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NORTHUMBRIAN WATER LIMITED
FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2010

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010

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DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (OFR)

For the year ended 31 March 2010

The directors present their annual report and operating and financial review and the audited financial statements for the year ended 31 March 2010

Cautionary statement

This annual report contains certain statements with respect to the future operations, performance and financial condition of Northumbrian Water Limited (NWL or the Company). By their nature, these statements involve uncertainty since future events and circumstances can cause results and developments to differ materially from those forecast. Such statements reflect knowledge and information available at the date of preparation of this annual report and the Company undertakes no obligation to update such statements. Nothing in this annual report should be construed as a profit forecast. Certain regulatory performance data contained in this annual report is subject to regulatory audit.

Principal activities

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

Directors

The directors who served during the year were as follows

Sir D Wanless	Non-Executive Chairman
J A Cuthbert	Executive Managing Director (retired 31 March 2010)
H Mottram OBE	Executive Director (appointed 1 March 2010)
C M Green	Executive Finance Director
G Neave	Executive Operations Director
A C Jones	Executive Regulation and Scientific Services Director
A G Balls	Independent Non-Executive Director
A M Frew	Independent Non-Executive Director
Dr S Lyster	Independent Non-Executive Director
Sir A P Brown	Non-Executive Director
C R Lamoureux	Non-Executive Director
M A B Nègre	Non-Executive Director
A J Scott-Barrett	Non-Executive Director
J M Williams	Non-Executive Director

Heidi Mottram OBE was appointed as Chief Executive Officer on 1 April 2010. Margaret Fay CBE was appointed to the Board on 1 June 2010.

BUSINESS OVERVIEW

Operating environment

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

DIRECTORS' REPORT and OFR (continued)

Operating environment (continued)

In the north east the business comprises the supply of both potable and raw water and the collection, treatment and disposal of sewage and sewage sludge to 2.7 million people. In this region there has been a gradual fall in overall water demand in recent decades as a consequence of a reduction in industrial demand for water. This trend is expected to continue for at least the next five years with a faster decline in the short term due to the impact of the economic recession. The north east compares well to the rest of the country as far as water resources are concerned and our major regional rivers can all be supported by Kielder Water. This provides very high security of supply for our customers.

In the south the business supplies potable water to 1.8 million people. This is a water scarce region that is forecast to experience further economic and population growth in the medium term. While this area has also seen a reduction in demand from heavy industry and the recession is likely to dampen housing growth in the near future, we have a current deficit, meaning supplies are not secure in a severe drought. Future growth will intensify the pressure on the balance between supply and demand. NWL is implementing long term plans to ensure the availability of water supplies to meet both current and future demand in a region where water resources are already constrained. After approval from the Environment Agency, the project to increase the capacity of Abberton Reservoir near Colchester, coupled with ongoing demand management measures, will secure supplies to the Essex area for the foreseeable future.

Regulatory environment

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

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

NWL aims to maintain good working relationships with its regulators and with regional organisations, such as local authorities, which have an interest in the services it provides and can influence the Company's business.

The final determination established a tough settlement for the period 2010-15. However, we are well placed to deliver the required objectives and to meet our commitments to providing safe and secure water supplies and protecting the environment. There is a change in emphasis in the quinquennial £1.2 billion investment programme, from achieving new quality standards to maintaining the high standards already achieved. We will also be working to tackle the challenges posed by climate change, reducing our operational carbon emissions and improving the resilience of our assets.

We welcome the passing of the Flood and Water Management Act 2010 which clarifies responsibilities in relation to flooding and sustainable drainage as well as tidying up and updating other water related legislation. The introduction of a duty on landlords to provide water companies with relevant details so that accurate bills can be issued to tenants is particularly welcome and should assist in collecting income from the private rented sector where bad debts have been relatively high.

The full implementation of Operator Self Monitoring was completed in January 2010. This involves NWL taking on responsibility for sampling and analysing the final effluent at sewage treatment works for compliance purposes. This task was previously undertaken by the EA and the transfer is consistent with the Better Regulation principles.

We are pleased that the final 'River Basin Management Plans' published by the EA for the rivers in our regions proposed an appropriate balance between challenging environmental targets and a clear evidence base for action. We support the emphasis on tackling diffuse pollution at source rather than end of pipe solutions.

DIRECTORS' REPORT and OFR (continued)

Regulatory environment (continued)

NWL intends to increase the emphasis given to catchment management across its operating areas and will increase the number of employees dedicated to promoting catchment management solutions. This will help tackle emerging challenges from water soluble pesticides and also bring a range of other benefits in terms of habitat protection, biodiversity and carbon management.

We are an active member of Water UK, the industry association which represents all UK water and waste water service suppliers at national and European level. It provides a very effective framework for the industry to engage with Government, regulators, stakeholder organisations and the public and helps to develop policy and improve understanding of the industry. We also meet regularly with national, regional and local authorities and other appropriate organisations to explain NWL's activities and related issues.

BUSINESS STRATEGY AND OBJECTIVES

Our mission

The NWG mission is to be the national leader in the provision of sustainable water and waste water services, and this is shared by NWL.

Strategic direction

Our strategy is to focus on our core competences of water and waste water management and, through that focus, to deliver value to all of our stakeholders. Our three priorities are

to maintain our strong reputation and relationships by

- delivering excellent service to customers,
- delivering regulatory outputs,
- creating shareholder value, and
- involving our main stakeholder groups

to ensure a stable financial profile by

- optimising cash flow,
- delivering operational efficiency, and
- securing low cost long term funds

to develop a culture of continuous improvement by

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

A clear framework

We have identified five key strategic themes. Four of these, People, Customer, Competitiveness and Environment, are important individually and also contribute to the fifth, Reputation. These themes underpin our drive for performance and delivery of our corporate objectives. The themes are mutually supportive and achieving the right balance between them is an essential part of our success.

People

We believe strongly that our people are the key to business success.

Customer

Customers are central to our thinking and our overriding objective is to properly understand and meet their needs.

DIRECTORS' REPORT and OFR (continued)

A clear framework (continued)

Competitiveness

To grow our business and meet the challenges of a developing market we strive to be competitive in everything we do

Environment

Our business is founded on water and environmental engineering and a great deal of what we do influences the environment. We seek to understand our impact on the environment and, also taking into account our impact on, and contribution to, the economy and communities in which we operate, aim always to deliver sustainable outputs from our activities

Reputation

Our ability to develop our business will be influenced by our reputation. A good reputation is often the starting point for good stakeholder relationships on which business growth can be achieved

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

NWL's corporate objectives are

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

We also prepare a detailed medium term business plan and annual budget, 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.

DIRECTORS' REPORT and OFR (continued)

FINANCIAL PERFORMANCE

Key performance indicators (KPIs)

We use a range of indicators to monitor performance. The definition, purpose and source of each financial KPI are shown on page 27. Performance against the financial KPIs is set out below.

KPI	Target	Performance	
		Current year	Previous year
Gearing to RCV – NWL group (see note 11) (%)	<70	61	61
Gearing to RCV – Appointed business only (%)	<65	60	60
Cash interest cover (times)	>3.0	3.9	3.8
Cash flow to net debt (%)	>13	18	18

All financial KPIs remained better than the target for the year. Gearing remained stable whilst cash interest cover improved slightly over the year.

Financial results and dividends

The Company's profit and loss account and balance sheet are set out on pages 29 and 30. The financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. The key accounting policies are summarised in note 1 to the statutory financial statements on pages 31 to 34 and these have been applied consistently throughout the current and preceding periods.

Profit after tax for the year was £143.0m (2009: £129.3m).

Turnover increased from £641.2m in 2008/09 to £651.5m for the year to 31 March 2010, an increase of 1.6%. Water and sewerage charges were increased by 3% (in line with the November 2008 Retail Price Index (RPI)) but that increase was partially offset by reductions in non-household revenue as a consequence of the current economic downturn. The K factor allowed for 2009/10 in the 2004 final determination was 0.6%, however, NWL chose not to apply this increase.

Operating costs, excluding capital maintenance costs, have increased from £274.6m in 2008/09 to £283.6m in 2009/10, principally reflecting the impact of increases in salaries, abstraction and rates plus one-off charges for bad debt relating to the closure of a major customer (£1.7m) and a provision for early retirement and severance costs (£5.4m). These increases have been partially offset by efficiencies, including the benefit of reduced power prices and the commissioning of the advanced anaerobic digestion plant at Bran Sands on Teesside during the year.

Energy costs were £36.4m (2009: £38.8m) and are expected to reduce by around £4.0m for the following year. This reflects the full year impact of the Bran Sands advanced anaerobic digestion plant and lower commodity prices. These savings will be sustained as we have procured our entire electricity requirement through to March 2015 at prices below the level funded in the final determination.

Capital maintenance costs have increased from £106.4m in 2008/09 to £112.5m in 2009/10, reflecting increased depreciation arising from the commissioning of new assets.

Net interest payable decreased from £91.4m in 2008/09 to £76.8m in 2009/10, a decrease of £14.6m within which net cash interest charges increased by £4.1m. The non-cash elements of the decrease reflect deflation of the principal on the index linked bonds (£29.0m), a reduction in the expected return on pension assets (£12.4m) and a decrease in the interest cost of pension plan obligations (£2.1m).

DIRECTORS' REPORT and OFR (continued)

Financial results and dividends (continued)

Profit on ordinary activities before tax for the year was £143.0m, 11% higher than the previous year (2009 £129.3m). The current tax charge of £42.8m (2009 £37.6m) principally reflects increased profitability and the timing of relief for prepaid pension contributions. The deferred tax credit of £7.2m (2009 £1.9m charge) is lower due to the discount increasing as a result of increases in the post-tax yields on UK government gilts during the year.

The directors recommend a final ordinary dividend amounting to £43.8m (2009 £42.5m) which, together with the interim dividend of £43.4m (2009 £42.9m), makes a total for the year of £87.2m (2009 £85.4m). This continues the stated dividend policy for the appointed business of 1.9% real annual growth (see note 9 to the statutory financial statements). The Board has proposed a dividend policy consistent with the underlying growth assumptions adopted by Ofwat at its price reviews in 2004 and 2009.

Capital investment

Capital investment in the regulated business for the period was £218.3m (2009 £245.2m). Investment for the five year AMP4 period has exceeded the funding allowed in the 2004 final determination by £92m, as outperformance on the quality programme has been more than offset by increased investment on capital maintenance. This includes £64m investment in our new sludge strategy, including the Bran Sands advanced digestion plant, and additional investment in response to extensive sewer flooding in recent years.

Work started in January 2010 on increasing the capacity of Abberton Reservoir near Colchester by 58%. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke in Norfolk. We are working closely with the EA on progressing this. Once this scheme is operating in 2014, we do not expect to have to develop further major resources in Essex for the next 25 years.

A long running formal programme, which began just after privatisation, to rehabilitate older parts of the water distribution network has come to an end, contributing to improved water quality results over recent years. Work using new cleaning techniques to refurbish more than 150 kilometres of the large diameter pipe network is well advanced. The network supplies drinking water to over half a million customers in south east Northumberland and parts of Tyneside. More than half of the programme has been completed successfully and work will be completed in 2011, significantly reducing customer complaints of discoloured water.

NWL's exceptional performance for sewage treatment works continued with all consented works remaining compliant over the year. Two major schemes, to further improve performance at Sunderland and Darlington sewage treatment works, were completed.

The advanced anaerobic digestion plant at Bran Sands is now fully operational and generating the expected volumes of biogas and electricity. Plans to provide a similar plant on Tyneside to process the remainder of the company's sludge, and also replace older technology, are progressing well.

Capital schemes to remove 277 properties from flooding registers were successfully completed. Planning to identify schemes for coming years forms a key part of our investment programme and is well advanced, with a further 250 properties to be addressed in 2010/11. The five year programme to improve the visual appearance of discharges from nearly 500 combined sewer overflows was successfully completed, with engineering works taking place at 106 locations in the year.

DIRECTORS' REPORT and OFR (continued)

OPERATIONAL PERFORMANCE

Key Performance Indicators

In addition to the financial indicators shown on page 5, NWL also uses non-financial indicators throughout the business. Performance against these indicators is reviewed by the management team each month. The definition, purpose and source of the main KPIs are shown on pages 27 and 28.

	North (N) South (S)	Target 2010/11	Target 2009/10	Target achieved	Performance	
					Current year	Previous year
Customer satisfaction						
Overall service (%)	N/S	91	90	x	88	88
Value for money (%)	N/S	87	85	x	83	84
Customer – levels of service						
Properties at risk of low pressure	N	256	274	✓	260	271
	S	55	126	✓	40	40
Properties subject to unplanned interruption of six hours or more	N	1,700	3,000	x	8,671 ¹	8,278
	S	1,100	2,000	✓	1,434	3,353
Properties subject to hosepipe bans at any time during the year	N/S	0	0	✓	0	0
Properties subject to sewer flooding (other causes)	N	150	150	x	281	286
Properties at risk of sewer flooding (once in 10 years or twice in 10 years)	N	688	76	x	397	559
Billing contacts responded to (within five working days) (%)	N	99.3	99.2	✓	99.4	99.2
	S	99.3	99.2	✓	99.4	99.6
Written complaints responded to (within 10 working days) (%) ²	N	n/a	99.8	✓	99.9	99.9
	S	n/a	99.8	✓	99.9	99.7
Bills based on meter readings (%)	N	99.9	99.95	x	99.92	99.90
	S	99.9	99.95	x	99.93	99.95
All telephone lines busy (%) ²	N	n/a	0.05	x	0.17	0.07
	S	n/a	0.25	✓	0.07	0.06
Abandoned telephone calls (%) ²	N	n/a	3.00	x	7.43	3.43
	S	n/a	2.00	x	4.31	1.95
Water						
DWI Mean Zonal Compliance (%)	N	99.85	99.90	✓	99.91	99.92
	S	99.95	99.98	x	99.82	99.99
DWI Operational Performance Index (%)	N	99.65	99.65	x	99.58	99.67
	S	99.98	99.98	x	99.97	99.98
Distribution Maintenance Index (%)	N	99.70	99.70	x	99.21	99.52
	S	99.85	99.85	✓	99.94	99.96
Environment						
Sewage treatment works (%)	N	100	99.7	✓	100	100
Bathing waters Mandatory Standard (%)	N	100	100	✓	100	100
Pollution incidents	N	102	89	x	114	94
Employees						
Employee turnover (rolling %) ³	N/S	-	industry average 9.2	-	6.5	6.4
Lost time reportable accidents (per 1,000 employees)	N/S	4.3	10	✓	5.7	6
Sickness absence (%)	N/S	2.85	2.85	x	3.18	2.94

1 Performance affected by two major bursts in Tyne & Wear and Northumberland

2 New Service Incentive Mechanism (SIM) measures have been introduced by Ofwat for 2010/11. These are being piloted and monitored during 2010/11, whereupon appropriate targets will be set

3 No target set, data for information

DIRECTORS' REPORT and OFR (continued)

Key Performance Indicators (continued)

Customer

We measure our performance for domestic customers in two key ways, customer research and performance against standards. Customer research is carried out each quarter in the regions served and, although the performance is slightly below the target, the level of customers being satisfied or very satisfied remains high. This is backed up by the fourth annual survey carried out by CCWater which shows similar high levels of satisfaction and also concluded, once again, that our customers are the most satisfied in the country in terms of water and sewerage services and also fairness of charges.

