FTSE 250 Index, excluding investment trusts.
Vesting schedules	(1) 30% vests at median performance with sliding scale based on ranking to 100% if the Company tops the group. Where the Company's TSR performance is below the median performance of the comparator group, none of that element of the award will vest. (2) 30% vests if the Company's TSR equals the FTSE 250 Index, increasing to 100% if the Company's TSR out-performs the Index by at least 6%. Where the Company's TSR performance is less than that of the Index, none of that element of the award will vest.
LTIP award made 9 December 2005 and policy for future awards	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth 70% of salary.
Performance conditions	As above.
Vesting schedules	(1) as above, but between median and upper quartile, the vesting will be calculated on a straight line basis comparing the Company's TSR to that of the median and upper quartile positions, rather than ranking. (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance. Where the Company's TSR performance is below the median, none of that element of the award will vest.

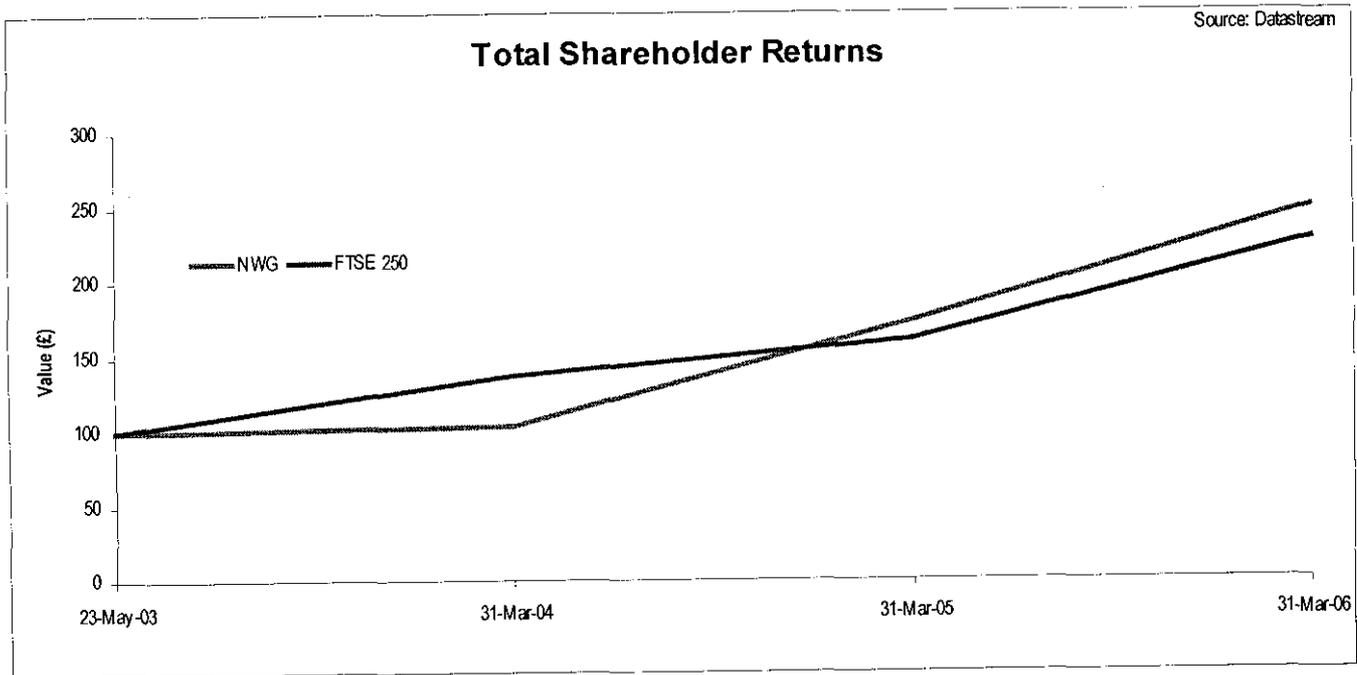
In addition, awards will only vest if the Committee is satisfied that the Company's TSR performance is consistent with the underlying business performance of the Company.

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

The performance conditions described above were chosen to align the interests of participants in the LTIP with those of shareholders. Rewards should only be earned over a number of years in circumstances where shareholders have benefited. An independent firm will be engaged by the Committee to calculate the TSRs and to assess the extent to which the performance conditions have been met, so that the process is rigorous and transparent.

### 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 2006, 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 2006, 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 37. 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 54.

## Service contracts

From 1 April 2006, all non-executive directors will be appointed for a term of 12 months with a 6 month notice period on either side. Details of the employment contracts of the directors who served during the year are set out below.

	<i>Contract start date</i>	<i>Unexpired term<sup>(1)</sup></i>	<i>Notice period by either side</i>	<i>Contract end date</i>
<b>Executive Directors</b>				
John Cuthbert <sup>(2)</sup>	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
Chris Green <sup>(2)</sup>	22 May 2003	Not fixed term	12 months	Normal retirement age (65)
<b>Non-executive Directors<sup>(3)</sup></b>				
Sir Fred Holliday	23 May 2003	2 months	None	27 July 2006
Sir Patrick Brown	12 May 2006	11 months	6 months	11 May 2007
Christophe Cros <sup>(4)</sup>	17 March 2005	N/A	N/A	Resigned 28 April 2005
Bernard Guirkinge <sup>(4)</sup>	27 May 2004	N/A	N/A	Resigned 28 April 2005
Ron Lepin	24 October 2005	28 months	None	23 October 2008
Martin Nègre	12 May 2006	11 months	6 months	11 May 2007
Sir Derek Wanless	1 December 2003	6 months	6 months	30 November 2006
Jenny Williams	27 May 2004	12 months	6 months	26 May 2007

### Notes:

1. Calculated as at 6 June 2006 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, who resigned following the disposal by Suez of its 25% shareholding.

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. Ron Lepin was appointed to the Board during the year, and will therefore seek appointment at the AGM. John Cuthbert and Chris Green 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 appointment and re-appointment are provided on pages 32 and 33.

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

### External appointments of executive directors

John Cuthbert is a non-executive director of One NorthEast, a regional development agency. His net fee for 2005/06 for this position is £4,714 paid to, and retained by, the Company. John is also an associate director of County Durham Development Company Limited. His fee for this position of £1,500 p.a. is donated to a charitable foundation in the north east of England. The Board's position on external appointments is described in the corporate governance report on page 41.

### 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 <sup>(1)</sup> £000	Total for the year ended 31 March 2006 £000	Total for the year ended 31 March 2005 £000
<b>Executive Directors</b>						
John Cuthbert	-	270	8	120	398	358
Chris Green	-	180	8	87	275	240
<b>Non-executive Directors</b>						
Sir Fred Holliday	125	-	24	-	149	145
Sir Patrick Brown <sup>(2)</sup>	38	-	-	-	38	38
Christophe Cros <sup>(3,4)</sup>	2	-	-	-	2	1
Bernard Guirkingier <sup>(3,5)</sup>	2	-	-	-	2	25
Ron Lepin <sup>(6)</sup>	12	-	-	-	12	-
Martin Nègre <sup>(7)</sup>	35	-	-	-	35	35
Sir Derek Wanless	30	-	-	-	30	30
Jenny Williams	30	-	-	-	30	25
<b>Total remuneration</b>	274	450	40	207	971	897

Notes:

1. The annual bonus is payable in June 2006, for performance during the year ended 31 March 2006.
2. Includes additional fee paid as Chairman of the Audit Committee.
3. The fees of these directors were payable to Suez.
4. Appointed on 17 March 2005 and resigned on 28 April 2005.
5. Appointed on 27 May 2004 and resigned on 28 April 2005.
6. Appointed on 27 October 2005. Fee payable to Ontario Teachers' Pension Plan Board.
7. Includes additional fee paid as Chairman of the Remuneration Committee.

### Directors' pensions and pension benefits (audited information)

The main features of the Northumbrian Water Pension Scheme are set out in note 27 to the financial statements. The Committee has reviewed its pensions policy in the light of the introduction of the new pension rules in April 2006, and 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 2005 £000	Accrued pension at 31 March 2006 £000	Increase in accrued pension £000	Increase in accrued pension net of inflation £000	Transfer value of net increase in accrued pension £000	Transfer value of accrued pension at 1 April 2005 £000	Transfer value of accrued pension at 31 March 2006 £000	Total change in transfer value less directors' contributions £000
John Cuthbert	108.7	125.9	17.2	14.7	231.0	1,523.0	1,983.2	446.7
Chris Green	59.8	67.4	7.6	6.2	117.8	771.0	1,077.5	295.7

Notes:

1. Accrued pensions shown are the amounts that would be paid annually on retirement based on service to the end of the year.
2. Voluntary contributions paid by the directors and resulting benefits are not shown.
3. The change in transfer value includes the effect of a change in the GN11 basis used to calculate transfer values following the formal actuarial valuation of the Scheme as at 31 December 2004. It also allows for fluctuations in the transfer value due to factors beyond the control of the Company and directors, such as changes in stock market conditions.
4. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11.
5. The total contribution paid by the Company during the year was £30,750.

**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 2006:

	Number of shares held at the start of the year or subsequent date of appointment	Number of shares held as at 31 March 2006 <sup>(1)</sup>
Sir Patrick Brown	43,000	43,000
John Cuthbert	100,000	100,000
Chris Green <sup>(2)</sup>	65,000	65,000
Sir Fred Holliday	8,700	8,700
Ron Lepin <sup>(3)</sup>	-	-
Martin Nègre <sup>(4)</sup>	190,000	190,000
Sir Derek Wanless	30,000	30,000
Jenny Williams	6,000	6,000

Notes:

1. There have been no changes in any of the above interests from the end of the year to 6 June 2006.
2. These shares are beneficially owned by Mrs Geraldine Green.
3. Appointed on 24 October 2005.
4. 20,000 of these shares are beneficially owned by Mrs Linda Nègre.

The directors had the following beneficial or family interests in debentures of NSL, a subsidiary of the Company, as at 31 March 2006:

	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 2006 <sup>(1)</sup>
John Cuthbert	8.625% Eurobonds 28.6.2006	40,000	40,000
Chris Green <sup>(2)</sup>	8.625% Eurobonds 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 6 June 2006. However, these debentures will be redeemed on 28 June 2006 at par.
2. These debentures are beneficially owned by Mrs Geraldine Green.

### Directors' interests in LTIP awards (audited information)

As at 31 March 2006, the directors had the following conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP:

	Award date	Awards held at the start of the year or subsequent date of appointment	Awarded during the year	Awards vested/lapsed during the year	Awards held as at 31 March 2006 <sup>(4)</sup>
John Cuthbert	27.1.04 <sup>(1)</sup>	85,603	-	-	85,603
	22.12.04 <sup>(2)</sup>	67,001	-	-	67,001
	9.12.05 <sup>(3)</sup>	-	75,903	-	75,903
Totals		152,604	75,903	-	228,507
Chris Green	27.1.04 <sup>(1)</sup>	56,618	-	-	56,618
	22.12.04 <sup>(2)</sup>	44,221	-	-	44,221
	9.12.05 <sup>(3)</sup>	-	50,602	-	50,602
Totals		100,839	50,602	-	151,441

Notes:

1. 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. 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. The market value of the shares on the date of the award was 249.16 pence per share. The three year performance period runs from 1 October 2005 to 30 September 2008.
4. There have been no changes to any of the above interests in awards under the LTIP from the end of the year to 6 June 2006.
5. The cost of conditional awards is charged to the income statement over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.2 million was charged to equity.
6. Details of the performance conditions are shown on page 48.

Ordinary 10 pence shares required to fulfil LTIP awards that have vested may be provided by Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited. The Trustees are Sir Patrick Brown, Martin Nègre and Anita Frew (a non-executive director of NWL). 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 2006, held a total of 976,668 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 SIP (audited information)

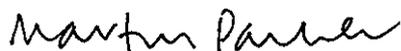
The directors who held office as at 31 March 2006 had the following interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP<sup>(1)</sup>.

	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 2006 <sup>(2)</sup>	Number of SIP shares held as at 6 June 2006 <sup>(2)</sup>
John Cuthbert	1,716	2,780	3,565
Chris Green	1,716	2,780	3,565

Notes:

1. A summary of the SIP can be found in the directors' report on page 37.
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  
6 June 2006

## **Directors' responsibilities**

### **Statement of directors' responsibilities**

The directors are responsible for preparing the annual report and Group and Company financial statements in accordance with applicable law and regulations.

United Kingdom company law requires the directors to prepare Group and Company financial statements for each financial year. Under that law the directors are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and have elected to prepare the Company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice.

The Group financial statements are required by law and IFRS as adopted by the EU to present fairly the financial position and performance of the Group.

The Company financial statements are required by law to give a true and fair view of the state of affairs of the Company.

In preparing each of the Group and Company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- for the Group financial statements, provide additional disclosures when compliance with specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance;
- for the Group financial statements, state that the company has complied with IFRS, subject to any material departures disclosed and explained in the financial statements;
- for the Company financial statements, state whether applicable United Kingdom accounting standards have been followed, subject to any material departures disclosed and explained in the Company financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and Company will continue in business.

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

## Report of the Auditors

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

We have audited the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2006 which comprise Consolidated Income Statement, the Consolidated Statement of Recognised Income and Expense, the Consolidated Balance Sheet, the Consolidated Cash Flow Statement, and the related notes 1 to 30. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2006 and on the information in the Directors' Remuneration Report that is described as having been audited.

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

### **Respective responsibilities of directors and auditors**

The directors are responsible for preparing the Annual Report and the Group financial statements in accordance with applicable United Kingdom law and IFRS as adopted by the EU as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the Group financial statements give a true and fair view, the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation and that the information given in the Directors' Report is consistent with the financial statements.

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

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2003 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 Group financial statements. The other information comprises Highlights, NWG at a Glance, the Chairman's Statement, the Managing Director's Statement, Corporate Responsibility, the Business Review, Appendix to the Business Review, Board Directors' Biographies, Directors' Report, the Corporate Governance Report, the unaudited part of the Directors' Remuneration Report and Shareholder Information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

**Basis of audit opinion**

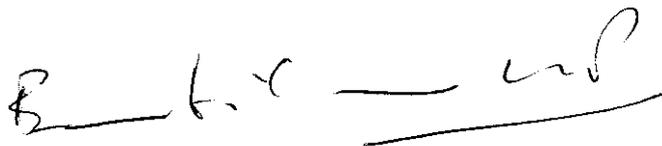
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group financial statements. It also includes an assessment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

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

**Opinion**

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the EU, of the state of the Group's affairs as at 31 March 2006 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the Group financial statements.



Ernst & Young LLP  
Registered Auditor  
Newcastle upon Tyne  
6 June 2006

Northumbrian Water Group plc

**Consolidated income statement**

For the year ended 31 March 2006

	Notes	Year to 31.3.2006 £m	Year to 31.3.2005 £m
<b>Continuing operations</b>			
Revenue	2	591.5	541.6
Operating costs	3	(355.3)	(345.5)
<b>Profit on ordinary activities before interest</b>	2	<b>236.2</b>	196.1
Finance costs payable	6	(112.7)	(107.7)
Finance income receivable	6	6.7	7.8
Share of profit after tax of associates and jointly controlled entities		0.1	0.1
<b>Profit on ordinary activities before taxation</b>	2	<b>130.3</b>	96.3
- current taxation	7	(15.6)	1.0
- deferred taxation	7	(23.6)	(21.0)
- overseas tax	7	(0.1)	(0.1)
<b>Profit for the year from continuing operations</b>		<b>91.0</b>	76.2
<b>Discontinued operations</b>			
Profit for the year from discontinued operations	8	15.4	1.2
<b>Profit for the year</b>		<b>106.4</b>	77.4
Attributable to:			
Equity shareholders of the Company		105.9	77.9
Minority interests		0.5	(0.5)
		<b>106.4</b>	<b>77.4</b>
Basic earnings per share for profit attributable to ordinary equity holders of the parent	9	20.55p	14.94p
Diluted earnings per share for profit attributable to ordinary equity holders of the parent	9	20.52p	14.92p
Basic earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent	9	17.57p	14.71p
Diluted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent	9	17.55p	14.69p
Adjusted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments)	9	19.62p	16.44p
Ordinary final dividend proposed per share	10	7.04p	7.13p
Special dividend paid per share	10	2.82p	-
Dividend paid per share	10	10.65p	7.50p

Northumbrian Water Group plc

**Consolidated statement of recognised income and expense**

For the year ended 31 March 2006

	Year to 31.3.2006	Year to 31.3.2005
	£m	£m
Actuarial gains	52.7	21.2
Losses on cash flow hedges	(3.8)	-
Gains on cash flow hedges	1.0	7.2
Tax on items charged or credited to equity	(15.6)	(7.3)
Translation differences	-	0.4
Profit for the year	106.4	77.4
<b>Total recognised income and expense</b>	<b>140.7</b>	<b>98.9</b>

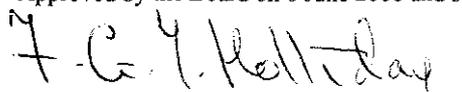
Northumbrian Water Group plc

**Consolidated balance sheet**

As at 31 March 2006

	Notes	31.3.2006 £m	31.3.2005 £m
<b>Non-current assets</b>			
Goodwill	11	3.7	0.1
Other intangible assets	11	64.2	64.2
Property, plant and equipment	12	2,985.6	2,800.3
Investments in jointly controlled entities	13	3.6	3.6
Investments in associates	13	-	1.4
Financial assets		22.2	27.6
Other investments	13	0.3	0.4
		<b>3,079.6</b>	<b>2,897.6</b>
<b>Current assets</b>			
Inventories	15	3.3	4.5
Trade and other receivables	16	109.5	117.3
Cash and cash equivalents	17	176.6	95.0
		<b>289.4</b>	<b>216.8</b>
<b>Total assets</b>		<b>3,369.0</b>	<b>3,114.4</b>
<b>Non-current liabilities</b>			
Interest bearing loans and borrowings	19	1,972.9	1,929.7
Provisions	21	3.1	2.7
Deferred income tax liabilities	7	495.6	450.4
Pension liability		3.7	76.4
Other payables		10.6	16.6
Grants		179.3	161.3
		<b>2,665.2</b>	<b>2,637.1</b>
<b>Current liabilities</b>			
Interest bearing loans and borrowings	19	236.7	73.9
Provisions	21	0.3	2.5
Trade and other payables	18	156.3	169.4
Income tax payable		9.7	1.2
		<b>403.0</b>	<b>247.0</b>
<b>Total liabilities</b>		<b>3,068.2</b>	<b>2,884.1</b>
<b>Net assets</b>		<b>300.8</b>	<b>230.3</b>
<b>Capital and reserves</b>			
Issued capital	23/24	51.9	51.9
Share premium reserve	24	446.5	446.3
Cash flow hedge reserve	24	1.5	4.3
Treasury shares	24	(1.7)	(0.9)
Retained earnings	24	(198.9)	(272.4)
<b>Equity shareholders' funds</b>		<b>299.3</b>	<b>229.2</b>
Minority interests	24	1.5	1.1
<b>Total capital and reserves</b>		<b>300.8</b>	<b>230.3</b>

Approved by the Board on 6 June 2006 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 2006

	Notes	Year to 31.3.2006 £m	Year to 31.3.2005 £m
<b>Operating activities</b>			
<b>Reconciliation of profit before interest to net cash flows from operating activities</b>			
Profit on ordinary activities before interest		236.2	196.1
Profit before interest on discontinued operations		1.2	1.8
Depreciation and other similar non-cash charges		83.6	78.9
Net charge for provisions, less payments		(0.5)	(1.1)
Movements in working capital		(5.5)	(7.7)
Cash generated from operations		315.0	268.0
Special contributions paid in respect of retirement benefits		(22.8)	-
Net interest paid		(119.7)	(113.6)
Income taxes (paid)/received		(6.5)	6.7
<b>Net cash flows from operating activities</b>		<b>166.0</b>	<b>161.1</b>
<b>Investing activities</b>			
Interest received		4.1	10.1
Capital grants received		21.4	21.3
Purchase of subsidiary undertaking (net of cash acquired)		2.4	-
Proceeds on disposal of subsidiary undertakings		18.6	-
Proceeds on disposal of property, plant and equipment		2.0	2.7
Dividends received from jointly controlled entities		0.8	0.3
Purchase of property, plant and equipment		(206.7)	(181.7)
Other cash items		0.2	-
<b>Net cash flows from investing activities</b>		<b>(157.2)</b>	<b>(147.3)</b>
<b>Financing activities</b>			
New borrowings		210.2	348.2
New loans issued		(2.1)	-
Maturity of/(deposits into) investments		2.0	(23.0)
Settled hedge instruments		(3.7)	4.3
Issue costs of new borrowings		(1.4)	(11.7)
Own shares purchased		(0.8)	(0.4)
Dividends paid to minority interests		(0.3)	(0.1)
Dividends paid to equity shareholders		(69.7)	(38.9)
Repayment of borrowings		(46.6)	(253.7)
Payment of principal under hire purchase contracts and finance leases		(4.7)	(4.0)
<b>Net cash flows from financing activities</b>		<b>82.9</b>	<b>20.7</b>
<b>Increase in cash and cash equivalents</b>		<b>91.7</b>	<b>34.5</b>
Cash and cash equivalents at start of year	17	62.2	27.7
<b>Cash and cash equivalents at end of year</b>	<b>17</b>	<b>153.9</b>	<b>62.2</b>
<b>Net cash flow in respect of discontinued operations</b>			
Cash consideration		29.8	-
Cash and cash equivalents disposed		(11.1)	-
Expenses paid in connection with disposals		(0.1)	-
		<b>18.6</b>	<b>-</b>

## Northumbrian Water Group plc

### Notes to the financial statements

#### 1. Accounting policies

##### (a) Statement of compliance

The consolidated financial statements have been prepared in accordance with IFRS as adopted for use in the European Union and as applied in accordance with the provisions of the Companies Act 1985. The directors consider the following accounting policies to be relevant in relation to the Group's financial statements.

##### (b) First time adoption

In general, the Group is required to apply its accounting policies determined under IFRS fully retrospectively to determine the opening IFRS balance sheet. In order to ease the transition to IFRS, the accounting standard IFRS 1 'First Time Adoption of International Financial Reporting Standards' includes several exceptions to this principle, some of which are mandatory and some permissive.

In preparing these financial statements the exemptions applied by the Group to the restatement of historical data are as follows:

Cumulative translation differences in respect of foreign operations are deemed to be zero at the date of transition. Any gains and losses on subsequent disposals of foreign subsidiaries will exclude translation differences arising prior to the transition date.

The Group has elected to recognise all cumulative actuarial gains and losses, in equity, at the date of transition. Future actuarial gains and losses will be recognised outside the income statement through the 'Statement of Recognised Income and Expense' (SORIE).