For 2010/11, Ofwat has introduced the Service Incentive Mechanism (SIM) and, amongst other things, this will monitor the quality of our service rather than the quantitative results. This year, improvements to customer service include a reduction in written complaint numbers by 22%, from 13,050 to 10,185. Our complaint handling and billing query service has been subject to audit by CCWater and they have commented favourably on how we performed, 96% of the 50 cases reviewed in both areas being classed as 'good'.

Water

The quality of water is critical to our customers and samples are taken on a daily basis for analysis under regulations monitored by the DWI. The quality in all areas served remained high. The DWI will investigate any incidents which could compromise quality and the number of such incidents fell during the year. NWL has appointed catchment management officers to work with farmers and regulators in Essex to help reduce the level of pesticides in the environment and their impact on raw water quality. This work is progressing well and has produced encouraging results.

Our assets proved very resilient during the harshest winter for 30 years and we were able to maintain supplies to customers during the period, thanks to the efforts of our employees. The severe freeze, followed by the thaw, did result in a significant increase in burst pipes and leakage which meant we, along with other companies, did not meet our annual targets this year although our three year rolling targets have again been met.

Environment

NWL's exceptional performance for sewage treatment works continued with all consented works remaining compliant over the year. All 34 bathing waters in the north east again passed the required Mandatory Standard and 30 of these met the more demanding Guideline Standard.

Employees

NWL employee turnover is relatively low at 6.5%, below the UK water industry average of 9.2%. The current level of sickness absence is 3.18%, which is well below the norm for the sector.

We place great emphasis on health and safety and employees are actively encouraged to be involved in identifying and eliminating hazards in the workplace. This has resulted in a significant reduction in accidents over recent years.

DIRECTORS' REPORT and OFR (continued)

FUTURE DEVELOPMENTS

Looking to the future

We consulted key stakeholders before publishing 'Looking to the future', our long term operational strategy for the next 25 years, in 2007. We published different versions for each of our operational areas and they have been well received by a range of stakeholders. They are available on our websites at www.nwl.co.uk and www.eswater.co.uk

In our strategy, we set out our long term aims for NWL alongside intermediate targets for the period to 2015 for the key areas of

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

Our long term operational strategy was produced to help inform our plans for the period 2010-15. The strategy builds on our achievements of the past 20 years and re-affirms our commitment to long term planning and investment to deliver value to all our stakeholders.

We identified three key challenges for the future

- sustaining and, where appropriate, improving services while keeping bills affordable,
- maintaining healthy and stable finances to ensure we can continue to borrow money to meet the investment needed in the business, and
- responding to climate change by further reducing greenhouse gas emissions and future-proofing our operations

Ofwat published a final determination of price limits for the period 2010-15 on 26 November 2009. The NWL Board confirmed, on 15 December 2009, that it would not ask Ofwat to refer its decision to the Competition Commission.

RISKS AND UNCERTAINTIES

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

This year, the Audit Committee commissioned an additional risk and assurance mapping report from Ernst & Young, to provide NWL's management and the Audit Committee with a view of the different assurance functions and the extent to which they provide assurance that the control activities mitigating the key business risks are working properly. In performing the review, Ernst & Young interviewed several of the managers most involved in the management of risk and, having done so

- identified the main risks in NWL's existing risk register and additional risks that they would typically expect to be included based on their knowledge of the water sector,
- identified the main audit and assurance activities, and
- mapped the sources of assurance against the control activities and risks checking for gaps and duplication

DIRECTORS' REPORT and OFR (continued)

RISKS AND UNCERTAINTIES (continued)

The main conclusions, which were reported by Ernst & Young to the NWL Board, were

- the mechanics of the risk assessment and the format of the risk register are typical of what Ernst & Young would expect to see within an effective risk management process,
- much of the content of the risk register is very typical of what they see within other companies operating within this sector, and
- there are many different sources of assurance across the business and the assurance coverage of key risks is reasonable

Having received Ernst & Young's assessment of the current approach to risk and assurance, the Board considered the documentation of risk appetite and the manner in which assurance is received. The Board agreed that, as well as ensuring that an effective 'bottom up' risk management programme is in place, they should also consider risks of a more strategic nature regularly. Subject to addressing Ernst & Young's points, the Board considered the current approach to general business risk to be acceptable, although Board papers could usefully make more explicit reference to how risks have been evaluated. However, a draft register of strategic risks will also be produced for discussion. As well as helping to identify these risks this should also help the Board agree whether its appetite for risk should be documented formally.

Financial risk

The financial ratios and financial results are described in the section headed Financial Performance on page 5. The management of financial risks relating to liquidity and treasury policies are covered under Capital Structure on page 13.

The current pressures within financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance. It is highly unlikely there will be a return to the exceptionally low cost of debt experienced from late 2005 to early 2007. Although market conditions have improved in recent months, some uncertainty remains. With the financing we have already put in place, we are sheltered from this uncertainty in the short term as we will not need to raise any new debt before the end of 2011.

The current economic climate is having an impact on revenues, particularly those from industrial and commercial customers and those associated with the housing market. We continue to monitor the uncertain situation very carefully and, in particular, the recovery of domestic revenue. We welcome the passing of the Flood and Water Management Act 2010, which will require landlords to disclose details of their tenants which will help improve debt collection.

Overall, industrial revenues are currently expected to be close to those assumed by Ofwat when setting prices for 2010-15. Our largest single customer, Artenius UK Limited, ceased production in 2009 and Ofwat assumed this plant would remain closed. However, in February 2010, it was bought by a Korean company, KP Chemicals, whose subsidiary, Lotte Chemical UK Limited, brought the plant back into operation in April 2010 (although NWL revenue will be slightly lower than under the previous Artenius contract). By contrast, a number of plants have closed which Ofwat had assumed would remain open. The most significant is Corus Cast Products where the blast furnace was mothballed in January 2010, although Corus has also announced that the South Bank Coke Ovens, which was also under threat of closure, will remain open for at least a further three years.

Regulatory risk

The fact that NWL has been able to accept the outcome of PR09 reduces the main source of regulatory risk.

The Flood and Water Management Act 2010 also includes provisions to implement the recommendations of the 'Pitt Review' on flooding as well as a range of other measures to tidy up aspects of water related legislation. The flooding measures primarily relate to local authorities and the EA but also have implications for water companies, particularly with regard to how they interact and cooperate with those bodies.

DIRECTORS' REPORT and OFR (continued)

Regulatory risk (continued)

The Labour Government signalled its intention to proceed with the transfer of certain private drains and sewers into water company ownership, increasing the network owned and maintained by NWL by about 70%. The timetable is slipping and we have still not seen the implementing regulations. The earliest practical date of transfer is now October 2011, but further delay in issuing the regulations will result in a delay in the transfer date. The costs associated with the transfer were not included in the PR09 price review. It is, therefore, likely that all sewerage companies will see an adjustment to price limits in light of the transfer.

The full impact of another item of legislation, the Traffic Management Act 2004, is not yet clear, but the Labour Government indicated its desire to increase charges for disruptive roadworks.

The General Election has delayed Government measures in response to the 'Cave Review' (on competition) and the 'Walker Review' (on charges and metering). The new coalition Government has made some early statements about its desire to consider the Cave, Walker and Pitt reviews. We expect this to provide greater clarity to the future direction of the industry. If and when changes are proposed, NWL will work constructively to ensure that new legislation takes account of the practical needs of the industry.

Through 2007 to 2009, the Company detected pesticides, metaldehyde and clopyralid, in its treated water at a number of sites, primarily in the Essex area. Whilst these pesticides are not of concern to human health, they were detected at levels in excess of the regulatory standard. As a result of this we agreed an undertaking with the DWI to carry out certain actions to mitigate the situation. This has predominantly involved proactive catchment management with the appointment of two catchment officers who have been working with farmers and regulators to advise on better use of such pesticides. Whilst this is likely to be a long term project, the early signs are very encouraging with the results detected this autumn and winter being significantly lower than the previous two years. This is also a much more sustainable solution than the alternative, which would be to construct major new treatment processes to remove any residual pesticides.

Environmental, social and governance risks

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

The first relates to the use of sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, the sector would need to find or develop alternative ways to re-use or dispose of its sewage sludge. This could mean higher capital and revenue costs to provide additional sludge processing facilities. The development of the 'Safe Sludge Matrix' and the proposed revision of the Sludge (Use in Agriculture) Regulations have reduced the immediate risk in this area. NWL is introducing advanced anaerobic digestion to both reduce sludge volumes and the carbon impact of its activities and provide a sustainable outlet for sludge. Advanced anaerobic digestion is already in operation at our Bran Sands site and plans to develop this at our Howdon site are well advanced.

The second is the potential for sewer flooding. As rainfall patterns become more variable and intense storms more frequent, localised heavy rainfall can result in sewers becoming overloaded. In the year, intense summer storms again caused extensive property flooding and incidents of internal property flooding were the highest ever reported, many due to a single storm over two days in July which affected the whole north east region. We welcome the focus on integrated flood management in the Flood and Water Management Act 2010.

Affordability and customer debt

Affordability is an issue for NWL with income deprivation levels in the northern area the highest of all water and sewerage companies and in the southern area, close to the national average.

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

DIRECTORS' REPORT and OFR (continued)

Affordability and customer debt (continued)

Debt recovery remains an important area, especially in the current economic climate, where, despite having some of the lowest charges in England and Wales, affordability is becoming an increasing concern for some customers. We continue to be mindful of their circumstances, ensuring our recovery techniques are appropriate and effective. Customers who deliberately avoid paying charges are actively pursued and we continue to work with Ofwat and Defra to seek changes to legislation to assist the industry to impose and collect charges.

Water resources

The way we retain, recycle and distribute our water resources is a central part of our business. While NWL has sufficient water resources in the north east, we believe it is still important to manage the demand for water so that it does not exceed levels that can be supplied in a sustainable way.

In our Essex and Suffolk areas, however, water resource availability is a key issue. We have been successful over many years in encouraging our customers to use less water and in keeping leakage at or below the economic level. Nonetheless, we need to continue to invest to achieve our aim of ensuring our customers have a safe, secure and reliable supply of water well into the future. In January 2010, we published our final 'Water Resources Management Plan' having received approval from the Secretary of State.

Work is progressing on increasing the capacity of our Abberton Reservoir near Colchester by 58%. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke in Norfolk. We are working closely with the EA on progressing this. Once this scheme is in operation in 2014, it is unlikely we will need to develop major resources in Essex for the next 25 years.

We will continue to play a leading role in the industry on water efficiency measures and to encourage customers to use water wisely. New water efficiency targets have been introduced in 2010/11 to reduce per capita consumption across the company and a number of initiatives have been piloted during the year. A new campaign will also be launched across the company to promote water efficiency ranging from water saving kits to activity in schools and development of our website. We will work with other stakeholders to develop a coordinated strategy for reducing water use to sustainable levels.

In areas where water is scarce, water meters have a key role to play in reducing demand. Around 45% of domestic households in Essex and 58% in Suffolk are now metered. In the north east, where supplies are more plentiful, 22% of households are metered. We aim to achieve as near to universal metering as possible in Essex by 2020 and in Suffolk by 2023. On current policies it will take considerably longer to achieve full metering in the north east as there is no economic, environmental or social driver to move more quickly.

Changing weather patterns

The water cycle and the changing weather have a direct influence on the provision of water and waste water services. Our employees are experienced in managing the effects of too much or too little rainfall, but changing weather patterns will present a growing challenge for the business.

In past years, we have carried out research into the likely impact of climate change on all our assets and water resources and this has been incorporated in our climate change policy as part of our corporate responsibility work. This work is continuing, based on the latest UKCP09 projections published last year by the UK Climate Impacts Programme.

Over the course of the year we will be doing more work in this area as we respond to the new adaptation reporting power granted to the Government by the 2008 Climate Change Act. This will set out in the public domain the extent to which the changing climate is likely to impact on the business and what actions we are taking to meet the challenge it represents.

DIRECTORS' REPORT and OFR (continued)

Employees

If we are to continue to optimise our assets, offer an excellent service to our customers, and achieve our regulatory obligations, we need to continue to recruit, retain and develop talented people as a leading employer in our regions. We will continue to offer all our employees terms and conditions at least commensurate with other major employers as well as appropriate training and development to support their ongoing performance and career progression. This includes the comprehensive management development framework, graduate and apprentice programmes, as well as initiatives such as the NVQ programme which reach many employees.

CAPITAL STRUCTURE

Cash flows and liquidity

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

The Company has not entered into any new debt facilities during the period. The Company has substantial cash resources and undrawn committed bank facilities available to maintain general liquidity. Total cash and short term cash deposits available to meet the requirements of the business through to the end of 2011 amounted to £89.4m (2009: £166.2m).

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

The Board is responsible for the financing strategy of the Company which is determined within treasury policies set by NWG. The Group's treasury function carries out treasury operations on behalf of the Company and its main purposes are to assess the 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 renewable on a five year basis. It also invests any surplus funds the Company 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 treasury policy prohibits 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

The Company is responsible for cash management. The Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0m and with a bank agreement availability period of no less than 3 months. At 31 March 2010, NWL had £75.0m (2009: £75.0m) available in standby committed bank facilities. These facilities matured in May 2010 and have not been renewed. However, given the surplus of cash available to fund the Company's operations, the Board have agreed to allow the current facilities to lapse, and to review the position in March 2011.

DIRECTORS' REPORT and OFR (continued)

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 Company's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2010, 72% (2009 72%) of the borrowings of the Company were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

Foreign currency risk

The Group's policy is that any foreign currency exposure in excess of £100,000 sterling equivalent of a transactional nature, or £3m sterling equivalent of a translation nature, should be covered immediately on recognition. At 31 March 2010, the Company had no currency exposures (2009 nil).

Market price risk

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

CORPORATE RESPONSIBILITY

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

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

We take our corporate responsibilities seriously. Our aim of balancing economic, social and environmental priorities underpins all of our activities and is an integral part of the way we do business.

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

The Chief Executive Officer is directly accountable to the NWL and NWG Boards for both the environment and sustainable development policies.

We have developed our own model to integrate corporate responsibility as an essential part of normal business practice in NWL. This model is published on our websites with links to our policy, action plan, key performance indicators, trend data and case studies for 25 key areas of our business.