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

The Group has taken advantage of the exemption available under IFRS 1 from restating business combinations before 1 April 2004 on an IFRS basis.

The Group has elected to adopt IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' with effect from 1 April 2004, rather than deferring application of these standards to 1 April 2005.

##### (c) Basis of consolidation

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

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

##### (d) Associates and jointly controlled entities

Investments in associates and jointly controlled entities in the Group accounts are accounted for using the equity method of accounting where the Group exercises significant influence over the associate. Significant influence is generally presumed to exist where the Group's effective ownership is 20% or more. The Group's share of the post tax profits less losses of associates and jointly controlled entities is included in the consolidated income statement and the Group's share of their net assets/liabilities is included in the consolidated balance sheet. Goodwill arising on the acquisition of associates and jointly controlled entities, representing the excess of the cost of investment compared to the Group's share of net fair value of the associate's identifiable assets, liabilities and contingent liabilities, is included in the carrying amount of the associate and is not amortised.

**(e) Goodwill**

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

**(f) Intangible assets other than goodwill**

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

Expenditure on internally developed intangible assets, excluding development costs, is taken to the income statement in the year in which it is incurred. Development expenditure is recognised as an intangible asset only after its technical feasibility and commercial viability can be demonstrated.

**(g) Property, plant and equipment**

***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).

Tangible 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; infrastructure assets 13-200 years (see below), 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.

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

***Infrastructure assets***

In the regulated water services business, infrastructure assets comprise a network of systems being mains and sewers, reservoirs, dams and sea outfalls. Prior to 1 April 2004, 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, was treated as additions to fixed assets. This treatment is not permitted under IAS 16. The opening balance for infrastructure assets was determined as described under 'First time adoption' above.

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

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

Dams and impounding reservoirs	150 years
Water mains	100 years
Sea outfalls	60 years
Sewers	200 years
Dedicated pipelines	13-15 years

**(h) Foreign currencies**

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

**(i) Inventories**

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

**(j) Revenues*****Provision of services***

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

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

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

***Interest***

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

***Dividends***

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

**(k) Grants and contributions**

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

**(l) Leases**

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

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

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

The Group operates a defined benefit pension scheme. The cost of providing this benefit is determined using the projected unit method, with actuarial valuations being carried out at each balance sheet date. The liability or asset recognised in the balance sheet represents the present value of the defined benefit obligations at the balance sheet date, less the fair value of the scheme assets and past service costs.

The defined benefit obligations represent the estimated amount of future benefits that employees have earned in return for their services in current and prior periods, discounted at a rate representing the yield on a high quality corporate bond at the balance sheet date, denominated in the same currency as the obligations and having the same terms of maturity as the related pension liability, applied to the estimated future cash outflows arising from these obligations.

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

#### ***Defined contribution scheme***

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

#### **(n) Share-based payments**

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

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

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

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

#### **(o) Taxes**

##### ***Current tax***

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

##### ***Deferred tax***

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

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

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

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

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

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

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

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

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

#### ***Value added tax***

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

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

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

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

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

A derivative instrument is considered to be used for hedging purposes when it alters the risk profile of an underlying exposure of the Group in line with the Group's risk management policies. Interest rate swap agreements are used to manage interest rate exposures. With effect from 1 April 2004, derivative financial instruments are stated at their fair value.

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

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

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

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

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

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

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

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

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

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

Borrowing costs are recognised as an expense when incurred.

**(r) Loans and receivables**

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

**(s) Cash and cash equivalents**

Cash and cash equivalents disclosed in the balance sheet comprise cash at bank and in hand and short term deposits with an original maturity of three months or less.

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

**(t) Trade and other receivables**

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

**(u) Investments**

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

**(v) Provisions**

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

**2. Segmental analysis**

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

**Northumbrian Water Limited**

NWL is one of the ten regulated water and sewerage businesses in England and Wales. NWL operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water.

**Water and waste water contracts**

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

**Related services**

AES provides environmental monitoring services, analysis and technical consultancy to major industrial groups, environmental regulators and local authorities throughout the UK and Ireland.

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

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

#### Revenue

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

#### Year ended 31 March 2005

Segment revenue	508.2	23.1	87.7	619.0	(60.5)	558.5
Inter segment revenue	-	(0.7)	(39.7)	(40.4)	23.5	(16.9)
Revenue to external customers	508.2	22.4	48.0	578.6	(37.0)	541.6

#### Profit on ordinary activities before interest

	Northumbrian Water Limited £m	Water and waste water contracts £m	Related services £m	Total £m	Discontinued operations £m	Total profit from continuing operations £m
<b>Year ended 31 March 2006</b>						
Segment profit before interest	234.6	1.8	16.4	252.8	(15.8)	237.0
Central unallocated costs and provisions						(0.8)
Profit on ordinary activities before interest						236.2
Net finance costs						(106.0)
Share of profit from associates and jointly controlled entities						0.1
Profit on ordinary activities before taxation						130.3

The trading profit disclosed as discontinued operations is part of related services. Profit on ordinary activities before interest for related services, includes the profit on disposal of £14.6 million for 2006.

#### Year ended 31 March 2005

Segment profit before interest	197.7	2.1	4.3	204.1	(1.8)	202.3
Central unallocated costs and provisions						(6.2)
Profit on ordinary activities before interest						196.1
Net finance costs						(99.9)
Share of profit from associates and jointly controlled entities						0.1
Profit on ordinary activities before taxation						96.3

## 2. Segmental analysis *continued*

### Assets and liabilities

	Northumbrian Water Limited		Water and waste water contracts		Related services		Total	
	31.3.2006 £m	31.3.2005 £m	31.3.2006 £m	31.3.2005 £m	31.3.2006 £m	31.3.2005 £m	31.3.2006 £m	31.3.2005 £m
Segment assets	2,954.9	2,819.7	139.4	75.2	6.7	8.3	3,101.0	2,903.2
Unallocated assets							268.0	211.2
							3,369.0	3,114.4
Segment liabilities	276.4	258.0	25.2	23.7	3.1	6.4	304.7	288.1
Unallocated liabilities							2,763.5	2,596.0
							3,068.2	2,884.1
Other segment information:								
Tangible fixed assets	211.9	193.1	0.9	0.7	1.0	1.2	213.8	195.0
Depreciation	84.0	75.9	3.3	2.8	1.1	2.0	88.4	80.7
Impairment of intangible	-	-	-	-	-	0.1	-	0.1

## 3. Operating costs

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Materials and consumables	20.0	20.4
Manpower costs (see note 5)	97.3	92.8
Own work capitalised	(22.5)	(19.6)
Depreciation of property, plant and equipment	88.0	79.3
(Profit)/loss on disposal of property, plant and equipment	(1.8)	1.3
Impairment of goodwill	-	0.1
Amortisation of capital grants	(3.7)	(3.3)
Costs of research and development	2.3	5.0
Operating lease payments	1.2	2.8
Other operating costs	174.5	166.7
Operating costs	355.3	345.5

## 4. Auditors' remuneration

New requirements for the disclosure of remuneration paid by the Group to its auditors were introduced in the Companies (Audit, Investigations and Community Enterprise) Act 2004 and regulations specifying these requirements were issued in 2005, and are mandatory for accounting periods beginning on or after 1 October 2005.

However, the Group has elected to give disclosures that comply with these requirements.

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Audit of the financial statements *	0.3	0.3
Other fees to auditors		
- taxation services	0.1	0.1
- IFRS project	-	0.1
	0.1	0.2

\* £80,000 of this relates to the Company (2005: £80,000)

## 5. Employee information

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

	Year to 31.3.2006	Year to 31.3.2005
	£m	£m
Wages and salaries	81.6	75.4
Social security costs	6.8	6.6
Other pension costs	8.9	10.8
<b>Total employment costs</b>	<b>97.3</b>	<b>92.8</b>

Total employment costs were charged as follows:

Capital schemes and infrastructure renewals	22.1	19.0
Manpower costs	75.2	73.8
	<b>97.3</b>	<b>92.8</b>

Included in wages and salaries is a total expense of shared-based payments of £0.6 million (2005: £0.3 million) which arises from transactions accounted for as equity-settled share-based payment transactions.

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

	Year to 31.3.2006	Year to 31.3.2005
	Number	Number
Northumbrian Water Limited	2,540	2,475
Water and waste water contracts	150	134
Related services	733	1,183
	<b>3,423</b>	<b>3,792</b>

The average number of employees for related services include 378 employees (2005: 821) in respect of discontinued operations.

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

## 6. Finance costs payable/(receivable)

	Year to 31.3.2006	Year to 31.3.2005
	£m	£m
Finance costs payable on debentures, bank and other loans and overdrafts	122.4	115.2
Amortisation of discount, fees, loan issue costs and other financing items	(12.7)	(13.9)
Derivatives	-	3.4
Finance costs payable on hire purchase contracts and finance leases	3.0	3.0
<b>Total finance costs payable</b>	<b>112.7</b>	<b>107.7</b>
Finance costs receivable	(6.7)	(7.8)
<b>Net finance costs payable</b>	<b>106.0</b>	<b>99.9</b>

## 7. Taxation

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

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Current tax:		
UK corporation tax - continuing operations	16.3	0.8
- discontinued operations (see note 8)	0.6	0.9
- adjustment in respect of prior periods	(0.7)	(1.8)
UK corporation tax	16.2	(0.1)
Overseas tax	0.1	0.1
<b>Total current tax</b>	<b>16.3</b>	<b>-</b>
Deferred tax:		
Origination and reversal of temporary differences in the year		
Deferred tax - continuing operations	22.5	24.6
- discontinued operations (see note 8)	0.1	-
- adjustment in respect of prior periods	1.1	(3.6)
<b>Total deferred tax</b>	<b>23.7</b>	<b>21.0</b>
<b>Tax charge in the income statement</b>	<b>40.0</b>	<b>21.0</b>
The tax charge in the income statement is disclosed as follows:		
Tax expense on continuing operations	39.3	20.1
Tax expense on discontinued operations (see note 8)	0.7	0.9
	<b>40.0</b>	<b>21.0</b>

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

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Current tax:		
Income tax on cash flow hedges settled during the year	-	1.3
Deferred tax:		
Actuarial gains and losses on pension schemes	15.8	6.4
Net loss on revaluation of cash flow hedges	-	0.9
Deferred tax on cash flow hedges settled during the year	-	(1.3)
Tax on share-based payment	(0.2)	-
<b>Tax charge in the statement of recognised income and expense</b>	<b>15.6</b>	<b>7.3</b>

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

	Year to 31.3.2006	Year to 31.3.2005
	£m	£m
Profit before taxation from continuing operations	130.3	96.3
Profit before taxation from discontinued operations	16.1	2.1
Accounting profit before tax	146.4	98.4
Accounting profit multiplied by standard rate of corporation tax (30%) (2005: 30%)	43.9	29.5
Effects of:		
Expenses not deductible for tax purposes	0.8	0.6
Depreciation in respect of non-qualifying items	0.9	0.7
Taxable overseas dividend income	-	0.4
Overseas tax losses not recognised	-	0.2
Non-taxable income	(0.5)	(0.7)
Non-taxable profit on disposal of subsidiaries	(4.4)	-
Retirement benefits	2.8	-
Adjustment to tax charge in respect of prior periods	0.4	(5.4)
Non-taxable amortisation of financing items	(3.9)	(4.2)
Other	-	(0.1)
Total tax expense reported in the income statement	40.0	21.0

**(d) Unrecognised tax losses**

The Group has tax losses which arose in Gibraltar of £10.8 million (2005: £10.7 million) that are available for offset against future taxable profits of the company in which the losses arose. A deferred tax asset has not been recognised in respect of these losses as they may not be used to offset taxable profits elsewhere in the Group and it is not expected that the company concerned will significantly utilise them in the foreseeable future.

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

At 31 March 2006, there was no recognised deferred tax liability (2005: £nil) for taxes that would be payable on the unremitted earnings of the Group's subsidiaries as the Group has determined that undistributed profits of its subsidiaries will not be distributed in the foreseeable future.

The temporary differences associated with investments in subsidiaries for which a deferred tax liability has not been recognised aggregate to £7.0 million (2005: £5.9 million).

**(f) Deferred tax**

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

	Year to 31.3.2006	Year to 31.3.2005
	£m	£m
Accelerated capital allowances	20.4	21.8
Provisions	0.9	5.5
Deferred income	(4.5)	(4.9)
Retirement benefits	7.2	(0.3)
Losses carried forward	(0.5)	(0.2)
Share-based payments	-	(0.1)
Finance costs payable	-	0.3
Cash flow hedges	-	(1.3)
Other	0.2	0.2
	23.7	21.0

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

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Deferred tax assets:		
Provisions	3.0	4.1
Deferred income	51.4	46.9
Retirement benefits	2.9	25.9
Losses available for offset against future taxable income	4.8	2.6
Share-based payments	0.3	0.1
Finance costs payable	5.5	5.5
Cash flow hedges	1.2	1.3
Other	0.4	0.6
<b>Deferred tax asset</b>	<b>69.5</b>	<b>87.0</b>
Deferred tax liabilities:		
Accelerated capital allowances	532.4	504.6
Intangible asset	19.3	19.3
Fair value adjustment on previous business combinations	13.0	13.2
Other	0.4	0.3
<b>Deferred tax liability</b>	<b>565.1</b>	<b>537.4</b>
<b>Net deferred tax liability</b>	<b>495.6</b>	<b>450.4</b>

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

The Group expects to continue to incur high levels of capital expenditure and to be able to claim capital allowances in excess of depreciation for the remainder of NWL's current regulatory period. The annual excess is expected to reduce, resulting in increased current tax charges, as tax deductions for deferred revenue expenditure move to a depreciation basis (as set out in HM Revenue and Customs' Tax Bulletin 53).

**8. Discontinued operations**

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

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Revenue	28.5	60.5
Inter segment	(9.3)	(23.5)
External revenue	19.2	37.0
Operating costs	(18.0)	(35.2)
Profit on ordinary activities before interest	1.2	1.8
Profit on disposal of discontinued operations	14.6	-
Profit before interest on discontinued operations	15.8	1.8
Net finance costs	0.3	0.3
Profit on ordinary activities before taxation	16.1	2.1
Current tax	(0.6)	(0.9)
Deferred tax	(0.1)	-
<b>Profit for the year from discontinued operations</b>	<b>15.4</b>	<b>1.2</b>

The tax charge is analysed as follows:

On profit on ordinary activities for the year	(0.7)	(0.9)
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The major classes of assets and liabilities of FPS, Entec and ULG at their date of disposal were as follows:

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

### 9. Earnings per share

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

	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence	Earnings 31.3.2005 £m	Weighted average number of shares 31.3.2005 million	Earnings per share 31.3.2005 pence
Net profit attributable to equity holders of the parent – continuing operations	91.0	517.9	17.57	76.2	518.1	14.71
Net profit attributable to equity holders of the parent – discontinued operations	15.4		2.98	1.2		0.23
Basic EPS	106.4	517.9	20.55	77.4	518.1	14.94

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

	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence	Earnings 31.3.2005 £m	Weighted average number of shares 31.3.2005 million	Earnings per share 31.3.2005 pence
Net profit attributable to equity holders of the parent – continuing operations	91.0	518.6	17.55	76.2	518.6	14.69
Net profit attributable to equity holders of the parent – discontinued operations	15.4		2.97	1.2		0.23
Diluted EPS	106.4	518.6	20.52	77.4	518.6	14.92

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

	Earnings 31.3.2006 £m	Weighted average number of shares 31.3.2006 million	Earnings per share 31.3.2006 pence	Earnings 31.3.2005 £m	Weighted average number of shares 31.3.2005 million	Earnings per share 31.3.2005 pence
Basic EPS	91.0	517.9	17.57	76.2	518.1	14.71
Deferred tax	23.6		4.55	21.0		4.05
Amortisation of debt fair value	(13.0)		(2.50)	(14.1)		(2.72)
Derivatives	-		-	2.1		0.40
Adjusted EPS	101.6	517.9	19.62	85.2	518.1	16.44

#### 10. Dividends paid and proposed

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Declared and paid during the year:		
Equity dividends on ordinary shares:		
Final dividend for 2004/05: 7.13p (2003/04: 4.63p)	36.9	24.0
Interim dividend for 2005/06: 3.52p (2004/05: 2.87p)	18.2	14.9
Special dividend for 2005/06: 2.82p (2004/05: nil)	14.6	-
Dividends paid	69.7	38.9
Proposed for approval by shareholders at the AGM:		
Final dividend for 2005/06: 7.04p (2004/05: 7.13p)	36.5	36.9

#### 11. Intangible assets

Group	Goodwill £m	Other £m	Total £m
Cost:			
At 1 April 2004	0.2	64.2	64.4
At 1 April 2005	0.2	64.2	64.4
Acquisition of subsidiary	3.6	-	3.6
<b>At 31 March 2006</b>	<b>3.8</b>	<b>64.2</b>	<b>68.0</b>
Impairment:			
At 1 April 2004	-	-	-
Impairment	(0.1)	-	(0.1)
<b>At 1 April 2005 and 31 March 2006</b>	<b>(0.1)</b>	<b>-</b>	<b>(0.1)</b>
<b>Net book value at 31 March 2006</b>	<b>3.7</b>	<b>64.2</b>	<b>67.9</b>
Net book value at 31 March 2005	0.1	64.2	64.3

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

The other intangible asset represents the right in perpetuity to receive income under the operating agreement with the Environment Agency in respect of the Kielder Water transfer scheme, and therefore, the directors consider the asset has an indefinite life. Accordingly, future cash flows which increase in line with inflation, have been discounted at a rate of 5.15% in perpetuity. This calculation satisfied the Group that the carrying value at 31 March 2006 had not been impaired.

## 12. Property, plant and equipment

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
<b>Cost:</b>							
At 1 April 2004	89.0	5.2	1,300.6	1,563.4	159.6	85.4	3,203.2
Additions	-	-	0.1	0.6	1.3	193.0	195.0
Schemes commissioned	0.4	-	77.0	124.5	7.5	(209.4)	-
Reclassifications	(1.3)	(0.2)	5.9	10.7	(15.1)	-	-
Disposals	(0.5)	-	(22.0)	(5.3)	(3.1)	-	(30.9)
At 1 April 2005	87.6	5.0	1,361.6	1,693.9	150.2	69.0	3,367.3
Additions	-	-	0.3	0.8	1.2	211.5	213.8
Schemes commissioned	0.7	-	78.0	102.6	11.6	(192.9)	-
Acquisition of subsidiary	-	-	-	38.9	25.9	-	64.8
Discontinued operations	(0.5)	(4.4)	-	(4.0)	(4.3)	-	(13.2)
Reclassifications	(1.2)	-	15.7	16.0	(23.1)	(7.3)	0.1
Disposals	(0.2)	(0.6)	(12.1)	(0.5)	(0.1)	-	(13.5)
<b>At 31 March 2006</b>	<b>86.4</b>	<b>-</b>	<b>1,443.5</b>	<b>1,847.7</b>	<b>161.4</b>	<b>80.3</b>	<b>3,619.3</b>
<b>Depreciation:</b>							
At 1 April 2004	25.4	2.7	41.7	349.3	94.1	-	513.2
Charge for the year	1.6	0.3	18.0	56.2	4.6	-	80.7
Reclassifications	0.2	(0.1)	-	-	(0.1)	-	-
Disposals	-	-	(22.0)	(2.0)	(2.9)	-	(26.9)
At 1 April 2005	27.2	2.9	37.7	403.5	95.7	-	567.0
Charge for the year	1.4	0.1	19.3	61.0	6.6	-	88.4
Reclassifications	-	-	0.9	(0.4)	-	-	0.5
Discontinued operations	-	(2.9)	-	(3.2)	(2.8)	-	(8.9)
Disposals	(0.6)	(0.1)	(12.1)	(0.2)	(0.3)	-	(13.3)
<b>At 31 March 2006</b>	<b>28.0</b>	<b>-</b>	<b>45.8</b>	<b>460.7</b>	<b>99.2</b>	<b>-</b>	<b>633.7</b>
<b>Net book value at 31 March 2006</b>	<b>58.4</b>	<b>-</b>	<b>1,397.7</b>	<b>1,387.0</b>	<b>62.2</b>	<b>80.3</b>	<b>2,985.6</b>
Net book value at 31 March 2005	60.4	2.1	1,323.9	1,290.4	54.5	69.0	2,800.3

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

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

	31.3.2006 £m	31.3.2005 £m
Infrastructure assets	2.2	2.2
Operational structures, plant and machinery	24.0	25.9
Fixtures, fittings, tools and equipment	-	0.3
	<b>26.2</b>	<b>28.4</b>

## 13. Investments

	31.3.2006 £m	31.3.2005 £m
Investments in associates	-	1.4
Investments in jointly controlled entities	3.6	3.6
Other investments	0.3	0.4
	<b>3.9</b>	<b>5.4</b>

**(a) Investments in associates**

The Group held a 50% interest in Ayr Environmental Services Limited (Ayres), the principal trading associate. On 23 December 2005, the Group increased its shareholding from 50% to 75%. Following the increase in shareholding, Ayres is fully consolidated into the Group's results.

The following table illustrates summarised financial information of the Group's investment in Ayres up to the date of full consolidation.

	31.3.2006	31.3.2005
	£m	£m
Revenue	4.3	5.7
Profit after tax	(0.6)	(0.4)
Share of the associate's balance sheet:		
Non-current assets	-	36.2
Current assets	-	4.5
Share of gross assets	-	40.7
Current liabilities	-	2.5
Non-current liabilities	-	36.8
Share of gross liabilities	-	39.3
Net assets	-	1.4

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

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

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

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

	VLS	Agreco	VLS	Agreco
	31.3.2006	31.3.2006	31.3.2005	31.3.2005
	£m	£m	£m	£m
Revenue	6.0	0.9	6.0	0.9
Profit after tax	0.5	0.2	0.4	0.1
Share of the jointly controlled entities' balance sheet:				
Non-current assets	5.2	-	5.1	-
Current assets	6.1	0.7	5.9	1.1
Share of gross assets	11.3	0.7	11.0	1.1
Current liabilities	(3.9)	(0.5)	(3.5)	(0.6)
Non-current liabilities	(4.0)	-	(4.4)	-
Share of gross liabilities	(7.9)	(0.5)	(7.9)	(0.6)
Net assets	3.4	0.2	3.1	0.5

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

Name of undertaking	Country of incorporation or registration and operation	Description of shares held	Proportion of nominal value of issued shares held by Group	Business activity
Northumbrian 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
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
Caledonian Environmental Services plc	Scotland	Ordinary shares of £1	75	Waste water services
Ayr Environmental Services Limited	Scotland	Ordinary shares of £1	75	Waste water services
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
Northumbrian Water Projects Limited	England and Wales	Ordinary shares of £1	100	Waste water services

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.