The Corporate Responsibility Committee (CRC) is a subcommittee of the NWL Board and comprises non-executive directors, management team members and senior managers from the business. The CRC maintains a strategic overview of corporate responsibility policies and issues. Within the business, a Corporate Responsibility Management Group (CRMG) drives and manages our corporate responsibility programme both prioritising activity and facilitating reporting and monitoring.

The CRMG is supported by two regional groups and by teams of community and environmental champions drawn from across the business to ensure communication and influence is as effective and widespread as possible. We also have specialist working groups responsible for investigating, advising on and driving change on specific projects, such as climate change, energy use, transport, waste and recycling.

DIRECTORS' REPORT and OFR (continued)

CORPORATE RESPONSIBILITY (continued)

The Corporate Responsibility Advisory Group (CRAG) is made up of senior representatives from partner organisations in the key areas of our partnership strategy, environment, community, health, regional support, education and WaterAid. The CRAG acts as a critical friend, helping to validate, guide and challenge NWL's CR strategy and activities.

In April 2009, NWL received the Queen's Award for Enterprise in the category of Sustainable Development. This award recognises our ongoing commitment to best practice and continual improvement in the areas of environmental performance, community investment and sustainability and recognition in this category is rare. The citation read:

"Northumbrian Water Ltd receives The Queen's Award for Enterprise for its ongoing and impressive commitment to sustainability"

"It has actively striven to promote best practice within its sector and is committed to ongoing review and continuous improvement"

"With a commendable and ever improving environmental performance in place, it is, however, Northumbrian's extremely impressive social and economic initiatives which elevate it to the status of sector leaders"

"A diverse suite of programmes have been implemented, encompassing local procurement, strong apprenticeship programmes, individual up skilling and the continuous leverage of their spending power, employment and wider economic presence to ensure maximum benefit for local communities"

"Northumbrian's driving commitment to sustainability governance provides an example and benchmark across sectors, demonstrating that strong leadership and ambition can make a tangible difference to communities both local and more widely"

Additionally, we were

- one of only seven companies nationally to achieve the new highest platinum plus ranking in the Business in the Community (BITC) Corporate Responsibility Index. The new platinum plus process evaluated the extent to which our business strategy is underpinned by a focus on long term sustainability. This improves on our platinum status in 2008 as one of the top 100 'Companies for corporate responsibility',
- awarded the BITC Big Tick award for its impact on society, power in partnership and for being a healthy workplace,
- the employee engagement winner at North East of England Chartered Institute of Personnel Development HR&D 2009 awards,
- the category winner of Culture for Success Large Employer Award for employee development, customer service, business growth and the contribution we have made to the community,
- holders of the Payroll Giving Quality Mark Gold Award,
- Beyond Sport Award finalist – best corporate responsibility in sport, and
- winners of the Waterways Renaissance Awards natural environment category for the Trinity Broads Restoration Project

The Group is a member of the FTSE4GoodIndex

Over many years, we have contributed resources with a value equivalent to at least 1% of our annual pre-tax profits (through cash, employee time and expertise, or use of our facilities) to projects which benefit the communities we serve. The Company made charitable donations totalling £156,517 (2009 £134,415) during the year.

DIRECTORS' REPORT and OFR (continued)

Communities

NWL supports the communities we serve in a number of different ways. As well as providing financial support and facilities, we encourage employees to volunteer their time, skills and expertise through our 'Just an hour' scheme. These activities generally support projects that make the areas we serve better places in which to live, work or invest. The programme focuses on key themes throughout these communities but, increasingly, we are developing initiatives designed to tackle lasting and sustainable change in specific areas.

Community support

Employees and volunteering

Currently 26% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 7,890 hours to the community. Over 600 different organisations were given financial and in-kind support during the year.

The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments totalling £49,605 for our nominated charities (Great North Air Ambulance Service, RNLI, Essex Air Ambulance, Myelin Project, Zoe's Place, Macmillan Cancer Support and St Cuthbert's Hospice). Since it began almost £310,000 has been raised for charity.

Education

Further to the launch of the 'Northumbrian Water GLOBE' programme, which saw us link up with the international environmental education initiative set up by Al Gore in 1996, we donated 85 fully automated weather stations and associated training to schools throughout the northern region, to collect weather data in areas where Meteorological Office coverage is poor. This data is now helping to increase understanding of the impact of climate change and is a valuable curriculum tool.

The 'Northumbrian Water Schools Awards', now in their fourth year in the northern region, are designed to recognise and celebrate the achievements being made by our schools. They cover both community and curriculum based projects and honour whole schools, classes and individuals.

In our southern operating area, we support 'Cash for Schools' along with the Essex Chronicle. This recognises excellence, with a focus on environmental projects from primary and secondary schools within the newspaper's distribution area.

Work with Colchester Borough Council, Essex County Council, Essex University and the Essex Wildlife Trust is ongoing to use Abberton Reservoir and the enlargement project to further education. A study will look at the need for further education facilities in the vicinity of Abberton Reservoir. Depending on the study's findings, NWL will provide accommodation for use as an education centre.

A wide range of educational materials are available on our websites for children and teachers.

Partnerships

Water for health

NWL continues to promote the health benefits of drinking tap water. To date, over £306,000 has been provided for mains-fed water coolers in schools and around 675 have been supplied in nearly 350 schools. We also continue to promote bottle-free water coolers as a sustainable alternative to bottle-fed coolers.

Environmental

Key partnerships have been developed with NWL to help the conservation of biodiversity on our sites. Our contribution includes funding project officers and current partnerships include:

- Northumberland Wildlife Trust (Kielder and Bakethin),
- Durham Wildlife Trust,
- Essex Wildlife Trust (Hanningfield),
- Broads Authority (Lound and Trinity Broads), and
- Davy Down Trust (North Stifford, Essex)

DIRECTORS' REPORT and OFR (continued)

Sustainable communities

NWL has developed some longer term projects to help build sustainable communities in the areas it serves. These projects are developed with partners to help bring about lasting change and some examples are given below.

Healthworks

NWL granted a 99 year lease to County Durham Primary Care Trust (PCT) on a redundant building at our Easington waterworks and worked in partnership with the PCT, the District of Easington Council, the Neighbourhood Management Pathfinder and other stakeholders to develop services for the local community in an area where census records show one of the worst health records in the country.

Beyond providing the building, we contributed research, marketing and communications support to improve awareness of the centre and helped with events to promote healthy living, targeted at primary and secondary schools and day centres, and linked to our 'Water for health' campaign.

We sit on the steering group for Healthworks which achieved almost 10,000 visitors in its first year alone and now provides over 45 health and community support services. It acts as a community focal point where service providers and community groups can come together to address issues that affect the quality of life in the local community. Facilities range from a juice bar to a gym and information kiosks, some of which can be used in a privacy setting with many more planned. Healthworks has been so successful that the plans for phase two were brought forward and this was opened in November by the Chairman, Sir Derek Wanless. Healthworks now includes a GP led walk-in health centre open from 8am to 8pm, 365 days a year, thus securing the future of Healthworks for the community, which is a unique approach to tackling the poor long term health of the residents in Easington.

Sporting partnerships

NWL prides itself on being immersed in the community and working with a wide and diverse range of sporting partners. This is a natural extension of our 'Water for health' campaign, which encourages people to lead a healthy lifestyle. Working with our sporting partners we support a diverse range of sports to get people active as well as educating them on healthy eating and good hydration.

Through our partnerships we have reached over 60,000 children and adults. We provide

- links and networks to enable sporting partners to get together to share ideas and resources,
- financial support of over £56,000 per annum which then levered over £2.0m (£1.3m of this was due to the phase two extension of Healthworks which is on our former site) from other sources,
- advice and marketing support on programme development,
- bottled tap water, sports bottles or mains-fed bottle-free coolers to reinforce the importance of drinking tap water to re-hydrate during sporting activities, and
- help with fundraising and raising the profile to attract additional investment.

We can generate wider support for projects by adding our name and commitment to them and by encouraging others to get involved thus generating additional funding sources for projects. Our involvement acts as a key catalyst to raise confidence that projects present real opportunities for the private sector.

Education

NWL is lead sponsor of Castle View Enterprise Academy, a new and exciting independent school for 11-16 year olds serving the areas of Castletown, Town End Farm and Hylton Castle in Sunderland. The area contains some of the most deprived wards in the region and 61-80% of the school catchment population is categorised as 'struggling families'.

The Academy opened in September 2009 and offers a new approach to education. It is one of three academies created in Sunderland with the City Council as co-sponsor using a unique model under the 'Building Schools for the Future' programme. Our aim as lead sponsor is to create a centre of excellence with a clear focus on raising standards of academic performance and enabling every student to achieve their personal best in all areas of academy life within a safe, secure and stable environment. The project has been almost four years from planning.

DIRECTORS' REPORT and OFR (continued)

Education (continued)

to opening and our employees have helped in the design, build and management arrangements. The company will use its business networks to complement the Academy's specialism which is business and enterprise.

Economy

Affordable housing

NWL has been working for the last five years with Hastoe housing on an affordable rural housing project as part of our 'Good Moves' programme. Planning permission has been granted for 12 affordable rural houses on a piece of land that is no longer required by NWL close to the Company's Hanningfield water treatment works in Essex. The homes will be located in a rural area where a significant need for affordable housing has been identified.

WaterAid

NWL has continued to raise funds and awareness for the work of WaterAid which brings sustainable water and sanitation solutions as well as hygiene education to the poorest parts of Africa and Asia. The employee fundraising committee has raised more than £3.0m, since 1997, with the help of the company and last year focused its fundraising support on specific projects in Tanzania.

Community Foundations

Community Foundations covering our areas of supply hold endowment funds totalling nearly £1.0m contributed by NWL over the last 18 years. These are long term investments with the income from the funds used to support community initiatives. Recipients are chosen by committees of our own employees (39 groups this year).

Kielder Partnership

Kielder Water and Forest Park includes the largest man-made reservoir in the UK and is surrounded by Kielder Forest, the largest man-made woodland in Europe. We have worked with partners in the Kielder Partnership to develop and regenerate the economy of this rural area through tourism development.

The Kielder Partnership is continuing to benefit from the impact of the £5.4m capital investment at Kielder Water & Forest Park between 2007 and 2010. Key developments include the Kielder Observatory, Lakeside Way trail, six new art installations and five flagship mountain bike trails. As a result five direct jobs have been created, tourism days have increased by 62,000 (26%) to 300,000, with 60% of these from outside the north east region, and direct and indirect spend has increased by £3,169,000 (33%) contributing £12.6m to the local economy.

The visitor economy is pivotal for a sustainable future as it is the key source of employment and income generation in an area with few opportunities due to the decline in traditional economic sectors such as agriculture and mining.

The partners have established the Kielder Water & Forest Park brand and the Big Picture Development Plan provides a long term vision for the area, including a range of sustainable solutions to attract new audiences.

It builds on the strengths of Kielder to create a destination which adds critical mass to other iconic attractions in the north east, as part of One North East's promotion of the region. Work is well under way and examples of significant recent achievements are provided below.

Affordable rural housing

There is a need for affordable rural housing to meet local employment needs and we supported this development by the Home Housing Group in Kielder village. Four of our employees live in these houses which are fully sustainable too, thanks to a pilot project which uses wood chip technologies to heat the home.

DIRECTORS' REPORT and OFR (continued)

Kielder Partnership(continued)

Artwork and observatory

The art and architecture programme has been developed over 15 years and there are now more than 20 innovative contemporary landscape art and architecture pieces to see, or interact with, making Kielder Water & Forest Park the largest outdoor public art gallery in the UK. Kielder also has the darkest night skies in England with minimal light pollution and the Kielder Observatory, which was designed to rise like the deck of a ship sailing above the landscape, offers exciting opportunities to those with an interest in learning more about the night sky.

Lakeside Way

This year has seen the completion of a 26 mile lakeside multi-user trail, with water access points, that encircles the shoreline of Kielder Water.

Britain's most beautiful marathon

In February, we launched the Kielder Marathon which will take place this autumn and is billed as Britain's most beautiful marathon. It will use the Lakeside Way and, with over 1,500 runners, it will help to promote the profile of the area.

Ospreys

In 2009, a long term project to encourage ospreys to return to the region was rewarded when a pair of first time parent birds nested on a specially erected platform and successfully reared a brood of three chicks, the first born in Northumberland for at least 200 years. Controlled access encouraged visitors to the site and this will be developed now that the birds have returned this year.

Environment

Carbon management plan

Northumbrian Water Limited published its carbon management plan to meet its target of a reduction of 50% in gross emissions by 2020 from a 2008 base (35% from a reduction in operational emissions and the rest from decarbonisation of the grid).

The carbon management plan includes energy efficiency, renewable energy and water efficiency and supports our activities to help us adapt to a changing climate. It represents a sustainable and responsible way forward for the business, our customers and the environment. The projects under way, which will help us to achieve our carbon reduction target, are outlined below.

- investment of £33.0m in new thermal hydrolysis advanced anaerobic digestion at Bran Sands, which provides 50% (c. 4.7 MW) of the energy requirements of the site. This will enable waste sludge to generate methane to fuel gas engines and produce green electricity. A similar plant will be constructed at Howdon, which is planned for completion in 2013/14. Together these plants will increase our use of renewable energy by 20%, as well as reduce our overall energy demand,
- hydroelectric installations at four reservoirs including the UK's largest man-made reservoir, Kielder Water. Work on a new £2.5m hydroelectric project at our Selsel Reservoir has begun and will generate up to 750 kilowatts of electricity – 4,000 megawatt hours a year. Renewable energy is also being generated with hydroelectric plants at Derwent, Lartington and Wear Valley reservoirs in addition to biogas combined heat and power plants at Stressholme, Hexham and Aycliffe,
- limiting tertiary UV disinfection outside the bathing water season at five major works reduces energy consumption and carbon emissions with no detrimental effect on the marine environment, and
- encouraging customers, through our 'using water wisely' campaign, to recognise that if they waste water, they also waste energy (information and tools are available for customers on our websites).

Through these projects, and by reviewing the efficiency of our pumps across the business, we have reduced the amount of energy used by almost 9% over the last five years.

DIRECTORS' REPORT and OFR (continued)

Carbon management plan (continued)

Northumbrian Water Limited has successfully achieved the Carbon Trust Standard for its efforts in reducing greenhouse gas emissions. The standard provides an objective benchmark against which our commitment and success in addressing our climate change impact was assessed and is significant as it demonstrates progress against our ambitious carbon management plan.

Climate change

We are continuing to develop our understanding of the potential impacts of a changing climate on the functions of the business. The latest 'UKCP09' projections of the future climate were published by the 'UK Climate Impacts Programme' last summer and provide a valuable resource for understanding the potential impacts on the business.