**14. Business combinations**

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

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

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

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

## 15. Inventories

	31.3.2006	31.3.2005
Group	£m	£m
Stores	3.3	3.4
Work in progress	-	1.1
	<b>3.3</b>	<b>4.5</b>

## 16. Trade and other receivables

	31.3.2006	31.3.2005
Group	£m	£m
Trade receivables	53.9	67.3
Amounts owed by jointly controlled entities	0.9	1.0
Amounts receivable from non-group companies for tax losses	0.9	-
Prepayments and accrued income	40.7	41.6
Other receivables	13.1	7.4
	<b>109.5</b>	<b>117.3</b>

## 17. Cash and cash equivalents

	31.3.2006	31.3.2005
Group	£m	£m
Cash at bank and in hand	48.4	83.9
Short term deposits	128.2	11.1
	<b>176.6</b>	<b>95.0</b>

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

	31.3.2006	31.3.2005
Group	£m	£m
Cash at bank and in hand	48.4	83.9
Short term deposits	128.2	11.1
Bank overdrafts	(22.7)	(32.8)
	<b>153.9</b>	<b>62.2</b>

## 18. Trade and other payables

	31.3.2006	31.3.2005
Group	£m	£m
Trade payables	11.0	18.2
Other payables	16.1	20.7
Interest payable	49.4	50.9
Accruals and deferred income	79.8	79.6
	<b>156.3</b>	<b>169.4</b>

## 19. Interest bearing loans and borrowings

Group	31.3.2006 £m	31.3.2005 £m
<b>Current:</b>		
Bank overdrafts	22.7	32.8
Current instalments due on borrowings (principal £201.8 million, 2005: £24.8 million)	209.5	36.6
Current obligations under finance leases and hire purchase contracts (see note 20)	4.5	4.5
	<b>236.7</b>	<b>73.9</b>
<b>Non-current:</b>		
Non-current obligations under finance leases and hire purchase contracts (principal £56.7 million, 2005: £57.3 million) (see note 20)	56.9	57.5
Non-current instalments on borrowings (principal £1,866.6 million, 2005: £1,812.9 million)	1,916.0	1,872.2
	<b>1,972.9</b>	<b>1,929.7</b>
Borrowings comprise the following:		
Loans (principal £374.9 million, 2005: £329.3 million)	386.3	344.3
Debentures (principal £nil, 2005: £9.2 million)	-	9.2
Eurobonds – due 28 June 2006 bearing interest rate of 8.625% (principal £171.2 million, 2005: £189.6 million)	172.3	196.3
Eurobonds – due 11 October 2017 bearing interest rate of 6.0% (principal £300.0 million, 2005: £300.0 million)	313.3	314.4
Eurobonds – due 6 February 2023 bearing interest rate of 6.875% (principal £350.0 million, 2005: £350.0 million)	398.5	401.6
Eurobonds – due 29 April 2033 bearing interest rate of 5.625% (principal £350.0 million, 2005: £350.0 million)	345.5	345.3
Eurobonds – due 23 January 2034 bearing interest rate of 5.87526% (principal £248.0 million, 2005: £248.0 million)	239.7	239.3
Eurobonds – due 31 March 2037 bearing interest rate of 6.627% (principal £61.6 million, 2005: £61.6 million)	58.6	58.4
Index linked Eurobonds – due 15 July 2036 bearing interest rate of 2.033% (principal £152.6 million, 2005: £nil)	151.4	-
Index linked Eurobonds – due 30 January 2041 bearing interest rate of 1.6274% (principal £60.1 million, 2005: £nil)	59.9	-
	<b>2,125.5</b>	<b>1,908.8</b>
Less current instalments due on bank loans (principal £201.8 million, 2005: £24.8 million)	209.5	36.6
	<b>1,916.0</b>	<b>1,872.2</b>

The difference between the principal value of £1,866.6 million (2005: £1,812.9 million) and the carrying value of £1,916.0 million (2005: £1,872.2 million) are unamortised issue costs of £16.7 million (2005: £15.7 million) and a credit of £66.1 million (2005: £75.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

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 £473.7 million (2005: £486.4 million) and bear rates of interest in the range of 5.05% to 8.55% (2005: 5.24% to 8.55%). Of these loans, £13.8 million (2005: £16.3 million) 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 £1,320.1 million (2005: £1,110.5 million) and bear rates of interest in the range of 5.25% to 11.00% (2005: 5.25% to 6.99%). Of these loans, £45.5 million (2005: £120.5 million) bear interest rates linked to LIBOR.

The aggregate amount of loans to the Group, any part of which falls due for repayment in five years or more, is £1,793.8 million (2005: £1,593.2 million).

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

Group	31.3.2006 £m	31.3.2005 £m
Amounts due:		
Not later than one year	4.5	4.5
After one year but not more than five years	17.7	16.3
Later than five years	58.1	62.3
	80.3	83.1
Less finance charges allocated to future periods	(18.9)	(21.1)
Present value of minimum lease payments	61.4	62.0
Disclosed as due:		
Not later than one year	4.5	4.5
After more than one year	56.9	57.5
	61.4	62.0

### Lease commitments

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

Group	31.3.2006 £m	31.3.2005 £m
Leases which expire:		
Not later than one year	1.0	1.2
After one year but not more than five years	2.6	2.9
After five years	25.9	25.9
	29.5	30.0

## 21. Provisions

Group	Reorganisation and restructuring provision £m	Other £m	Total £m
At 1 April 2005			
Current	1.1	1.4	2.5
Non-current	2.7	-	2.7
	3.8	1.4	5.2
Arising during the year	0.7	-	0.7
Reversal of unused amounts	(0.8)	-	(0.8)
Utilised	(0.3)	(0.1)	(0.4)
Disposal of subsidiary undertaking	-	(1.3)	(1.3)
<b>At 31 March 2006</b>	<b>3.4</b>	<b>-</b>	<b>3.4</b>
Analysed as:			
Current	0.3	-	0.3
Non-current	3.1	-	3.1
	3.4	-	3.4

The reorganisation and restructuring provision represents outstanding severance and pension contributions of £nil (2005: £0.8 million) in respect of costs of restructuring programmes within the Group, £3.4 million (2005: £3.0 million) relating to discretionary pension liabilities.

Other provisions relate to dilapidations in respect of leasehold properties, which have been transferred on the disposal of Entec.

## **22. 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 2006, the Group had £275.0 million available in standby committed bank facilities (2005: £90.0 million).

### **(e) Interest rate risk**

The Group finances its operations through a mixture of retained profits and bank borrowings. It borrows at both fixed and floating rates of interest and, accordingly, uses interest rate swaps to generate the desired interest profile and to manage the Group's exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2006, 80% (2005: 88%) 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 effect on the Group's pre-tax profits.

### **(h) Credit risk**

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

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

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

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

<b>Year ended 31 March 2005</b>	<b>Within 1</b>					<b>More than 5</b>	
<b>Group</b>	<b>year</b>	<b>1-2 years</b>	<b>2-3 years</b>	<b>3-4 years</b>	<b>4-5 years</b>	<b>years</b>	<b>Total</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>Fixed rate:</b>							
Loans receivable	-	-	-	-	-	4.6	4.6
Eurobonds	(9.3)	(194.9)	(4.0)	(3.9)	(4.0)	(1,339.2)	(1,555.3)
Subordinated loans	-	-	-	-	-	(3.8)	(3.8)
Bank loans	(18.8)	(13.6)	(19.2)	(18.7)	(18.2)	(98.8)	(187.3)
Debentures	(5.7)	-	-	-	-	(3.5)	(9.2)
Obligations under finance leases and hire purchase contracts	(2.7)	(2.0)	(1.5)	(1.0)	(0.4)	(0.1)	(7.7)
<b>Fixed rate at 31 March 2005</b>	<b>(36.5)</b>	<b>(210.5)</b>	<b>(24.7)</b>	<b>(23.6)</b>	<b>(22.6)</b>	<b>(1,440.8)</b>	<b>(1,758.7)</b>
<b>Variable rate:</b>							
Cash and cash equivalents	95.0	-	-	-	-	-	95.0
Financial investments	2.0	2.1	1.9	1.7	1.4	13.9	23.0
Bank loans	(17.7)	(2.8)	(2.8)	(2.8)	(2.8)	(124.3)	(153.2)
Overdrafts	(32.8)	-	-	-	-	-	(32.8)
Obligations under finance leases and hire purchase contracts	(1.8)	(2.0)	(2.5)	(3.1)	(3.7)	(41.2)	(54.3)
<b>Variable rate at 31 March 2005</b>	<b>44.7</b>	<b>(2.7)</b>	<b>(3.4)</b>	<b>(4.2)</b>	<b>(5.1)</b>	<b>(151.6)</b>	<b>(122.3)</b>
<b>Net borrowings at 31 March 2005</b>							<b>(1,881.0)</b>

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

**(j) Currency exposures**

At 31 March 2006, after taking into account the effects of forward foreign exchange contracts, the Group had no currency exposures (2005: £nil).

**(k) Borrowing facilities**

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

	31.3.2006	31.3.2005
Group	£m	£m
Expiring in one year or less	200.0	90.0
Expiring in more than two years but not more than five years	75.0	-
	<b>275.0</b>	<b>90.0</b>

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

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

Group	Book value		Fair value	
	31.3.2006	31.3.2005	31.3.2006	31.3.2005
	£m	£m	£m	£m
<b>Financial assets:</b>				
Cash and cash equivalents	176.6	95.0	176.6	95.0
Financial investments	21.0	23.0	21.0	23.0
Sterling loans receivable	1.6	4.6	1.6	4.6
Interest rate swaps	-	-	1.0	-
<b>Financial liabilities:</b>				
Overdraft	(22.7)	(32.8)	(22.7)	(32.8)
Bank loans (principal of £368.8 million, 2005: £325.5 million)	(380.2)	(340.5)	(377.2)	(334.7)
Subordinated loan stock	(6.1)	(3.8)	(6.1)	(3.8)
Debentures (principal of £nil, 2005: £9.2 million)	-	(9.2)	-	(8.9)
Eurobonds (principal of £1,693.5 million, 2005: £1,499.2 million)	(1,739.2)	(1,555.3)	(1,861.0)	(1,583.4)
Obligations under finance leases and hire purchase contracts (principal of £61.2 million, 2005: £61.8 million)	(61.4)	(62.0)	(61.4)	(62.0)
	<b>(2,010.4)</b>	<b>(1,881.0)</b>	<b>(2,128.2)</b>	<b>(1,903.0)</b>

The fair values of the interest rate swaps, forward foreign currency contracts and sterling denominated long term fixed rate debt with a book value of £1,739.2 million (2005: £1,564.5 million), have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

The difference between the principal value of £2,123.5 million (2005: £1,895.7 million) and the carrying value of £2,180.8 million (2005: £1,967.0 million) are unamortised issue costs of £16.7 million (2005: £15.7 million) and a credit of £74.0 million (2005: £87.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

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

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

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

### Cash flow hedges – interest rate swap

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

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

This hedge was designated as highly effective and an unrealised gain of £1.0 million relating to the interest rate swap is included in equity.

### 23. Authorised and issued share capital

Group	31.3.2006 £m	31.3.2005 £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	51.9	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 976,668 (2005: 681,296) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 47 to 49. As at 31 March 2006, the share price of the ordinary 10 pence shares in the Company was 238.75 pence (2005: 176.25 pence).

### 24. Reconciliation of movements in equity

Group	Equity share capital £m	Share premium reserve £m	Cash flow hedge reserve £m	Treasury shares £m	Retained earnings £m	Total equity £m	Minority interests £m	Total £m
At 1 April 2005	51.9	446.3	4.3	(0.9)	(272.4)	229.2	1.1	230.3
Shares purchased	-	-	-	(0.8)	-	(0.8)	-	(0.8)
Refund of share issue costs	-	0.2	-	-	-	0.2	-	0.2
Total recognised income and expense for the year	-	-	(2.8)	-	143.0	140.2	0.5	140.7
Share-based payment	-	-	-	-	0.2	0.2	-	0.2
Equity dividends paid	-	-	-	-	(69.7)	(69.7)	(0.1)	(69.8)
<b>At 31 March 2006</b>	<b>51.9</b>	<b>446.5</b>	<b>1.5</b>	<b>(1.7)</b>	<b>(198.9)</b>	<b>299.3</b>	<b>1.5</b>	<b>300.8</b>

### 25. Additional cash flow information

#### Analysis of Group net debt

Group	As at 1.4.2005 £m	Cash flow £m	In respect of acquisitions £m	In respect of disposals £m	Other non-cash movements £m	As at 31.3.2006 £m
Cash and cash equivalents	62.2	98.9	3.9	(11.1)	-	153.9
Loans (principal of £2,066.8 million, 2005: £1,833.1 million)	(1,881.2)	(162.1)	(70.7)	1.4	9.7	(2,102.9)
Finance leases (principal of £61.2 million, 2005: £61.8 million)	(62.0)	4.7	-	-	(4.1)	(61.4)
	(1,881.0)	(58.5)	(66.8)	(9.7)	5.6	(2,010.4)

The difference between the principal value of £2,128.0 million (2005: £1,894.9 million) and the carrying value of £2,185.3 million (2005: £1,966.2 million) are unamortised issue costs of £16.7 million (2005: £15.7 million) and a credit of £74.0 million (2005: £87.0 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

## 26. Financial commitments

### Capital expenditure

	31.3.2006	31.3.2005
Group	£m	£m
Expenditure contracted for	96.8	82.4

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.

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

The Group operates a defined benefit pension scheme providing benefits based on final pensionable remuneration to 2,351 active members at 31 March 2006. The Scheme, the Northumbrian Water Pension Scheme (NWPS), comprises four unitised sub-funds - WPS, Northumbrian Water (North), Northumbrian Water (South) and MIS.

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

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

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

	Sub-fund			
	WPS	North	South	MIS
Members' contributions	6%	5%	5%	5%/6%
Employers' contributions	29.1%	23.1%	2.6%	73%

The recommended employer contribution rate was assessed using the projected unit method and the following actuarial assumptions:

Investment return:	
Pre-retirement	6.2%
Post-retirement	5.3%
Pay increases	3.75%
Pension increases	3.0%
Price inflation	3.0%

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

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

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

The employers' proposals were accepted by the NWPS Trustee.

The Group also contributes to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP). Members and employers contribute 3% and 6% of salary respectively. The NWGPPP is provided by an insurance company and members have their own individual policy. There were 258 contributing members at 31 March 2006. The Group made contributions amounting to £1.5 million (2005: £1.0 million) to the defined contribution pension scheme.

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

A qualified actuary, using revised assumptions that are consistent with the requirements of IAS 19, has updated the actuarial valuation described above at 31 December 2004. Investments have been valued, for this purpose, at fair value.

IAS 19 actuarial assumptions:

	31.3.2006	31.3.2005
	%	%
Pay increases	3.6	3.9
Pension increases	2.9	2.9
Price inflation	2.9	2.9
Discount rate	4.9	5.4
Mortality assumptions *	PMA/PFA92	PMA/PFA92

\* 2006 – projected to the year of use (2005: c2002 for current pensioners and c2020 for future pensioners).

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

	Long term expected rate of return 31.3.2006	31.3.2006	Long term expected rate of return 31.3.2005	31.3.2005
	%	£m	%	£m
Equities	7.2	451.6	7.7	373.0
Corporate bonds	4.9	48.2	5.4	39.6
Government bonds	4.2	60.5	4.7	45.2
Property	5.7	65.1	6.2	53.7
Cash	4.5	34.4	4.7	12.3
Total fair value of assets		659.8		523.8
Present value of liabilities		(663.5)		(600.2)
Deficit		(3.7)		(76.4)
Related deferred tax asset		1.1		22.9
Net pension liability		(2.6)		(53.5)

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

	31.3.2006	31.3.2005
	£m	£m
Recognised in the income statement:		
Current service cost	12.0	11.8
Interest cost	32.3	31.1
Expected return on plan assets	(36.5)	(32.5)
Losses on curtailments and settlements	0.3	1.1
Recognised in operating costs in arriving at profit on ordinary activities before interest	8.1	11.5

Recognised in the statement of recognised income and expense:

Net actuarial gains recognised in the statement of recognised income and expense	52.7	21.2
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History of experience gains and losses:

	31.3.2006	31.3.2005	31.3.2004
	£m	£m	£m
Fair value of assets	659.8	523.8	472.1
Present value of defined benefit obligation	(663.5)	(600.2)	(565.7)
Deficit	(3.7)	(76.4)	(93.6)
Experience adjustments arising on plan assets	87.1	25.6	28.5
Experience adjustments arising on plan liabilities	(34.4)	(4.4)	8.0

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

	31.3.2006	31.3.2005
	£m	£m
At 1 April	600.2	565.7
Current service cost	12.0	11.8
Interest cost	32.3	31.1
Contributions by plan participants	3.3	3.1
Actuarial losses on obligations	34.4	4.4
Income which increases liabilities	(0.7)	0.3
Benefits paid	(18.3)	(17.3)
Losses on curtailments and settlements	0.3	1.1
<b>At 31 March</b>	<b>663.5</b>	<b>600.2</b>
Present value of funded obligations	661.9	599.1
Present value of unfunded obligations	1.6	1.1
Present value of defined benefit obligations	663.5	600.2

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

	31.3.2006	31.3.2005
	£m	£m
At 1 April	523.8	472.1
Expected return on plan assets	36.5	32.5
Actuarial gains on plan assets	87.1	25.6
Contributions by employer	28.1	7.5
Contributions by plan participants	3.3	3.1
Income which increases liabilities	(0.7)	0.3
Benefits paid	(18.3)	(17.3)
<b>At 31 March</b>	<b>659.8</b>	<b>523.8</b>

## 28. Special purpose entities

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

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

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

	31.3.2006	31.3.2005
	£m	£m
<b>Income statement:</b>		
Finance costs receivable	15.0	13.2
Finance costs payable	(15.0)	(13.2)
<b>Profit for the year</b>	-	-
<b>Balance sheet:</b>		
Investments	239.7	239.3
Current assets	1.7	1.6
Non-current liabilities	(241.4)	(240.9)
	-	-
<b>Cash flow statement:</b>		
<b>Investing activities</b>	0.6	(0.4)
<b>Financing activities</b>		
Cash outflow from loan granted to Reiver Finance Limited	-	(248.0)
Cash inflow from guaranteed secured Eurobonds	-	248.0
Cash inflow from loan	-	1.5
<b>Increase in cash and cash equivalents</b>	0.6	1.1

## 29. Related parties

During the year the Group entered into transactions, in the ordinary course of business, with other related parties. Those transactions with directors of the Company are disclosed in the directors' remuneration report on pages 46 to 54. In accordance with IAS 24, the directors consider that there are no further disclosures in respect of key management. Transactions entered into, and trading balances outstanding at 31 March 2006 with other related parties, are as follows:

	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m
<b>Related party:</b>				
<b>Associates</b>				
2006	3.3	-	-	-
2005	4.4	-	-	-
<b>Jointly controlled entities</b>				
2006	-	4.3	0.9	6.2
2005	-	5.3	1.0	7.1

Purchases from jointly controlled entities include £1.6 million (2005: £2.7 million) in respect of capital purchases under finance leases, £2.2 million (2005: £2.1 million) in respect of operating leases and £0.5 million (2005: £0.5 million) in respect of finance costs payable under finance leases.

## 30. Transition to IFRS

NWG is required to report its consolidated financial results under IFRS from 1 April 2005. This is the first year that the Group has presented its financial statements under IFRS. To assess the impact on the Group's financial results, this statement presents the reconciliations (from UK GAAP to IFRS) for the income statement for the year ended 31 March 2005 and the balance sheet at 31 March 2005. A reconciliation of the net assets (from UK GAAP to IFRS) at the transition date, 1 April 2004, has also been presented.

The restated financial information for the year ended 31 March 2005 and the opening balance sheet at 1 April 2004 are those which were notified to investors in the regulatory news service release on 28 November 2005.

The analyses below have been presented in a reformatted structure using the IFRS format adopted for the year ended 31 March 2006.

**(a) Reconciliation of the consolidated income statement for the year ended 31 March 2005**

	UK GAAP £m	Property, plant & equipment (d(i)) £m	Pensions (d(ii)) £m	IAS 39 (d(iii)) £m	Deferred tax (d(iv)) £m	Jointly controlled entities and associates (d(v)) £m	Other £m	Restated under IFRS £m
<b>Revenue</b>	578.6	-	-	-	-	-	-	578.6
Operating costs	(373.9)	(4.1)	(2.7)	-	-	-	-	(380.7)
<b>Group operating profit</b>	204.7	(4.1)	(2.7)	-	-	-	-	197.9
Share of associates' operating profit	2.2	-	-	-	-	(2.2)	-	-
Share of jointly controlled entities' operating profit	1.0	-	-	-	-	(1.0)	-	-
<b>Profit on ordinary activities before interest</b>	207.9	(4.1)	(2.7)	-	-	(3.2)	-	197.9
Finance costs	(99.1)	-	-	(3.4)	-	2.9	-	(99.6)
Share of profit after tax of associates and jointly controlled entities	-	-	-	-	-	0.1	-	0.1
<b>Profit on ordinary activities before taxation</b>	108.8	(4.1)	(2.7)	(3.4)	-	(0.2)	-	98.4
- current taxation	(1.3)	-	-	1.3	-	-	-	-
- deferred taxation	(8.9)	1.2	0.8	(0.3)	(13.9)	-	0.1	(21.0)
- share of associates and jointly controlled entities tax	(0.2)	-	-	-	-	0.2	-	-
<b>Profit for the year</b>	98.4	(2.9)	(1.9)	(2.4)	(13.9)	-	0.1	77.4

Basic and diluted earnings per share for profit attributable to ordinary equity holders of the parent

	19.1p	(0.6p)	(0.4p)	(0.5p)	(2.7p)	-	-	14.9p
Adjusted earnings per share (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments)	18.1p	(0.8p)	(0.5p)	-	-	-	* (0.1p)	16.7p
Dividend per share	10.00p	-	-	-	-	-	-	10.00p