The water industry is one of the largest users of energy in the UK and we aim to play a full part in support of Government's plans to reduce emissions. We have been working hard over recent years to reduce our carbon footprint while preparing ourselves for the future challenges of a change in climate and the weather events we may face as a consequence. NWL agreed, last year, a plan to reduce emissions by 35% by 2020, when compared with a 2008 baseline. If the emissions associated with electricity production also fall, in line with Government predictions, this should mean that our emissions will be halved by the 2020 milestone date.

RELATIONSHIPS

Employees and Employment Policies

Our key asset is our employees and we aim to recruit and retain the best people, with a diverse range of skills, experience and backgrounds, who are committed to making the company successful. In return, we aim to provide opportunities and training for employees to develop their skills and capabilities to equip them to meet the challenges of their roles, while rewarding the contributions of both teams and individuals. Our employees also have access to a scheme which provides a wide range of benefits including tax efficient benefits such as childcare vouchers, water services, cars for personal use and discounted store vouchers. Currently 72% of employees participate in the scheme, up from 62% last year.

The active involvement and engagement of everyone across the business is an important part of delivering performance and NWL continues to formally seek the views of employees through an annual employee engagement survey. This year's survey had the largest response rate ever at 71% and the feedback covered working life, training, communications, managers and the company. All employees were invited to workshops to consider the results and identify areas for improvement in their working practices and environment, the outputs contributed to the development of departmental action plans. Overall, employee satisfaction levels remain very high with the company achieving its Engagement & Satisfaction Index targets this year. In addition, 80% of respondents told us they are proud to work for the company, 82% would recommend working for the company and 77% believe that NWL is a great organisation to work for.

During workshops, employees were given the opportunity to influence the development of the 2010-15 People Plan and to respond to the employee survey results. This involved all employees and allowed them to highlight both positive and negative aspects of working for NWL. This was the first time that employees on a large scale have participated in the strategic development of the business and this engagement, at every level in the business, resulted in valuable new ideas which have been incorporated into our forward planning.

Our key employment policies, which reflect the framework set out in the Group's Code of Conduct, are outlined below.

Equality and diversity

The Company operates an equal opportunity policy designed to ensure that no job applicant or employee receives less favourable treatment on the grounds of age, gender, marital status, disability, race, ethnic or national origin, religion or sexual orientation. NWL monitors its workforce profile against census and sector data and aims to be recognised as an employer of choice within the diverse communities it serves, ensuring it takes full advantage of the rich backgrounds and abilities of current and potential employees.

DIRECTORS' REPORT and OFR (continued)

Equality and diversity(continued)

We welcome employment applications from people with disabilities and, where existing employees develop disabilities, they are supported to remain in employment, wherever practicable, by providing appropriate adjustments to their roles and/or effective redeployments. Occupational health physicians assist this process with professional medical advice.

Consultation and engagement

NWL engages with its employees through a variety of means, including formal consultation processes. The importance of an inclusive and engaging management style is fully recognised. In 2009, NWL continued to build on its award winning approach by engaging with all employees over some 120 workshops in a dialogue on improvements to our working practices and environment and to seek their views on the areas that should be covered in the 2010-15 People Plan.

Training and Development

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

Our people are the key to our business success. NWL introduced an extensive People Plan in 2005/06, as part of a human resources strategy for the following five years. This outlined the organisation's aims up to 2010 and set out a schedule of programmes and matrices in support. Training and development and supporting the performance and aspirations of our people are key elements of the plan.

One of the objectives of the People Plan is to develop leadership skills in current and potential managers. We have continued to implement our Management Development Framework which is structured to cover the training needs of those who show the potential for management right through to development at director level. As part of this framework we are working in partnership with Newcastle Business School to provide qualifications from a Diploma to a Masters degree in leadership and management. In 2010, we are planning to roll out a new step in our Management Development Framework to some of our operational departments. This development programme for supervisors, team leaders and works managers includes assessment against National Qualification Framework (NQF) Levels 2, 3 and 4 management standards, as appropriate, supported by formal development and coaching.

Everyone who joins NWL receives a personalised induction plan providing their familiarisation and training programme for the first few weeks of their employment. In addition, they are invited to a corporate induction day where they meet senior managers and are introduced to the company and our approach to key areas including health and safety, terms and conditions, pensions and community involvement.

We recognise the vital contribution that training and management development can make to fully realise both organisational and individual potential. Our approach focuses on giving the skills and competencies needed for role and job objectives, to ensure people are working safely and competently with the potential to develop and attain aspirations.

Our aim is to build and maintain a culture which values, encourages and recognises outstanding performance, where we share a commitment to our objectives and to delivering our personal best. From corporate induction day and induction planning, to individual coaching, accreditation of skills through national vocational qualifications, to management and leadership programmes, we provide the resources needed to help employees reach their full potential.

We signed the Government's Skills Pledge at the end of 2007, publicly committing to develop 90% of the workforce, around 2,600 employees, to at least NQF Level 2 – the equivalent of five GCSEs at grades A to C – by the end of 2010.

DIRECTORS' REPORT and OFR (continued)

Training and Development (continued)

An ambitious NVQ programme has been rolled out in our customer and operational areas. Funding has been secured from the Learning and Skills Council's 'Train to Gain' fund and also through Business Link.

NWL's successful four year apprenticeship scheme began in September 2007. We now have three intakes of mechanical and electrical apprentices at different stages in their training with all of the apprentices guaranteed jobs on successful completion of the bespoke programme. In 2009, for the first time, we introduced an information technology/telecoms apprenticeship further developing the range of jobs available to young people in our regions.

Our Graduate Development Programme has been re-launched to provide potential leaders for the future. Candidates undertake a two year programme with three to six month placements in different parts of the business. In addition to a line manager they are also given a senior manager mentor. Employment is also guaranteed on successful completion of the programme. We currently have eight graduates on the programme and plan to recruit an additional three during 2010.

Recognising our employees' academic achievements, the fourth annual skills awards were celebrated this year. Attended by senior managers from around the business, and with guest speaker Kriss Akabusi, the events were again motivational and memorable.

Communication

The Company uses a wide range of communication methods including magazines, newsletters, intranet, notice Boards and regular team meetings. 'Unplugged', NWL's magazine, contains articles on activities and news from across the business, focusing on employees and their achievements. NWL issues all employees with a series of information booklets clearly explaining areas such as the company's mission and values, terms, conditions and benefits of employment, occupational health and wellbeing programmes and People Plan objectives.

Disclosure (Whistleblowing)

The Company encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be illegal or unethical. The Audit Committee regularly reviews the disclosure policy.

Health and safety

A safe working environment is given high priority in the business. A health and safety policy is maintained and implemented through the Company's health and safety team. Our emphasis on the importance of health and safety within NWL has resulted in major improvements to our safety record in recent years. This year we experienced 10 reportable accidents and incidents per 1,000 employees, which is a continual decline over the previous six years.

We have established a medium term plan for taking health and safety forward in the company to 2015. We aim to further reduce the number of accidents by 10% each year and to reinforce the safety culture in the company.

NWL proactively supports and encourages employees to strive for high standards of health and wellbeing by providing a wide range of services, support and resources relating to occupational health, with the Group's medical advisor providing comprehensive occupational health services, general health promotion and stress management. NWL employees also have on and offsite access to specialist advice and treatment to support recovery from musculoskeletal disorders (MSD). We have reduced sickness absence due to MSD by 22%.

We continue to promote healthy eating, hydration and to discourage smoking in our workforce and offer excellent health screening and medical insurance schemes. Around 2,200 employees have been through our health screening and fitness standards programmes, both of which now include lifestyle advice elements.

Employee Share Incentive Plan (SIP)

The directors believe that employee investment strengthens the ties between the Company's employees and the Group. More than a third of employees participate in the SIP, with an interest in 0.5% of the issued share capital. The scheme provides one free matching share for every three shares bought by an employee. Shares for

DIRECTORS' REPORT and OFR (continued)

Employee Share Incentive Plan (continued)

the SIP are purchased at market price by the Trustee and dividends are paid in cash directly to participants. There are no performance conditions attached to the SIP but free shares not held in trust for at least 12 months are forfeited. Employees participating in the SIP are given the opportunity to exercise their voting rights through the Trustee of the SIP.

Customers

Our relationship with customers is core to the success of our business and it is essential that they trust our service. Customer service is at the heart of the company and all employees have a clear focus on getting things 'right first time every time'. Although we are required to meet regulated standards for customer service, the quality of our service goes beyond that.

For the third year, we only increased our prices by the rate of inflation and did not use the real increase allowed by Ofwat. This decision benefited customers directly.

We measure the views of our customers with quarterly tracking research alongside qualitative work in focus groups. This helps us to understand their views on service, value for money and other issues as well as their general perception of the company.

We keep customers informed about our activities through leaflets with bills, an annual magazine called 'Source' and our websites at www.nwl.co.uk and www.eswater.co.uk. The sites include information about our services and now allow customers to ask questions and investigate work being carried out in their area. If customers are directly affected by any work, we give advance warning and explain the need for the timing of such work. We also communicate more broadly with local communities through public meetings.

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

Business customers

NWL has longstanding relationships with its key industrial and commercial customers in the areas we serve. The north east, in particular, has a significant industrial base and existing customers and potential investors in the region value the availability not only of high quality potable and raw water but also access to reliable effluent treatment services.

The economic situation has had a significant impact on some business sectors which are important in our operating regions and NWL has been working closely with major customers in those sectors to mitigate the impact where possible. The closures at Corus and Artenius in the Tees Valley have been well publicised. Details of a contract with the new owner of the Artenius site and of a contract extension by one Corus business are given on page 10. Furthermore, with the regional economic agencies, NWL has secured existing and encouraged new business.

Leisure customers

NWL is one of the founding members of Kielder Water & Forest Park Development Trust, which has been accepted by the Charity Commission for registration as a charity. This will replace the existing Kielder Partnership and will seek to promote sustainable development, recreation, access and leisure, education, infrastructure and a range of other charitable purposes at Kielder and in the surrounding area.

The development of Kielder Water & Forest Park is supported by the Northumberland Strategic Partnership, Government Office for the North East and One North East. This year has seen the completion of a 26 mile lakeside multi-user track and water access points as well as the opening of an award winning observatory and a range of mountain biking tracks. The website at www.visitkielder.com provides further details of all facilities.

NWL continues to develop its leisure facilities at all strategic sites, investing in fishing facilities, holiday accommodation and supporting 'Access for All'.

DIRECTORS' REPORT and OFR (continued)

Quality

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

The company also achieved companywide certification to the international occupational health and safety management standard OHSAS 18001 in 2007

Research and development

We run a programme of research and development linked to our operations, which includes the development of technical solutions for water and waste water management, collaborative research within the sector and partnerships with academic and research organisations. This has supported the invention, development, trial and/or implementation of

- a device for reducing flooding and pollution,
- energy efficiency of waste water aeration systems to determine optimum design and best practice cleaning and replacement cycles,
- microbial fuel cells or electrochemical cells, which generate electricity or hydrogen respectively from waste water,
- beneficial re-uses for water treatment sludge,
- reed-bed based solution for thickening iron rich water treatment sludge and aluminium rich sludge,
- de-watering and thickening water treatment works sludge,
- leak detection technology,
- early warning system for leaks and bursts, and
- remote pipeline condition assessment

During the year, the Company invested £2.1m (2009 £1.8m) in research and development

Political contributions

During the year, the Group has worked with politicians of all parties, officials and opinion formers. This work has included making representations on issues which NWL feels are important to our customers and communities such as competition, the Flood and Water Management Bill, adoption of private sewers, Water for health, climate change, the Water Framework Directive and other legislative issues which could affect our customers

We do not support any political party and we do not, directly or through any subsidiary, make what are commonly regarded as donations to any political party or other political organisations. However, the wide definition of donations in the Political Parties, Elections and Referendums Act 2000 covers activities which form part of the necessary relationship between the Group and political parties and political organisations. These activities include attending Party Conferences, as these provide the best opportunity to meet a range of stakeholders, both national and local, to explain our activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during 2009/10 were as follows (2009 £7,195)

Name of political party	£
Conservative	1,916
Labour	6,427
Liberal Democrats	1,432
Total	9,775

NWG shareholder authority to permit the Company to continue with these activities until the 2011 AGM will be sought at this year's AGM

DIRECTORS' REPORT and OFR (continued)

Company payment policy

The Company's policy is to agree payment terms with suppliers and to pay on time according to those agreed terms. The Company's policy is to make payment not more than 30 days after receipt of a valid invoice, except as otherwise agreed. The ratio, expressed in days, between the amount invoiced by its suppliers during the year and the amount owed to its trade creditors at 31 March 2010, was 16 days (2009 19 days)

Fixed assets

Freehold land and buildings are carried in the financial statements at historical cost with a net book value of £79.1m (2009 £60.8m). In the opinion of the directors, at 31 March 2010, there is no significant difference between the net book value and market value of property capable of disposal within the foreseeable future. Note 10 gives more details of the fixed asset movements during the year.

Pensions

The Group operates both a defined benefit pension scheme, of which the Company is the principal member, which closed to new entrants on 31 December 2007, and an occupational defined contribution arrangement which began on 1 January 2008.

The deficit (under FRS 17) of the defined benefit scheme of £119.4m, at 31 March 2009, has increased to £133.1m at 31 March 2010. This is mainly due to a reduction in the discount rate assumption to 5.5% (2009 6.1%), partially offset by an increase in the market value of the scheme's assets since March 2009.

The triennial actuarial valuation of the defined benefit scheme as at 31 December 2007 resulted in a surplus of £42.0m (6%) on an 'ongoing' basis, which took into account the prepaid contributions (in 2006 and 2007) for the period up to 31 December 2010. While the actuarial valuation incorporates longer term forecasts and assumptions than the FRS 17 valuation, the prevailing market conditions are difficult and we will continue to monitor carefully. Furthermore, the final determination to March 2015 reflected NWL's request to fund £6.0m per annum in respect of the defined benefit pension deficit from 1 January 2012.

Further information about the pension schemes in which the Company participates is contained in note 26 to the financial statements.

Directors' remuneration

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

Indemnification of directors

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

Directors' declaration

As required under section 418 of the Companies Act 2006, 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.

Auditors

The Company has appointed Ernst & Young LLP as its auditors and has, by elective resolution pursuant to section 487 of the Companies Act 2006, dispensed with the obligation to appoint auditors annually.