\* Rounding

**(b) Reconciliation of the consolidated balance sheet as at 31 March 2005**

	UK GAAP £m	Property, plant & equipment (d(i)) £m	Pensions (d(ii)) £m	IAS 39 (d(iii)) £m	Deferred tax (d(iv)) £m	Dividends £m	Other £m	Restated under IFRS £m
<b>Non-current assets</b>								
Goodwill	0.1	-	-	-	-	-	-	0.1
Other intangible assets	64.2	-	-	-	-	-	-	64.2
Property, plant and equipment	2,806.6	(6.3)	-	-	-	-	-	2,800.3
Investments in jointly controlled entities	3.6	-	-	-	-	-	-	3.6
Investments in associates	1.4	-	-	-	-	-	-	1.4
Other investments	0.4	-	-	-	-	-	-	0.4
Pension asset	13.0	-	(13.0)	-	-	-	-	-
	<b>2,889.3</b>	<b>(6.3)</b>	<b>(13.0)</b>	-	-	-	-	<b>2,870.0</b>
<b>Current assets</b>								
Inventories	4.5	-	-	-	-	-	-	4.5
Trade and other receivables	121.9	-	-	-	-	-	-	121.9
Cash and cash equivalents	118.0	-	-	-	-	-	-	118.0
	<b>244.4</b>	-	-	-	-	-	-	<b>244.4</b>
<b>Total assets</b>	<b>3,133.7</b>	<b>(6.3)</b>	<b>(13.0)</b>	-	-	-	-	<b>3,114.4</b>
<b>Non-current liabilities</b>								
Interest bearing loans and borrowings	1,929.7	-	-	-	-	-	-	1,929.7
Provisions	5.2	-	-	-	-	-	-	5.2
Deferred income tax liabilities	167.7	(2.2)	(26.8)	-	311.9	-	(0.2)	450.4
Pension liability	-	-	76.4	-	-	-	-	76.4
Other payables	16.6	-	-	-	-	-	-	16.6
Interest rate swap	4.3	-	-	(4.3)	-	-	-	-
Grants	160.2	1.1	-	-	-	-	-	161.3
	<b>2,283.7</b>	<b>(1.1)</b>	<b>49.6</b>	<b>(4.3)</b>	<b>311.9</b>	-	<b>(0.2)</b>	<b>2,639.6</b>
<b>Current liabilities</b>								
Interest bearing loans and borrowings	73.9	-	-	-	-	-	-	73.9
Trade and other payables	205.5	-	-	-	-	(36.9)	0.8	169.4
Income tax payable	1.2	-	-	-	-	-	-	1.2
	<b>280.6</b>	-	-	-	-	<b>(36.9)</b>	<b>0.8</b>	<b>244.5</b>
<b>Total liabilities</b>	<b>2,564.3</b>	<b>(1.1)</b>	<b>49.6</b>	<b>(4.3)</b>	<b>311.9</b>	<b>(36.9)</b>	<b>0.6</b>	<b>2,884.1</b>
<b>Net assets</b>	<b>569.4</b>	<b>(5.2)</b>	<b>(62.6)</b>	<b>4.3</b>	<b>(311.9)</b>	<b>36.9</b>	<b>(0.6)</b>	<b>230.3</b>
<b>Capital and reserves</b>								
Issued capital	51.9	-	-	-	-	-	-	51.9
Share premium	446.3	-	-	-	-	-	-	446.3
Cash flow reserve	-	-	-	4.3	-	-	-	4.3
Treasury shares	(0.9)	-	-	-	-	-	-	(0.9)
Retained earnings	71.0	(5.2)	(62.6)	-	(311.9)	36.9	(0.6)	(272.4)
<b>Equity shareholders' funds</b>	<b>568.3</b>	<b>(5.2)</b>	<b>(62.6)</b>	<b>4.3</b>	<b>(311.9)</b>	<b>36.9</b>	<b>(0.6)</b>	<b>229.2</b>
Minority interests	1.1	-	-	-	-	-	-	1.1
<b>Total capital and reserves</b>	<b>569.4</b>	<b>(5.2)</b>	<b>(62.6)</b>	<b>4.3</b>	<b>(311.9)</b>	<b>36.9</b>	<b>(0.6)</b>	<b>230.3</b>

(c) Reconciliation of the consolidated balance sheet as at 1 April 2004 (date of transition)

	UK GAAP £m	Property, plant & equipment (d(i)) £m	Pensions (d(ii)) £m	IAS 39 (d(iii)) £m	Deferred tax (d(iv)) £m	Dividends £m	Other under IFRS £m	Restated under IFRS £m
<b>Non-current assets</b>								
Goodwill	0.2	-	-	-	-	-	-	0.2
Other intangible assets	64.2	-	-	-	-	-	-	64.2
Property, plant and equipment	2,692.8	(2.8)	-	-	-	-	-	2,690.0
Investments in jointly controlled entities	3.4	-	-	-	-	-	-	3.4
Investments in associates	1.8	-	-	-	-	-	-	1.8
Other investments	0.4	-	-	-	-	-	-	0.4
Pension asset	14.3	-	(14.3)	-	-	-	-	-
	<b>2,777.1</b>	<b>(2.8)</b>	<b>(14.3)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,760.0</b>
<b>Current assets</b>								
Inventories	4.8	-	-	-	-	-	-	4.8
Trade and other receivables	110.4	-	-	-	-	-	-	110.4
Income tax receivable	7.7	-	-	-	-	-	-	7.7
Interest rate swap	-	-	-	3.4	-	-	-	3.4
Cash and cash equivalents	44.8	-	-	-	-	-	-	44.8
	<b>167.7</b>	<b>-</b>	<b>-</b>	<b>3.4</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>171.1</b>
<b>Total assets</b>	<b>2,944.8</b>	<b>(2.8)</b>	<b>(14.3)</b>	<b>3.4</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,931.1</b>
<b>Non-current liabilities</b>								
Interest bearing loans and borrowings	1,853.0	-	-	-	-	-	-	1,853.0
Provisions	6.3	-	-	-	-	-	-	6.3
Deferred income tax liabilities	158.8	(1.0)	(32.4)	0.1	298.1	-	(0.2)	423.4
Pension liability	-	-	93.6	-	-	-	-	93.6
Other payables	13.4	-	-	-	-	-	-	13.4
Interest rate swap	-	-	-	2.9	-	-	-	2.9
Grants	142.8	0.5	-	-	-	-	-	143.3
	<b>2,174.3</b>	<b>(0.5)</b>	<b>61.2</b>	<b>3.0</b>	<b>298.1</b>	<b>-</b>	<b>(0.2)</b>	<b>2,535.9</b>
<b>Current liabilities</b>								
Interest bearing loans and borrowings	48.0	-	-	-	-	-	-	48.0
Trade and other payables	199.5	-	-	-	-	(24.0)	0.8	176.3
	<b>247.5</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(24.0)</b>	<b>0.8</b>	<b>224.3</b>
<b>Total liabilities</b>	<b>2,421.8</b>	<b>(0.5)</b>	<b>61.2</b>	<b>3.0</b>	<b>298.1</b>	<b>(24.0)</b>	<b>0.6</b>	<b>2,760.2</b>
<b>Net assets</b>	<b>523.0</b>	<b>(2.3)</b>	<b>(75.5)</b>	<b>0.4</b>	<b>(298.1)</b>	<b>24.0</b>	<b>(0.6)</b>	<b>170.9</b>
<b>Capital and reserves</b>								
Issued capital	51.9	-	-	-	-	-	-	51.9
Share premium	446.3	-	-	-	-	-	-	446.3
Cash flow reserve	-	-	-	(2.9)	-	-	-	(2.9)
Treasury shares	(0.5)	-	-	-	-	-	-	(0.5)
Retained earnings	23.4	(2.3)	(75.5)	3.3	(298.1)	24.0	(0.6)	(325.8)
<b>Equity shareholders' funds</b>	<b>521.1</b>	<b>(2.3)</b>	<b>(75.5)</b>	<b>0.4</b>	<b>(298.1)</b>	<b>24.0</b>	<b>(0.6)</b>	<b>169.0</b>
Minority interests	1.9	-	-	-	-	-	-	1.9
<b>Total capital and reserves</b>	<b>523.0</b>	<b>(2.3)</b>	<b>(75.5)</b>	<b>0.4</b>	<b>(298.1)</b>	<b>24.0</b>	<b>(0.6)</b>	<b>170.9</b>

**(d) Explanation of reconciling items between UK GAAP and IFRS**

**(i) Property, plant and equipment**

In the regulated water services business, infrastructure assets comprise a network of systems being mains and sewers, reservoirs, dams and sea outfalls. Prior to 1 April 2004, 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, was treated as additions to fixed assets. This treatment is not permitted under IAS 16. The opening balance for infrastructure assets was determined as described under 'First time adoption' above.

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

Infrastructure assets are depreciated evenly to their estimated residual values over their estimated economic lives.

**(ii) Pensions and other post-retirement benefits**

*Defined benefit scheme*

The Group operates a defined benefit pension scheme. The cost of providing this benefit is determined using the projected unit method, with actuarial valuations being carried out at each balance sheet date. The liability or asset recognised in the balance sheet represents the present value of the defined benefit obligations at the balance sheet date, less the fair value of the scheme assets and past service costs.

The defined benefit obligations represent the estimated amount of future benefits that employees have earned in return for their services in current and prior periods, discounted at a rate representing the yield on a high quality corporate bond at the balance sheet date, denominated in the same currency as the obligations and having the same terms of maturity as the related pension liability, applied to the estimated future cash outflows arising from these obligations.

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

*Defined contribution scheme*

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

**(iii) Financial instruments**

With effect from 1 April 2004, derivative financial instruments are stated at their fair value.

Under IAS 39, derivative financial instruments are always measured at fairvalue, with hedge accounting employed in respect of those derivatives fulfilling the stringent requirements for hedge accounting as prescribed under IAS 39.

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

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

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

**(iv) Deferred tax**

Deferred tax is provided using the liability method on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Under IFRS the discounting of deferred tax is not permitted.

**(v) Presentation of jointly controlled entities and associates**

Under IFRS the Group's share of profit after tax is disclosed on the face of the income statement. Under UK GAAP, the results of the jointly controlled entities were included within turnover, operating profit, interest and taxation in the income statement. The results of associates were included within operating profit, interest and taxation.

*(vi) Restatement of cash flow statement from UK GAAP to IFRS*

The transition from UK GAAP to IFRS has no effect upon the reported cash flows generated by the Group. The IFRS cash flow statement is presented in a different format from that required under UK GAAP with cash flows split into three categories of activities – operating activities, investing activities and financing activities. The reconciling items between the UK GAAP presentation and the IFRS presentation have no impact on the cash flows generated.

In preparing the cash flow statement under IFRS, cash and cash equivalents include cash at bank in hand, highly liquid interest bearing securities with original maturities of three months or less, and bank overdrafts. Under UK GAAP highly liquid interest bearing securities were classified as cash equivalents.

## **Parent Company auditors' report**

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

We have audited the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2006 which comprise the Balance Sheet and the related notes 31 to 40. These parent Company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

We have reported separately on the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2006.

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, the Directors' Remuneration Report and the parent Company financial statements in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the parent Company financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the parent Company financial statements give a true and fair view, the parent Company financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and that the information given in the parent Company directors' report is consistent with the financial statements.

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

We read other information contained in the Annual Report and consider whether it is consistent with the audited parent Company financial statements. The other information comprises Highlights, NWG at a Glance, the Chairman's Statement, the Managing Director's Statement, Corporate Responsibility, the Business Review, Appendix to the Business Review, Board Directors' Biographies, Directors' Report, the Corporate Governance Statement, the unaudited part of the Directors' Remuneration Report and Shareholder Information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent Company financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

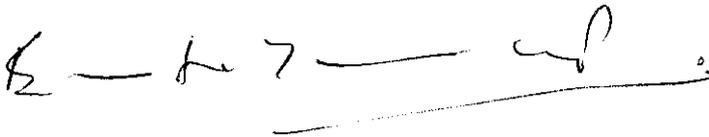
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the parent Company financial statements and the part of the Directors'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

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

### **Opinion**

In our opinion:

- the parent Company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 March 2006;
- the parent Company financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the directors' report is consistent with the parent Company financial statements.