DIRECTORS' REPORT and OFR (continued)

Financial statements preparation and going concern

The directors believe that the Company is well placed to manage its business risks successfully despite the current uncertain economic outlook. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

In arriving at their decision, the Directors have taken into account

- the acceptance of the 2009 Final Determination by the Board,
- the financial strength of the Company at the balance sheet date and performance during 2009/10,
- the strength of the key financial ratios over the planning horizon of the Company's one year budget and five year medium term plan as reflected in strong investment grade credit ratings,
- the fact that the Company already has funding and facilities in place to meet all operational and capital investment requirements to the end of 2011 and is in advanced discussions with lenders to obtain substantial new long-term facilities to fund the investment programme through to and including 2013,
- its contractual arrangements with suppliers for key materials and support services and its capital framework arrangements,
- its robust People Plan for 2010-15 which underpins the employment resources to fulfil all operational requirements, and,
- the Company's formal risk and governance arrangements which are monitored by the Audit Committee and Board.

Statement of Directors' responsibilities

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to

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

The directors are responsible for keeping proper accounting records which are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

By order of the Board



Martin Parker
Company Secretary
7 July 2010

APPENDIX TO THE DIRECTORS' REPORT and OFR

DEFINITION OF KEY PERFORMANCE INDICATORS

Financial KPIs

Gearing to RCV

Definition and calculation: The ratio of net debt (including loans to other group companies) to Regulatory Capital Value (RCV). The RCV represents the total capital value of the appointed water and sewerage business on which Ofwat allows a rate of return at price reviews based on its view of the cost of capital.
Purpose: The RCV generates most of the revenue stream of the Company and regulatory gearing is an important factor in credit ratings.
Source of underlying data: The RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Net debt is calculated from the balance sheet in the audited financial statements.

Regulatory gearing

Definition and calculation: The ratio of NWL appointed business net debt to RCV. The RCV represents the total capital value of the appointed water and sewerage business on which Ofwat allows a rate of return at price reviews based on its view of the cost of capital.
Purpose: The RCV generates most of the revenue stream of the Company and regulatory gearing is an important factor in credit ratings.
Source of underlying data: The RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Net debt is disclosed in the audited regulatory accounts.

Cash interest cover

Definition and calculation: Cash generated from operations less tax divided by net interest paid.
Purpose: Measures the ability of the Company to service its debt.
Source of underlying data: Audited financial statements.

Cash flow to net debt

Definition and calculation: Cash generated from operations less tax paid divided by net debt.
Purpose: Indicates the Company's ability to reduce debt in the absence of need for additional investment, without resorting to asset disposal.
Source of underlying data: Audited financial statements.

Non-financial KPIs

CUSTOMER

Customer satisfaction

Definition and calculation: Domestic customers' satisfaction with overall service and overall value for money, expressed as satisfaction averaged over the surveys carried out during the year. Average satisfaction is based on a scale of 1 to 10 using the score of 6 and above as satisfied. Net scores are used to show true satisfaction by taking into consideration those who are dissatisfied who score between 1 and 3.
Purpose: To enable tracking of perception of reputation, service and value for money over time.
Source of underlying data: Independent surveys of 500 customers (300 north, 200 south) chosen at random, but representative of the customer base, carried out each quarter – a total of 2,000 customers.

Customer – levels of service

Definition and calculation: Customer service standards are established by Ofwat and calculated using source data in the Company.
Purpose: To monitor customer service performance of NWL.
Source of underlying data: Information collected by the Company and submitted to Ofwat. It is independently certified.

APPENDIX TO THE DIRECTORS' REPORT and OFR (continued)

DEFINITION OF KEY PERFORMANCE INDICATORS (continued)

WATER

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 the DWI

ENVIRONMENT

Sewage treatment works

Definition and calculation: Percentage of population equivalent served by non-compliant works failing Look Up Tables' consents
Purpose: To monitor the performance of NWL's sewage treatment works and their impact on the environment
Source of underlying data: Information recorded by NWL and the EA and reported on by the latter

Bathing waters Mandatory Standard

Definition and calculation: Percentage of bathing waters complying with Mandatory Standards
Purpose: To monitor the impact of NWL's coastal treatment works on the environment
Source of underlying data: Information recorded and reported by the EA

Pollution incidents

Definition and calculation: Number of category 1, 2 and 3 pollution incidents in the calendar year as defined by the EA
Purpose: To monitor the performance of NWL's sewerage system and its impact on the environment
Source of underlying data: Information recorded and reported to Ofwat by the EA

EMPLOYEE

Lost time reportable accidents

Definition and calculation: Injury accidents that are reported to the Health & Safety Executive as required by the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 1995. Calculated as number of accidents reported in financial year per 1,000 employees
Purpose: To monitor the safety performance of NWL over time
Source of underlying data: Completed NWL accident/incident report forms. Employee numbers provided by the human resources department

Sickness absence

Definition and calculation: Sickness absence days as a percentage of total working days multiplied by the end of month headcount
Purpose: To track and trend sickness absence levels across the organisation
Source of underlying data: Sicknotes, return to work interviews and weekly returns by managers

Employee turnover

Definition and calculation: Number of leavers within the year as a percentage of average headcount
Purpose: To track the employee turnover within the business to ensure that it is within benchmark data
Source of underlying data: Current employees' details are held within the human resources management system – reports show leavers against headcount

PROFIT AND LOSS ACCOUNT
for the year ended 31 March 2010

	Note	<u>2010</u> £'m	<u>2009</u> £'m
Turnover	2	651 5	641 2
Operating costs	3(a)	(283 6)	(274 6)
Capital maintenance costs	3(b)	<u>(112 5)</u>	<u>(106 4)</u>
Total operating costs		<u>(396 1)</u>	<u>(381 0)</u>
OPERATING PROFIT		255 4	260 2
Net interest payable	4	<u>(76 8)</u>	<u>(91 4)</u>
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION	3(c)	178 6	168 8
Taxation	8(a)	<u>(35 6)</u>	<u>(39 5)</u>
PROFIT FOR THE FINANCIAL YEAR	24	<u><u>143 0</u></u>	<u><u>129 3</u></u>

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2010

	Note	<u>2010</u> £'m	<u>2009</u> £'m
Profit for the financial year		143 0	129 3
Pension liability actuarial gain / (loss) in the year	26	1 1	(207 8)
Deferred tax related to pension adjustments	26	<u>(0 3)</u>	<u>58 2</u>
Total recognised gains and losses relating to the year		<u><u>143 8</u></u>	<u><u>(20 3)</u></u>

BALANCE SHEET
at 31 March 2010

	Note	2010 £'m	2009 £'m
FIXED ASSETS			
Tangible assets	10	3,377 9	3,268 7
Investments	11	160 9	160 9
		3,538 8	3,429 6
CURRENT ASSETS			
Stocks	12	2 8	2 7
Debtors due in less than one year	13	123 0	122 8
Debtors due in more than one year	14	3 2	3 3
Investments	15	88 2	159 4
Cash at bank and in hand		1 2	6 8
		218 4	295 0
CREDITORS			
Amounts falling due within one year	16	(173 0)	(178 2)
		45 4	116 8
NET CURRENT ASSETS			
TOTAL ASSETS LESS CURRENT LIABILITIES		3,584 2	3,546 4
CREDITORS Amounts falling due after more than one year			
	17	(1,901 0)	(1,925 4)
PROVISIONS FOR LIABILITIES AND CHARGES			
	21	(219 0)	(222 5)
ACCRUALS AND DEFERRED INCOME			
	22	(386 7)	(388 8)
		(2,506 7)	(2,536 7)
NET ASSETS EXCLUDING PENSION LIABILITY		1,077 5	1,009 7
Pension liability	26	(95 6)	(86 0)
NET ASSETS INCLUDING PENSION LIABILITY		981 9	923 7
CAPITAL AND RESERVES			
Called up share capital	23	122 7	122 7
Profit and loss account	24	859 2	801 0
EQUITY SHAREHOLDERS' FUNDS			
	24	981 9	923 7

Approved by the Board and signed on their behalf by

H Mottram



C M Green
7 July 2010



**NOTES TO THE STATUTORY FINANCIAL STATEMENTS
for the year ended 31 March 2010**

1. STATEMENT OF ACCOUNTING POLICIES

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

(a) Basis of accounting

The financial statements have been prepared under the historical cost convention on a going concern basis. The Company is exempt by virtue of section 400 of the Companies Act 2006 from the requirement to prepare group financial statements, as it is included in the group financial statements of Northumbrian Water Group plc. These financial statements therefore present information about the individual company and not about its group.

(b) Turnover

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

(c) Cash flow statement

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

(d) Tangible fixed assets and depreciation

Tangible fixed assets comprise

(i) Infrastructure assets

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

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

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

The depreciation charge for infrastructure assets is based on the Company's independently certified asset management plan which has estimated the level of expenditure required to 2020 to maintain the operating capability of the network. This is adjusted if the forecast expenditure is expected to differ significantly from the amounts included in the original plan.

(ii) Non-infrastructure assets

Other assets are included at cost less accumulated depreciation and, where required, provision for impairment. Additions are included at cost.

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

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

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

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

(ii) Assets in the course of construction

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

(e) Grants and contributions

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

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

(f) Hire purchase and leasing

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

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

(g) Stocks

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

(h) Pension costs

The Company is a member of the Northumbrian Water Pension Scheme, which has both defined benefit sections and a defined contribution section. The Scheme is accounted for in accordance with FRS 17 "Retirement Benefits"

The defined benefit sections provide benefits based on final pensionable remuneration. The scheme assets are measured at fair value and the scheme liabilities are measured at present value. The difference between the assets and liabilities is recognised in the balance sheet. The current service cost, past service cost, settlements and curtailments are recognised within operating costs in the profit and loss account. The expected return on plan assets and the change in present value of scheme obligations are recognised in the profit and loss account respectively as interest receivable and interest payable. Actuarial gains and losses on experience adjustments and changes in actuarial assumptions are recognised in the statement of total recognised gains and losses

The costs of the defined contribution section are charged to the profit and loss account in the period they arise

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

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

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

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

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

(j) Foreign currency

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

(k) Research and development

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

(l) Fixed Asset Investments

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

(m) Derivative financial instruments

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

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

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

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

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

(n) Liquid resources

Liquid resources comprise external deposits and cash

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

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

(p) Share based payments

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

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

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

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

2. TURNOVER, PROFIT BEFORE TAX AND NET ASSETS

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

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

	2010	2009
	£'m	£'m
Materials and consumables	19.3	18.6
Other external charges	78.6	81.0
Net manpower costs (note 7)	102.9	94.6
Other operating charges	110.4	107.4
Own work capitalised	(27.6)	(27.0)
	283.6	274.6

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

	2010	2009
	£'m	£'m
Depreciation		
Non-infrastructure assets	73 9	69 9
Infrastructure assets	38 8	38 1
Assets held under finance leases	4 3	4 0
Amortisation of capital grants and contributions	(4 3)	(4 4)
Profit on disposal of fixed assets	(0 2)	(1 2)
	112 5	106 4

(c) Profit on ordinary activities before taxation:

	2010	2009
	£'m	£'m
Profit on ordinary activities before taxation is stated after charging		
Operating leases		
Plant and machinery	0 2	0 3
Other assets	1 0	1 3
Costs of research and development	2 1	1 8
Directors' emoluments (note 5)	1 2	1 0

Auditors' remuneration in respect of the statutory audit amounted to £106,900 (2009 £106,983) Auditors' remuneration for the regulatory audit amounted to £17,916 (2009 £17,930) Fees of £14,773 and £15,787 (2009 £14,785 and £15,799) were also incurred in the auditing of RAG 5 information and the June Return respectively The remuneration to auditors for non-audit services is disclosed on a consolidated basis in the group financial statements of the ultimate parent company

4. NET INTEREST PAYABLE

	2010	2009
	£'m	£'m
Net interest payable comprises		
Interest payable		
Bank loans and overdrafts	18 3	22 6
Group loans	63 8	92 7
Financing charges payable under finance leases	4 0	4 7
Total interest payable	86 1	120 0
Interest receivable		
Group interest	(13 7)	(22 7)
External interest	(0 1)	(0 1)
Total interest receivable	(13 8)	(22 8)
Other finance charges / (income) relating to pension scheme (note 26)	4 5	(5 8)
Net interest payable	76 8	91 4

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

The remuneration of the directors of the Company was as follows

	2010	2009
	£'000	£'000
Emoluments (including benefits in kind)	<u>1,172.6</u>	<u>996.6</u>

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

Four of the directors at 31 March 2010 were members of a defined benefit pension scheme where the Company makes contributions towards the cost (2009: 4)

One of the directors at 31 March 2010 was a member of a defined contribution scheme where the Company makes contributions towards the cost (2009: none)

The directors who held office as at 31 March 2010 held the following conditional interests in the ordinary 10p shares of the Group, awarded in accordance with the terms of its Long Term Incentive Plan (LTIP)

Name of Director	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2010
J A Cuthbert	21 12 06 ¹	66,721	-	44,521	22,200 ²	-
	13 12 07 ³	79,230	-	-	-	79,230
	15 12 08 ⁴	103,100	-	-	-	103,100
Totals		249,051	-	44,521	22,200	182,330
C M Green	21 12 06 ¹	49,423	-	32,978	16,445 ²	-
	13 12 07 ³	61,620	-	-	-	61,620
	15 12 08 ⁴	78,650	-	-	-	78,650
	04 01 10 ⁵	-	83,240	-	-	83,240
Totals		189,693	83,240	32,978	16,445	223,510
A C Jones	21 12 06 ¹	25,899	-	17,282	8,617 ²	-
	13 12 07 ³	22,450	-	-	-	22,450
	15 12 08 ⁴	28,850	-	-	-	28,850
	04 01 10 ⁵	-	34,429	-	-	34,429
Totals		77,199	34,429	17,282	8,617	85,729
G Neave	21 12 06 ¹	32,374	-	21,602	10,772 ²	-
	13 12 07 ³	27,470	-	-	-	27,470
	15 12 08 ⁴	34,800	-	-	-	34,800
	04 01 10 ⁵	-	41,606	-	-	41,606
Totals		94,644	41,606	21,602	10,772	103,876

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

- 1 The market value of the shares on the date of the award was 302.75 pence per share. The three year performance period ran from 1 October 2006 to 30 September 2009.
- 2 Shares vested on 21 December 2009 and the closing price on that date was 269.00 pence per share.
- 3 The market value of the shares on the date of the award was 334.00 pence per share. The three year performance period runs from 1 October 2007 to 30 September 2010.
- 4 The market value of the shares on the date of the award was 251.00 pence per share. The three year performance period runs from 1 October 2008 to 30 September 2011.
- 5 The market value of the shares on the date of the award was 272.50 pence per share. The three year performance period runs from 1 October 2009 to 30 September 2012.
- 6 The cost of conditional awards is charged to the profit and loss account over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.6m was charged to the profit and loss account (2009: £0.4m).
- 7 Details of the performance conditions are shown in Note 11 (iv) of the Regulatory Accounts.
- 8 The market price of the shares on 31 March 2010 was 283.10 pence per share. During the year, the highest market price was 295.70 pence per share and the lowest market price was 203.00 pence per share.
- 9 Aggregate gross gains made by directors on exercise of awards at date of vesting was £156,111 (2009: £135,428).
- 10 Some or all of the shares will vest only if specified performance targets are achieved during the three year performance period. For further information, please refer to the Directors' Remuneration Report in the NWG accounts and to note 11 to the Regulatory Accounts.

The directors who held office as at 31 March 2010 held the following interests in the ordinary 10p shares of the Group, purchased and held in accordance with the terms of the Share Incentive Plan

Name of Director	Number of SIP shares held as at 1 April 2009	Number of SIP shares held as at 31 March 2010
J A Cuthbert	4,785	5,653
C M Green	4,785	5,653
A C Jones	4,785	5,653
G Neave	590	590

(b) Highest paid director

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

	2010	2009
	£'000	£'000
Emoluments (including benefits in kind)	300.0	248.5

The accrued pension entitlement under the Company's defined benefit scheme of the highest paid director at 31 March 2010 was £172,000 (2009: £163,400)

6. TRANSACTIONS WITH DIRECTORS AND OFFICERS

No transactions or arrangements with Directors and Officers which are disclosable under the provisions of the Companies Act 2006 have occurred during the year.

7. EMPLOYEE INFORMATION

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

	2010	2009
	£'m	£'m
Gross costs charged to the profit and loss account		
Wages and salaries	64.5	60.9
Social security costs	5.3	5.0
Other pension costs	11.9	7.8
	<u>81.7</u>	<u>73.7</u>
Costs recharged to other group companies		
Wages and salaries	2.0	2.0
Social security costs	0.2	0.1
Other pension costs	0.4	0.3
	<u>2.6</u>	<u>2.4</u>
Net costs charged to the profit and loss account		
Wages and salaries	62.5	58.9
Social security costs	5.1	4.9
Other pension costs	11.5	7.5
	<u>79.1</u>	<u>71.3</u>
Costs charged to capital schemes		
Wages and salaries	18.7	19.2
Social security costs	1.6	1.6
Other pension costs	3.5	2.5
	<u>23.8</u>	<u>23.3</u>
Total net employee costs	<u>102.9</u>	<u>94.6</u>

The average monthly number of employees on the payroll during the financial year was 2,930 (2009 2,942) and the total at the year end was 2,894 (2009 2,966)

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

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Current tax		
UK corporation tax on profits for the year at 28% (2009 28%)	38 9	33 0
Adjustments in respect of prior years	(1 3)	(1 1)
Payable in respect of group relief for the current year at 28% (2009 28%)	5 0	5 7
Adjustments in respect of prior years	<u>0 2</u>	<u>-</u>
Total current tax charge (note 8b)	<u>42 8</u>	<u>37 6</u>
Deferred tax		
Movement in the year at 28% (2009 28%)		
Origination and reversal of timing differences in the year	6 0	8 4
Adjustments in respect of prior periods	<u>0 3</u>	<u>1 1</u>
	6 3	9 5
Increase in discount arising from current year movements	<u>(13 5)</u>	<u>(7 6)</u>
Movement in the year (note 21)	<u>(7 2)</u>	<u>1 9</u>
Total deferred tax (credit) / charge (note 21)	<u>(7 2)</u>	<u>1 9</u>
Tax on profit on ordinary activities	<u><u>35 6</u></u>	<u><u>39 5</u></u>

Tax losses have provisionally been claimed from other group companies in the current year of £13 6m (2009 £17 1m) for which payment will be made at the rate of 28% (2009 28%) Further payments are due to group companies of £1 2m (2009 £0 9m) in respect of UK UK transfer pricing adjustments

Discount has increased due to increases in the post-tax yields on UK government gilts during the year

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

	2010	2009
	£'m	£'m
Profit on ordinary activities before tax	178.6	168.8
Profit on ordinary activities multiplied by standard rate of corporation tax of 28% (2009 28%)	50.0	47.3
Effects at 28% (2009 28%) of		
Expenses not deductible for tax purposes	0.2	0.3
Non-taxable income	(2.0)	(2.1)
Depreciation in respect of non-qualifying items	5.1	4.8
Industrial buildings allowances claimed in the year	(3.4)	(4.8)
Accelerated tax depreciation	(11.5)	(10.6)
Pension deficit	4.0	0.5
Other timing differences	1.5	1.7
Refinancing of infrastructure assets	-	1.6
Adjustments in respect of prior years	(1.1)	(1.1)
Transfer pricing adjustments	(1.2)	(0.9)
Balancing payment payable	1.2	0.9
Total current tax charge (note 8a)	42.8	37.6

(c) Factors that may affect future tax charges:

The Company expects to continue to incur high levels of capital expenditure and accordingly it expects to be able to continue to claim tax reliefs in excess of depreciation during the 2010-15 regulatory review period

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

On 22 June 2010 the Emergency Budget announced by the UK Coalition Government contained details of proposed changes to corporation tax rates and the rates of capital allowances, both of which are expected to be fully implemented by 2014. The rate of corporation tax is to be cut from 28% to 27% with effect from 1 April 2011 and by a further 1% per annum until it reaches 24% on 1 April 2014. The main rate of capital allowances is to be reduced from 20% to 18% with effect from 1 April 2012, together with a reduction in the special/long life pool rate from 10% to 8%.

As none of these changes had been enacted or substantively enacted by the balance sheet date, no adjustment is recognised in these financial statements. If all the changes had been enacted at the balance sheet date the Company's deferred tax liability of £216.6m (see note 21) would have been reduced by £30.4m to £186.2m and the deferred tax asset relating to the pension deficit of £37.2m (see note 26) would have been reduced by £5.2m to £32.0m. The reduction in the deferred tax liability would have been dealt with in the profit and loss account. The reduction in the deferred tax asset relating to the pension deficit would have been dealt with in the statement of total recognised gains and losses. The reductions in deferred tax are expected to be implemented over a period of four years in line with legislative changes.

9. DIVIDENDS

	<u>2010</u> £'m	<u>2009</u> £'m
Equity		
Dividends paid		
Final paid for the year ended 31 March 2009 of 34 64p (year ended 31 March 2008 33 41p) per share on an aggregated basis	42 5	41 0
Interim paid of 35 43p (2009 34 96p) per share on an aggregated basis	<u>43 4</u>	<u>42 9</u>
Total dividends paid in the year	<u>85 9</u>	<u>83 9</u>
Dividends proposed		
Final proposed for year ended 31 March 2010 of 35 75p (year ended 31 March 2009 34 64p) per share on an aggregated basis	<u>43 8</u>	<u>42 5</u>

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

The Company has maintained its policy of steady real growth of 1.9% per annum for the appointed business dividend. Dividends from the non-appointed business are determined by the directors and are based on performance.

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

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

10. TANGIBLE FIXED ASSETS

	Freehold land and buildings	Infra- structure assets	Operational structures, plant and machinery	Fixtures, fittings, tools and equipment	Assets in the course of construction	Total
	£'m	£'m	£'m	£'m	£'m	£'m
Cost						
At 1 April 2009	94 6	1,883 5	2,043 2	143 3	176 2	4,340 8
Additions	-	-	-	-	226 3	226 3
Schemes commissioned	20 3	107 3	130 9	26 9	(285 4)	-
Disposals	-	(6 6)	(3 0)	-	-	(9 6)
At 31 March 2010	114 9	1,984 2	2,171 1	170 2	117 1	4,557 5
Depreciation						
At 1 April 2009	33 8	297 8	626 7	113 8	-	1,072 1
Charge for year	2 0	39 3	67 9	7 8	-	117 0
Disposals	-	(6 6)	(2 9)	-	-	(9 5)
At 31 March 2010	35 8	330 5	691 7	121 6	-	1,179 6
Net book value						
At 31 March 2010	79 1	1,653 7	1,479 4	48 6	117 1	3,377 9
At 31 March 2009	60 8	1,585 7	1,416 5	29 5	176 2	3,268 7
Leased assets included above						
Net book value						
At 31 March 2010	-	47 8	23 6	-	-	71 4
At 31 March 2009	-	48 3	24 1	-	-	72 4

11. FIXED ASSET INVESTMENTS

	Loans to Group Companies £'m
At 1 April 2009	160.9
Capitalised interest	-
At 31 March 2010	<u>160.9</u>

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

In May 2004 NWL made a loan of £1.5m to Bakethin Holdings Limited, a quasi subsidiary company, maturing in January 2034. The interest on the loan is capitalised and at 31 March 2010 the balance was £1.9m (2009 £1.9m)

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

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

12. STOCKS

	2010 £'m	2009 £'m
Raw materials and consumables	2.8	2.7

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

13. DEBTORS DUE IN LESS THAN ONE YEAR

	2010 £'m	2009 £'m
Trade debtors	65.4	63.0
Amounts owed by other group companies	4.2	8.1
Other debtors	4.9	5.7
Prepayments and accrued income	48.5	46.0
	<u>123.0</u>	<u>122.8</u>

Trade debtors are shown net of bills raised in advance

14. DEBTORS DUE IN MORE THAN ONE YEAR

	2010 £'m	2009 £'m
Interest rate hedge	3.2	3.3

15. INVESTMENTS

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Short term deposits with NSL	88 2	159 4

16. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Obligations under finance leases (note 19)	7 0	6 8
Loans (note 18)	17 7	19 1
Trade creditors	6 0	6 6
Amounts owed to other group companies	12 1	12 0
Taxation and social security	2 2	2 1
Corporation tax	7 9	6 1
Other creditors	12 4	12 4
Receipts in advance	16 5	17 3
Accruals and deferred income	91 2	95 8
	<u>173 0</u>	<u>178 2</u>

Accruals and deferred income includes accruals related to capital projects of £31.8m (2009 £37.9m)

Included in amounts owed to other group companies is £10.4m (2009 £10.3m) payable in respect of tax losses surrendered from fellow group companies

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

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Obligations under hire purchase contracts and finance leases (note 19)	104 1	104 8
Loans (note 18)	344 7	362 3
Amounts owed to other group companies (note 20)	1,451 7	1,458 2
Other creditors	0 5	0 1
	<u>1,901 0</u>	<u>1,925 4</u>

18. LOANS

	2010	2009
	£'m	£'m
Loans are repayable as follows		
Within one year (note 16)	177	191
Between one and two years	230	176
Between two and five years	1315	1256
After five years	1902	2191
	<u>3624</u>	<u>3814</u>

Loans wholly repayable within 5 years amount to £58 0m (2009 £67 4m)

Loans not wholly repayable within 5 years amount to £304 4m (2009 £314 0m) and bear interest rates in the range 1 02% to 7 27%

19. OBLIGATIONS UNDER FINANCE LEASES

Obligations under hire purchase contracts and finance leases are as follows

	2010	2009
	£'m	£'m
Amounts due		
Within one year	70	68
Between one and two years	67	64
Between two and five years	168	168
After five years	1546	1600
	<u>1851</u>	<u>1900</u>
Less		
Finance charge allocated to future periods	(740)	(784)
	<u>1111</u>	<u>1116</u>
Disclosed as due		
Within one year (note 16)	70	68
After more than one year (note 17)	1041	1048
	<u>1111</u>	<u>1116</u>

The aggregate gross amount of obligations under hire purchase contracts and finance leases, any part of which falls due for repayment in five years or more, is £185 1m (2009 £190 0m)

20. AMOUNTS DUE TO OTHER GROUP COMPANIES

Amounts due to other group companies include loans repayable as follows

	2010	2009
	£'m	£'m
After five years	1,451.7	1,458.2

NWF issued £200.0m and £150.0m Guaranteed Eurobonds in February 1998 and September 2001 respectively, maturing February 2023, with an annual coupon of 6.875%. The issues were guaranteed by the Company who received the issue proceeds by way of inter-company loans of £194.2m and £163.2m respectively. Finance costs allocated during the year amounted to £0.2m (2009 £0.2m). Amortisation of loan issue receipts during the year amounted to £0.3m (2009 £0.3m).

NWF issued £300.0m Guaranteed Eurobonds in December 2001, maturing October 2017, with an annual coupon of 6.0%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £301.0m. Amortisation of loan receipts during the year amounted to £0.1m (2009 £0.1m).

NWF issued £250.0m and £100.0m Guaranteed Eurobonds in December 2002 and December 2004, maturing April 2033 with an annual coupon of 5.625%. Both issues were guaranteed by the Company who received the issue proceeds by way of inter-company loans of £246.6m and £100.8m respectively. Finance costs allocated during the year amounted to £0.2m (2009 £0.2m).

NWF issued £150.0m Guaranteed Index Linked Eurobonds in September 2005, maturing July 2036, with a real coupon of 2.033%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £150.0m. Indexation (amortisation) / accretion during the year amounted to £(2.5)m (2009 £8.2m).

NWF issued £60.0m Guaranteed Index Linked Eurobonds in January 2006, maturing January 2041, with a real coupon of 1.6274%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £60.0m. Indexation (amortisation) / accretion during the year amounted to £(1.0)m (2009 £3.2m).

NWF issued two £100.0m Guaranteed Index Linked Eurobonds in June 2006 with real coupons of 1.7118% and 1.7484% and with maturities of 2049 and 2053 respectively. Both issues were guaranteed by the Company who received the issue proceeds by way of two inter-company loans of £100.0m. Indexation (amortisation) / accretion during the year amounted to £(3.2)m (2009 £10.8m).

21. PROVISIONS FOR LIABILITIES AND CHARGES

	£'m
Pension provision for former directors	
At 1 April 2009	2.7
Utilised during the year	<u>(0.3)</u>
At 31 March 2010	<u>2.4</u>
Deferred tax	
At 1 April 2009	219.8
Total movement in the year (note 8a)	(7.2)
Included above relating to pensions (note 26)	<u>4.0</u>
At 31 March 2010	<u>216.6</u>
Provisions for liabilities and charges	<u><u>219.0</u></u>

The pension provision for former directors relates to pensions payable to former directors of water-only companies which have since merged with the Company. The provision of £2.4m represents the full future amounts payable, based on an actuarial assessment, for which the Company is directly liable.