Ernst & Young LLP  
Registered Auditor  
Newcastle upon Tyne  
6 June 2006

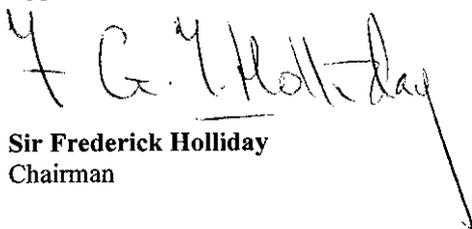
Northumbrian Water Group plc

**Company balance sheet**

As at 31 March 2006

	Notes	31.3.2006 £m	31.3.2005 £m (restated)
<b>Fixed assets</b>			
Other investments	33	1,022.6	1,022.7
		1,022.6	1,022.7
<b>Current assets</b>			
Debtors: receivable within one year	34	7.4	11.3
Cash at bank		12.7	47.3
		20.1	58.6
<b>Creditors: amounts falling due within one year</b>	35	(9.5)	(49.0)
<b>Net current assets</b>		10.6	9.6
<b>Total assets less current liabilities</b>		1,033.2	1,032.3
<b>Creditors: amounts falling due after more than one year</b>	36	(490.0)	(490.0)
<b>Net assets</b>		543.2	542.3
<b>Capital and reserves</b>			
Called up share capital	38	51.9	51.9
Share premium account	39	446.5	446.3
Other reserve	39	(1.7)	(0.9)
Profit and loss account	39	46.5	45.0
<b>Equity shareholders' funds</b>		543.2	542.3

Approved by the Board on 6 June 2006 and signed on its behalf by:



Sir Frederick Holliday  
Chairman



John Cuthbert  
Managing Director

## Notes to the Company financial statements

### 31. Accounting policies

#### (a) Basis of accounting

The financial statements have been prepared in accordance with applicable United Kingdom law and accounting standards including FRS 21 'Events after the balance sheet date'. The accounting policies have been reviewed in accordance with the requirements of FRS 18. The directors consider the following accounting policies to be relevant in relation to the Company's financial statements. The Company's financial statements are included in the consolidated financial statements of Northumbrian Water Group plc. Accordingly, the Company has taken advantage of the exemption from preparing a profit and loss account and cash flow statement. The Company is also exempt from disclosing related party transactions with subsidiaries of NWG.

#### (b) Prior year adjustment

The Company has adopted FRS 21 'Events after the balance sheet date' in these financial statements. Dividends are now accrued where an obligation exists at the balance sheet date. Consequently, dividends which the Company approves in a general meeting at the balance sheet date are no longer accrued, but are required to be disclosed in the notes to the financial statements. The prior year comparative figures have been restated to reflect the dividends paid in that year, in accordance with the first year adoption requirements of FRS 21.

#### (c) Turnover

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

#### (d) Fixed asset investments

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

#### (e) Taxation

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 Company 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.

#### (f) 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.

#### (g) Treasury risks

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

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

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

##### *Liquidity risk*

As regards day to day liquidity, the Company is responsible for cash management but is reliant upon the borrowing facilities available to the Group. 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.

##### *Interest rate risk*

The Company finances its operations through a mixture of retained profits and borrowings. It borrows at both fixed and floating rates of interest and, as noted above, on occasion uses derivatives to generate the desired interest profile and to manage its exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2006, 80% (2005: 88%) of the borrowings of NWG were at fixed rates of interest. At 31 March 2006, the Group had £275.0 million available in standby committed bank facilities.

#### 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 recognition.

#### Currency exposures

At 31 March 2006, the Company had no currency exposures (2005: £nil).

#### Market price risk

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

### 32. Auditors' remuneration

Auditors' remuneration for the year ended 31 March 2006 was £80,000 (2005: £80,000).

### 33. Investments

	£m
At 1 April 2005	1,022.7
Refund of transaction costs	(0.1)
<b>At 31 March 2006</b>	<b>1,022.6</b>

### 34. Debtors

	31.3.2006 £m	31.3.2005 £m (restated)
Trade debtors	-	0.1
Amounts owed by subsidiary undertakings	3.0	6.7
Deferred tax	4.0	4.0
Prepayments and accrued income	0.4	0.5
	<b>7.4</b>	<b>11.3</b>

Amounts owed by subsidiary undertakings include amounts receivable for the provisional surrender of tax losses amounting to £1.6 million (2005: £4.7 million). The deferred tax asset relates wholly to other timing differences.

The deferred tax asset provided in the financial statements comprises:

	Year to 31.3.2006 £m	Year to 31.3.2005 £m
Other timing differences	5.5	5.5
Discount	(1.5)	(1.5)
<b>Discounted provision for deferred tax</b>	<b>4.0</b>	<b>4.0</b>

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

	31.3.2006 £m	31.3.2005 £m (restated)
Amounts owed to subsidiary undertakings	9.3	48.9
Accruals and deferred income	0.2	0.1
	<b>9.5</b>	<b>49.0</b>

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

	31.3.2006 £m	31.3.2005 £m
Amounts owed to subsidiary undertakings	490.0	490.0

### 37. Loans

	31.3.2006 £m	31.3.2005 £m
Loans are repayable as follows:		
In more than five years	490.0	490.0

### 38. Authorised and issued share capital

	31.3.2006 £m	31.3.2005 £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	51.9	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 976,668 (2005: 681,296) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 47 to 49. As at 31 March 2006, the share price of the ordinary 10 pence shares in the Company was 238.75 pence (2005: 176.25 pence).

### 39. Reserves

	Own shares £m	Share premium account £m	Profit and loss account £m
At 1 April 2004 as previously stated	(0.9)	446.3	42.4
Prior year adjustment (see note 31(b))	-	-	(19.0)
At 31 March 2004 restated	(0.9)	446.3	23.4
Loss for the year	-	-	(17.6)
Amortisation of LTIP awards	-	-	0.1
Dividends as restated	-	-	39.1
At 31 March 2005 restated	(0.9)	446.3	45.0
Loss for the year	-	-	(22.2)
Purchase of own shares for the LTIP	(0.8)	-	-
Amortisation of LTIP awards	-	-	0.2
Refund of transaction costs	-	0.2	-
Dividends paid and received	-	-	23.5
At 31 March 2006	(1.7)	446.5	46.5

### 40. Commitments

The Company has issued letters of continuing support to subsidiary companies with net liabilities amounting to £7.2 million (2005: £nil), net current liabilities £nil (2005: £139.1 million). These subsidiary companies are expected to meet their working capital requirements from operating cash flows.

The Company is party to a cross guarantee arrangement with other group companies in respect of bank facilities. Overdrafts outstanding at 31 March 2006 in respect of the arrangement amounted to £21.7 million (2005: £57.5 million). The directors do not expect any loss to arise as a result of this arrangement.

## Shareholder information

### Electronic communications/summary financial statements

Due to the relatively small number of our shareholders, there are no savings to be achieved by producing summary financial statements as well as the full annual report and financial statements.

We have introduced an electronic communications facility so that shareholders can choose to receive an email notification when the annual report is available to view or download from our website, instead of receiving a printed copy of the annual report. To register, email the words 'Northumbrian Water Group shareholder' to [ecomms@capitaregistrars.com](mailto:ecomms@capitaregistrars.com) and include your full name, address and Investor Code in the body of the email.

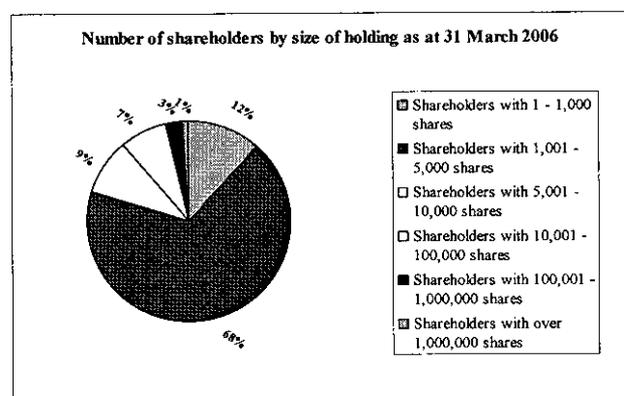
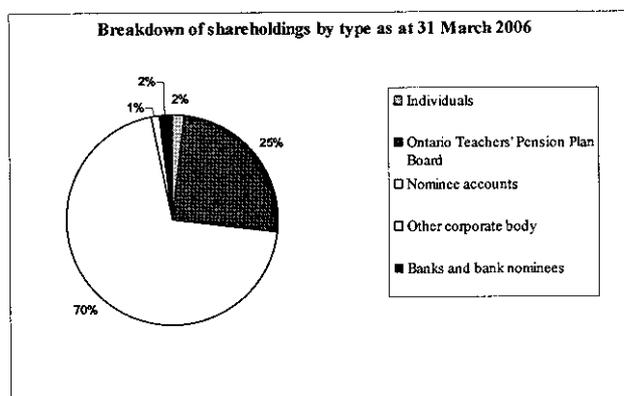
### Drip/Scrip

The Company receives occasional requests from shareholders wishing to receive their dividends in the form of shares instead of cash. There are costs involved in providing this service, and at present it would not be cost effective. This issue is kept under regular review.

### ShareDeal

You can make use of a low cost share dealing service provided by Capita Registrars to buy or sell shares in NWG. Further information is available at [www.capitaregistrars.com](http://www.capitaregistrars.com), or by telephoning 0870 4584577.

### Shareholder analysis



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  
Email: [ssd@capitaregistrars.com](mailto:ssd@capitaregistrars.com)  
Web: [www.capitaregistrars.com](http://www.capitaregistrars.com)

### For general shareholder queries please contact Secretariat on:

Tel: 0191 301 6704/0191 301 6701  
Fax: 0191 301 6705  
Email: [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk)

### To request financial statements and other Company literature please contact Communications on:

Tel: 0191 301 6734  
Email: [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk)

### Annual General Meeting

The Notice of Meeting, information about the AGM to be held on 27 July 2006 and the proxy voting card are enclosed with these financial statements. Shareholder questions and special needs requests should be addressed to Secretariat at our registered office address, by telephone on 0191 301 6701, or by email at [shareholders@nwl.co.uk](mailto:shareholders@nwl.co.uk)

### Company Secretary & registered office

Martin Parker  
Northumbrian Water Group plc  
Northumbria House  
Abbey Road  
Pity Me  
Durham, DH1 5FJ  
Tel: 0870 6084820

### Financial calendar 2006

27 July	AGM
16 August	Ex-dividend date
18 August	Record date
15 September	Final dividend payment
6 December	Interim results announcement
20 December	Ex-dividend date
22 December	Record date

### 2007

2 February	Interim dividend payment
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### Group websites

[www.nwg.co.uk](http://www.nwg.co.uk)  
[www.nwl.co.uk](http://www.nwl.co.uk)  
[www.eswater.co.uk](http://www.eswater.co.uk)  
[www.aes-labs.co.uk](http://www.aes-labs.co.uk)  
[www.agrer.com](http://www.agrer.com)

**Northumbrian Water main switchboard**

Tel: 0870 608 4820

**Northumbrian Water customer queries**

Customer services: 0845 717 1100

Customer accounts: 0845 733 5566

**Essex & Suffolk Water customer queries**

Customer services: 0845 782 0999

Customer accounts: 0845 782 0111