The provision for deferred tax comprises

	2010 £'m	2009 £'m
Accelerated tax depreciation	507.2	495.5
Other timing differences	<u>(62.6)</u>	<u>(61.2)</u>
Undiscounted provision for deferred tax	444.6	434.3
Discount	<u>(228.0)</u>	<u>(214.5)</u>
Discounted provision for deferred tax	<u><u>216.6</u></u>	<u><u>219.8</u></u>

22. ACCRUALS AND DEFERRED INCOME

	Gilt lock £'m	Capital grants and contributions £'m	Proceeds from Kielder securitisation £'m	Total £'m
At 1 April 2009	0.5	211.0	177.3	388.8
Additions	-	10.0	-	10.0
Amortised / transferred during the year	<u>-</u>	<u>(5.0)</u>	<u>(7.1)</u>	<u>(12.1)</u>
At 31 March 2010	<u><u>0.5</u></u>	<u><u>216.0</u></u>	<u><u>170.2</u></u>	<u><u>386.7</u></u>

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

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

23. CALLED UP SHARE CAPITAL

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Authorised 122,650,000 Ordinary Shares of £1 each (2009 122,650,000)	<u>122 7</u>	<u>122 7</u>
	<u>2010</u>	<u>2009</u>
	£'m	£'m
Allotted, called-up and fully paid 122,650,000 Ordinary Shares of £1 each (2009 122,650,000)	<u>122 7</u>	<u>122 7</u>

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

	<u>Profit and loss account</u>	<u>Total share- holders' funds</u>
	£'m	£'m
At 31 March 2009	801 0	923 7
Profit for the year	143 0	143 0
Share based payment	0 3	0 3
Actuarial gain on pension liability in the year (note 26)	1 1	1 1
Deferred tax related to actuarial loss on pension liability in the year (note 26)	(0 3)	(0 3)
Dividends paid (note 9)	<u>(85 9)</u>	<u>(85 9)</u>
At 31 March 2010	<u>859 2</u>	<u>981 9</u>

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

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Expenditure contracted for but not provided for	<u>85.3</u>	<u>168.8</u>

(b) Lease commitments:

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

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Land and buildings		
Leases which expire		
After one year but not more than five	0.1	0.3
In five years or more	<u>0.5</u>	<u>0.6</u>
	<u>0.6</u>	<u>0.9</u>
Other		
Leases which expire		
Between two and five years	<u>0.1</u>	<u>0.1</u>
	<u>0.1</u>	<u>0.1</u>

26. PENSIONS

NWL participates in the Group defined benefit pension scheme, Northumbrian Water Pension Scheme (NWPS or the scheme), providing benefits based on final pensionable remuneration to 2,033 active members at 31 March 2010 (2009 2,169)

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 2007. At that date the value of assets amounted to £732.3m and the funding level was 106.1%

The future service contribution rate jointly payable by members and the employers from 31 December 2007 was 22.6% of pensionable salaries. Members' contributions are 7.3% on average with the employers paying 15.3%

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

Investment Return	
Pre-retirement	6.1%
Post-retirement	5.2%
Pay Increases	3.7%
Pension Increases	3.4%
Price Inflation	3.4%

Following the 2004 actuarial valuation the employers had prepaid contributions to the scheme up to 31 December 2010. The scheme actuary recommended that regular contributions should recommence from 1 January 2011.

26. PENSIONS (continued)

The scheme also has a defined contribution section which had 389 active members at 31 March 2010 (2009 310). Members can choose to contribute either 3%, 4% or 5% of salary, with employers contributing 6%, 7% or 8% depending on the member contribution rate. The contributions paid to the defined contribution section by the Company in the year totalled £0.6m (2009 £0.4m).

NWPS is a multi-employer scheme and it is not possible to separately identify the Company's share of the net assets and liabilities. However, as more than 99% of the active members of the scheme are employed by the Company, the full costs, assets and liabilities of the Scheme have been recognised in the financial statements.

The additional disclosures regarding the defined benefit scheme as required under FRS 17 'Retirement benefits' and the relevant impact on the financial statements are set out below.

A qualified actuary, using revised assumptions that are consistent with the requirements of FRS 17, has updated the actuarial valuation described above as at 31 March 2010. Investments have been valued, for this purpose, at fair value.

FRS 17 actuarial assumptions	2010	2009
Pay increases ¹	4.7%	4.0%
Pension increases	3.7%	3.0%
Price inflation	3.7%	3.0%
Discount rate	5.5%	6.1%
Mortality assumptions ^{2,3}	PCMA/PCFA00	PCMA/PCFA00
- Life expectancy for a member aged 65 – female (years)	23.0	22.9
- Life expectancy for a member aged 65 – male (years)	20.7	20.6

¹ including promotional salary scale

² 115% of PCMA/PCFA00

³ PCMA/PCFA00 (year of birth with medium cohort improvements)

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 2010	2010	Long term expected rate of return 2009	2009
	%	£'m	%	£'m
Equities	7.5	499.3	7.2	369.0
Corporate bonds	5.5	70.7	6.1	38.9
Government bonds	4.5	27.2	4.2	50.0
Property	6.0	66.6	5.7	58.7
Cash	3.9	14.3	4.0	1.8
Loan to Scheme from NSL	0.5	(14.7)	2.0	(39.8)
Total fair value of assets		663.4		478.6
Present value of liabilities		(796.5)		(598.0)
Deficit under FRS17		(133.1)		(119.4)
Past service cost owed from group company		0.3		-
Related deferred tax ¹		37.2		33.4
Net pension liability		(95.6)		(86.0)

¹ The movement in deferred tax of £3.8m comprises £0.3m relating to the actuarial gain in the year, which is recognised as a charge in the statement of total recognised gains and losses, and £4.1m relating to other items, which is recognised as a credit in the profit and loss account.

26. PENSIONS (continued)

Analysis of the amount that has been charged to the profit and loss account under FRS 17

	2010	2009
	£'m	£'m
Current service cost	9 9	9 6
Past service cost	4 6	0 3
Recognised in operating costs in arriving at operating profit	<u>14 5</u>	<u>9 9</u>

	2010	2009
	£'m	£'m
Interest cost on plan obligations	36 1	38 5
Expected return on plan assets	(31 6)	(44 3)
Recognised in net interest payable (note 4)	<u>4 5</u>	<u>(5 8)</u>

Analysis of the actuarial gain / (loss) that has been recognised in the statement of total recognised gains and losses

	2010	2009
	£'m	£'m
Net actuarial gain / (loss)	<u>1 1</u>	<u>(207 8)</u>

Cumulative amounts recognised since adopting the standard

	2010	2009	2008	2007	2006
Fair value of assets	663 4	478 6	666 7	710 8	659 8
Present value of defined benefit obligation	(796 5)	(598 0)	(576 3)	(668 1)	(663 5)
(Deficit) / surplus	(133 1)	(119 4)	90 4	42 7	(3 7)
Experience adjustments arising on plan assets	177 4	(205 3)	(93 4)	0 6	87 1
Experience adjustments arising on plan liabilities	-	18 7	0 6	1 7	34 0

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

	2010	2009
	£'m	£'m
Present value at 1 April	598 0	576 3
Current service cost	9 9	9 6
Past service cost	4 6	0 3
Interest cost	36 1	38 5
Contributions by plan participants	0 1	0 1
Actuarial losses on obligations	176 3	2 5
Benefits paid	(28 5)	(29 3)
Present value at 31 March	<u>796 5</u>	<u>598 0</u>

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

	2010	2009
	£'m	£'m
At 1 April	478 6	666 7
Expected return on plan assets	31 6	44 3
Actuarial gains / (losses) on plan assets	177 4	(205 3)
Contributions by employer	4 2	2 1
Contributions by plan participants	0 1	0 1
Benefits paid	(28 5)	(29 3)
At 31 March	<u>663 4</u>	<u>478 6</u>

26. PENSIONS (continued)

Sensitivity to key assumptions

FRS 17 encourages disclosure of the sensitivity of the results to the methods and assumptions used

The costs of a pension arrangement require estimates regarding future experience. The financial assumptions used for FRS 17 reporting are the responsibility of the directors of the Company. These assumptions reflect market conditions at the balance sheet date. Changes in market conditions which result in changes in the net discount rate (essentially the difference between the discount rate and the assumed rates of increases of salaries, deferred pension revaluation or pensions in payment), can have a significant effect on the value of the liabilities reported.

A reduction in the net discount rate will increase the assessed value of liabilities, as a higher value is placed on benefits paid in the future. A rise in the net discount rate will have an opposite effect of similar magnitude. The overall effect of a change in the net discount rate of 0.1% would change the liabilities by around £14.4m.

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

The disclosures have been prepared using the mortality assumptions adopted for the 2007 formal valuation, detailed earlier in this note. The effect of increasing the assumed life expectancies by one year would be to increase the value of liabilities by around 2.8%.

27. SHARE INCENTIVE PLANS**(a) 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 Group. Further details of the LTIP can be found in the directors' remuneration report on pages 33 and 34.

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

	March 2010 Number	March 2009 Number
Outstanding at 1 April	1,190,034	1,103,069
Granted during the year	414,679	462,700
Forfeited/lapsed during the year	(238,686)	(270,480)
Exercised	(123,734)	(105,255)
Outstanding at 31 March	<u>1,242,293</u>	<u>1,190,034</u>
Exercisable at 31 March	<u>4,724</u>	<u>9,023</u>

The weighted average exercise price throughout the year was £nil (2009: £nil). The fair value of conditional share awards granted during the year was £0.1m (2009: £0.1m).

The weighted average share price at the date of exercise for the conditional share awards is 268.71 pence (2009: 248.08 pence).

For the conditional awards outstanding as at 31 March 2010, the weighted average remaining contractual life is 1.8 years (2009: 1.8 years).

27. SHARE INCENTIVE PLANS (continued)

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

	March 2010	March 2009
Dividend yield	4.7%	4.9%
Expected share price volatility	29%	28%
Share price at award	272.50p	251.50p
Expected FTSE 250 index volatility	24%	23%
Risk free interest rate %	2.1%	2.6%
Expected life of option (years)	3	3

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

(b) Share Incentive Plan (SIP)

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

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

	March 2010 Number	March 2009 Number
Outstanding at 1 April	117,687	97,876
Granted during the year	134,397	119,922
Forfeited during the year	(1,805)	(2,861)
Exercised	(107,078)	(97,250)
Outstanding at 31 March	143,201	117,687

28. RELATED PARTY DISCLOSURES

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

29. ULTIMATE PARENT COMPANY

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

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

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF NORTHUMBRIAN WATER LIMITED

We have audited the financial statements of Northumbrian Water Limited for the year ended 31 March 2010 which comprise the Profit and Loss Account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, and the related notes 1 to 29. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. 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 auditor's 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

As explained more fully in the Directors' Responsibilities Statement set out on page 26, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the company's affairs as at 31 March 2010 and of its profit for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

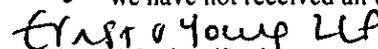
Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit.


Debbie O'Hanlon (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
Newcastle upon Tyne
9 July 2010

HISTORICAL COST PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2010

	Note	2010			2009		
		Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis
		£'m	£'m	£'m	£'m	£'m	£'m
Turnover	2	623.4	25.9	649.3	614.4	26.1	640.5
Operating costs		(311.0)	(12.6)	(323.6)	(302.3)	(12.9)	(315.2)
Historical cost depreciation		(74.1)	(0.8)	(74.9)	(70.4)	(0.6)	(71.0)
Operating income		0.2	-	0.2	1.1	-	1.1
OPERATING PROFIT	A	<u>238.5</u>	<u>12.5</u>	<u>251.0</u>	<u>242.8</u>	<u>12.6</u>	<u>255.4</u>
Net interest (payable) / receivable		(86.6)	9.8	(76.8)	(101.9)	10.5	(91.4)
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		<u>151.9</u>	<u>22.3</u>	<u>174.2</u>	<u>140.9</u>	<u>23.1</u>	<u>164.0</u>
Taxation – current		(38.5)	(4.3)	(42.8)	(32.9)	(4.7)	(37.6)
– deferred	A	8.6	0.1	8.7	23.4	0.1	23.5
PROFIT FOR THE FINANCIAL YEAR		<u>122.0</u>	<u>18.1</u>	<u>140.1</u>	<u>131.4</u>	<u>18.5</u>	<u>149.9</u>
Dividends		(78.9)	(7.0)	(85.9)	(76.9)	(7.0)	(83.9)
RETAINED PROFIT FOR THE YEAR		<u>43.1</u>	<u>11.1</u>	<u>54.2</u>	<u>54.5</u>	<u>11.5</u>	<u>66.0</u>

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2010

	2010			2009		
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis
	£'m	£'m	£'m	£'m	£'m	£'m
Profit for the financial year	122.0	18.1	140.1	131.4	18.5	149.9
Pension liability actuarial gain / (loss) in the year	1.2	-	1.2	(202.5)	(3.4)	(205.9)
Deferred tax related to pension adjustments	(0.3)	-	(0.3)	56.6	1.0	57.6
Total recognised gains and losses relating to the year	<u>122.9</u>	<u>18.1</u>	<u>141.0</u>	<u>(14.5)</u>	<u>16.1</u>	<u>1.6</u>

HISTORICAL COST BALANCE SHEET**At 31 March 2010**

	Note	2010			2009		
		Appointed	Non-	Aggregated	Appointed	Non-	Aggregated
		business	appointed	basis	business	appointed	basis
		£'m	£'m	£'m	£'m	£'m	£'m
FIXED ASSETS							
Tangible assets	A	3,069 0	107 1	3,176 1	2,985 6	99 9	3,085 5
Investments – loans to group companies		-	160 9	160 9	-	160 9	160 9
TOTAL FIXED ASSETS		3,069 0	268 0	3,337 0	2,985 6	260 8	3,246 4
CURRENT ASSETS							
Stocks		2 5	0 3	2 8	2 4	0 3	2 7
Debtors	A	125 4	0 9	126 3	128 1	(2 0)	126 1
Cash		-	22 2	22 2	-	26 8	26 8
Short term deposits		88 2	-	88 2	159 4	-	159 4
TOTAL CURRENT ASSETS		216 1	23 4	239 5	289 9	25 1	315 0
CREDITORS Amounts falling due within one year							
Overdrafts		(21 0)	-	(21 0)	(20 0)	-	(20 0)
Infrastructure renewals accrual		(16 0)	(1 9)	(17 9)	(24 6)	(1 9)	(26 5)
Creditors		(131 2)	(9 4)	(140 6)	(137 3)	(8 6)	(145 9)
Borrowings		(24 7)	-	(24 7)	(25 9)	-	(25 9)
Corporation tax payable		(7 7)	(0 2)	(7 9)	(6 1)	-	(6 1)
TOTAL CREDITORS		(200 6)	(11 5)	(212 1)	(213 9)	(10 5)	(224 4)
NET CURRENT ASSETS		15 5	11 9	27 4	76 0	14 6	90 6
TOTAL ASSETS LESS CURRENT LIABILITIES		3,084 5	279 9	3,364 4	3,061 6	275 4	3,337 0
CREDITORS Amounts falling due after more than one year							
Borrowings		(1,900 5)	-	(1,900 5)	(1,925 3)	-	(1,925 3)
Other creditors		(0 5)	-	(0 5)	(0 1)	-	(0 1)
TOTAL CREDITORS		(1,901 0)	-	(1,901 0)	(1,925 4)	-	(1,925 4)
PROVISIONS FOR LIABILITIES AND CHARGES							
Deferred tax provision	A	(166 8)	(1 6)	(168 4)	(171 5)	(1 6)	(173 1)
Deferred income – grants and contributions	A	(55 4)	(1 0)	(56 4)	(56 5)	(0 5)	(57 0)
Post employment liability	A	(93 1)	(1 5)	(94 6)	(83 8)	(1 4)	(85 2)
Other provisions		(2 4)	-	(2 4)	(2 7)	-	(2 7)
Other deferred income		(0 5)	(170 2)	(170 7)	(0 5)	(177 3)	(177 8)
NET ASSETS EMPLOYED		865 3	105 6	970 9	821 2	94 6	915 8
CAPITAL AND RESERVES							
Called up share capital		92 1	30 6	122 7	92 1	30 6	122 7
Profit and loss account		773 2	75 0	848 2	729 1	64 0	793 1
CAPITAL AND RESERVES		865 3	105 6	970 9	821 2	94 6	915 8

Approved by the Board and signed on their behalf by


H Mottram
7 July 2010

C M Green 

**(A) RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL
COST REGULATORY ACCOUNTS
For the year ended 31 March 2010**

In preparing its statutory accounts, the Company has followed common industry practice and adopted the infrastructure renewals accounting basis as set out in FRS 15 Tangible Fixed Assets. However, for the purpose of the regulatory accounts, Ofwat has requested that FRS 15 is not applied for infrastructure renewals accounting, thereby providing a basis consistent with prior years. In addition, Ofwat has decided to depart from UK GAAP and disapply the provisions of Note G of FRS 5, which states the turnover should not include amounts that the company does not expect to collect. A reconciliation between the statutory and historical cost regulatory accounts is set out below.

	Statutory UK GAAP £'m	Regulatory £'m	Explanation of difference
PROFIT AND LOSS ACCOUNT			
Turnover	651.5	649.3	Statutory accounts include provision for revenue recognition of £2.2m in accordance with Note G of FRS 5, which is disappplied for regulatory purposes (see note 1(c))
Operating Profit	255.4	251.0	Adjustments mainly relating to Section 19 "overlap" (£3.0m) (see note 1(a)(i)) and amortisation of infrastructure income (£1.4m) (see note 1(a)(ii))
Deferred tax credit	7.2	8.7	Adjustments relating to amortisation of infrastructure income (£0.4m), Section 19 "overlap" (£0.8m) and discount (£0.3m)
BALANCE SHEET			
Tangible fixed assets (net book value)	3,377.9	3,176.1	Adjustments relating to – infrastructure grants and contributions netted off (£179.3m), Section 19 "overlap" (£40.4m) and infrastructure renewals provision (£17.9m)
Provisions for liabilities and charges – deferred tax	216.6	168.4	Adjustments relating to amortisation of infrastructure income (£5.5m), Section 19 "overlap" (£11.3m) and discount (£31.4m)
Deferred income – grants and contributions	216.0	56.4	Adjustments relating to gross up (£179.3m) and amortisation (£19.7m) of infrastructure grants and contributions
Post employment liability	95.6	94.6	Adjustment relating to additional charge in statutory accounts for VLS pension scheme (£1.0m)

The non-appointed debtor balance includes a credit of £9.5m (2009 £7.1m) owed to the appointed business. The aggregated debtor balance therefore agrees to the statutory accounts.

CURRENT COST PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2010

	Note	<u>2010</u> £'m	<u>2009</u> £'m
Turnover	2	623 4	614 4
Current cost operating costs	3	(441 6)	(429 8)
Operating income	2	0 1	1 2
Working capital adjustment	2	<u>(1 0)</u>	<u>-</u>
CURRENT COST OPERATING PROFIT		180 9	185 8
Net interest payable		(86 6)	(101 9)
Financing adjustment		<u>66 6</u>	<u>(4 8)</u>
CURRENT COST PROFIT BEFORE TAXATION		160 9	79 1
Taxation			
Current tax		(38 5)	(32 9)
Deferred tax		<u>8 6</u>	<u>23 4</u>
CURRENT COST PROFIT ATTRIBUTABLE TO SHAREHOLDERS		131 0	69 6
Dividends		<u>(78 9)</u>	<u>(76 9)</u>
CURRENT COST PROFIT / (LOSS) RETAINED		<u>52 1</u>	<u>(7 3)</u>

All note references to the summary current cost financial statements refer to the notes to the current cost accounts on pages 61 to 63

CURRENT COST BALANCE SHEET
At 31 March 2010

	Note	<u>2010</u> £'m	<u>2009</u> £'m
FIXED ASSETS			
Tangible assets	4	14,005 6	13,404 7
Third party contributions since 1989/90		(99 4)	(96 2)
		<u>13,906 2</u>	<u>13,308 5</u>
Working capital	5	30 1	22 8
Short term deposits		88 2	159 4
Overdraft		(21 0)	(20 0)
Infrastructure renewals accrual		(16 0)	(24 6)
NET OPERATING ASSETS		<u>13,987 5</u>	<u>13,446 1</u>
NON OPERATING ASSETS AND LIABILITES			
Borrowings		(24 7)	(25 9)
Non-trade debtors		3 2	7 4
Non-trade creditors due within one year		(36 6)	(37 0)
Corporation tax payable		(7 7)	(6 1)
Total non-operating liabilities		<u>(65 8)</u>	<u>(61 6)</u>
CREDITORS AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Borrowings		(1,900 5)	(1,925 3)
Other creditors		(0 5)	(0 1)
Total creditors due after more than one year		<u>(1,901 0)</u>	<u>(1,925 4)</u>
PROVISIONS FOR LIABILITIES AND CHARGES			
Deferred tax provision		(166 8)	(171 5)
Post employment liability		(93 1)	(83 8)
Other provisions		(2 4)	(2 7)
Total provisions		<u>(262 3)</u>	<u>(258 0)</u>
NET ASSETS		<u>11,758 4</u>	<u>11,201 1</u>
CAPITAL AND RESERVES			
Called up share capital		92 1	92 1
Profit and loss account		445 5	392 5
Current cost reserve	6	11,220 8	10,716 5
TOTAL CAPITAL AND RESERVES		<u>11,758 4</u>	<u>11,201 1</u>

CURRENT COST CASH FLOW STATEMENT**For the year ended 31 March 2010**

Note	2010			2009			
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis	
	£'m	£'m	£'m	£'m	£'m	£'m	
NET CASH FLOW FROM OPERATING ACTIVITIES	7	362 6	4 4	367 0	354 2	10 5	364 7
Returns on investments and servicing of finance							
Interest received		8 0	9 9	17 9	9 3	10 3	19 6
Interest paid		(89 1)	-	(89 1)	(93 9)	-	(93 9)
Interest in finance lease rentals		(4 1)	-	(4 1)	(4 5)	-	(4 5)
Net cash flow from returns on investments and servicing of finance		(85 2)	9 9	(75 3)	(89 1)	10 3	(78 8)
Taxation paid		(36 3)	(4 5)	(40 8)	(31 2)	(4 9)	(36 1)
Capital expenditure and financial investment							
Gross cost of purchase of fixed assets		(173 1)	(7 9)	(181 0)	(207 3)	(0 9)	(208 2)
Receipt of grants and contributions		12 2	0 6	12 8	10 9	0 2	11 1
Infrastructure renewals expenditure		(50 9)	(0 1)	(51 0)	(36 8)	-	(36 8)
Disposal of fixed assets		0 2	-	0 2	1 1	-	1 1
Net cash outflow from investing activities		(211 6)	(7 4)	(219 0)	(232 1)	(0 7)	(232 8)
Equity dividend paid		(78 9)	(7 0)	(85 9)	(76 9)	(7 0)	(83 9)
Management of liquid resources							
Net cash flow from management of liquid resources		71 2	-	71 2	23 7	-	23 7
NET CASH FLOW BEFORE FINANCING		21 8	(4 6)	17 2	(51 4)	8 2	(43 2)
Financing							
Capital element in finance lease rentals		(3 7)	-	(3 7)	(3 1)	-	(3 1)
New bank loans		-	-	-	140 8	-	140 8
Repayment of bank loans & debentures		(19 1)	-	(19 1)	(94 6)	-	(94 6)
Net cash (outflow)/inflow from financing		(22 8)	-	(22 8)	43 1	-	43 1
(DECREASE)/INCREASE IN CASH		(1 0)	(4 6)	(5 6)	(8 3)	8 2	(0 1)

NOTES TO THE REGULATORY FINANCIAL STATEMENTS
For the year ended 31 March 2010

1. STATEMENT OF REGULATORY ACCOUNTING POLICIES

(a) Historical cost information

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

The accounting policies set out on pages 31 to 34 apply to the historical cost regulatory financial information, with the exception of

- capital grants and contributions to infrastructure assets which is not in accordance with the Companies Act 2006 (as described in (ii) below)
- infrastructure renewals accounting which, in accordance with RAG 3 06, has been accounted for in accordance with RAG 2 03, "Classification of Infrastructure Expenditure" RAG 2 03 is not in accordance with FRS 12, "Provisions, Contingent Liabilities and Contingent Assets" and FRS 15, "Tangible Fixed Assets" as described in section (i) below
- recognition of income relating to energy generation as described in section 1(c) below

(i) Infrastructure assets

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

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

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

In accordance with RAG 3 06 the Company has not applied FRS 12 and FRS 15, in respect of infrastructure renewals accounting and has continued to charge infrastructure renewal costs (calculated in accordance with our Asset Management Plan (AMP)) to the profit and loss account. Expenditure during the year is charged to the provision

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

- restatement of the cost and accumulated depreciation of infrastructure fixed assets to reflect infrastructure renewals expenditure, depreciation and retirement of assets since renewals accounting was first adopted. Accordingly, infrastructure renewals provisions and prepayments at years ended 31 March 2009 and 31 March 2010 would have been included within infrastructure fixed assets
- the depreciation of infrastructure assets and the inclusion of the infrastructure renewals charge as a component of the depreciation charge for the year
- restatement of the cost of infrastructure fixed assets to reflect the treatment of Section 19 "overlap" expenditure. The objective of the Section 19 quality programme is to address water discolouration problems caused by iron pipes, either through relining those pipes or replacing them where relining is not possible. The "overlap" represents the extra cost of replacing pipes rather than relining them where their structural condition is insufficient to withstand the relining process. Such expenditure is included in the infrastructure renewals charge in the regulatory financial statements. The statutory financial statements classify such expenditure as capital in nature and include this under infrastructure assets in the fixed asset note, resulting in a higher profit in the statutory financial statements

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

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

Grants and contributions relating to infrastructure assets have been deducted from the cost of those assets, in accordance with RAG 3 06. This is not in accordance with the Companies Act 2006 which requires fixed assets to be stated at their purchase price or production cost without deduction of grants and contributions which are accordingly accounted for as deferred income. The effect of the departure on the value of tangible fixed assets is disclosed in note (A). The statutory financial statements reflect grants and contributions as deferred income and amortise them to profit and loss account over the expected useful economic lives of the assets, resulting in a higher operating profit in the statutory financial statements.

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

(b) Current cost information

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

(i) Tangible fixed assets

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

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

- **Land and Buildings**

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

- **Infrastructure assets**

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

- **Other fixed assets**

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

- **Surplus land**

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

- **Grants and contributions**

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

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

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

(iii) Working capital adjustment

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

(iv) Financing adjustment

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

(c) Turnover recognition

The revenue recognition policy is the same in the regulatory and statutory accounts, with the exception of income relating to energy generation. As required by Ofwat in their reporting guidance for the 2010 Annual Return, income relating to energy generation, which is recorded as turnover in the statutory accounts, is recorded as negative operating expenditure in the regulatory accounts

Additional charges added to a customer's account as a result of debt recovery activity, such as court costs or solicitors fees, are recognised as negative operating costs when payment is received in both the statutory and regulatory accounts

All water and sewerage charges billed to customers are recognised as income at the time they are billed and apportioned over the period to which they relate. For consumption by measured customers which has not yet been billed an accrual is estimated

Charges for water and sewerage services remain due in full whilst a property contains furnishings and fittings or when a property is unfurnished and water is being used for any purpose including refurbishment. If the Company has turned off the supply of water at the mains to a property at a customer's request then water supply charges are not payable

If the supply of water is turned off and the property is unfurnished the property is considered unoccupied and charges are not payable. If, however, the supply of water is turned off and the property remains furnished it is considered ready for occupation and in this case sewerage charges in respect of the drainage of surface water and contribution to highway drainage continue to be payable

If a property is recorded as empty in the billing system an empty property process is followed. The purpose of this process is to verify whether the property is occupied or not and, if occupied, to identify the chargeable person and raise a bill. No bills are raised in the name of "the occupier"

The empty property process comprises a number of steps including an initial letter asking the occupier to either contact the Company or return a completed registration form, a check of the property record against Land Registry information and visits to the property by Company representatives. If these steps confirm that a property appears to be empty then the supply may be turned off

New properties are charged from the date a meter is installed, if consumption is being recorded on the meter. If the property is unoccupied but water is being registered the developer will be charged. Once the developer is no longer responsible for a property, if no new occupier has been identified the property will be treated as unoccupied and the empty property process followed, as outlined above

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

	2010			2009		
	Water services	Sewerage services	Appointed business	Water services	Sewerage services	Appointed business
	£'m	£'m	£'m	£'m	£'m	£'m
Unmeasured household	187.8	152.8	340.6	185.9	151.1	337.0
Unmeasured non-household	2.3	2.0	4.3	2.5	2.7	5.2
Measured household	72.9	33.8	106.7	65.6	30.1	95.7
Measured non-household	55.2	56.5	111.7	54.3	55.5	109.8
Trade effluent	-	2.6	2.6	-	2.7	2.7
Large user and special agreement	24.0	18.5	42.5	24.7	24.4	49.1
Non-potable large user and special agreement	8.1	-	8.1	9.8	-	9.8
Rechargeable works	1.0	0.4	1.4	1.2	0.2	1.4
Bulk supplies/inter-company payments	0.5	-	0.5	0.5	-	0.5
Other appointed business (third party)	1.5	0.4	1.9	1.6	0.2	1.8
Other sources	1.8	1.3	3.1	1.0	0.4	1.4
Total turnover	355.1	268.3	623.4	347.1	267.3	614.4
Operating income						
Current cost profit on disposal of fixed assets	0.1	-	0.1	1.1	0.1	1.2
Working capital adjustment	(0.6)	(0.4)	(1.0)	-	-	-

3. OPERATING COSTS

Cost allocation methodology

The table below has been prepared in accordance with RAG 4.03, "Guideline for the analysis of operating costs and assets". All costs are recorded in the general ledger by cost centre. Cost centres are defined as either direct departments, comprising operational and customer functions, or support departments. Direct departments are mostly directly allocated to service activities based on the nature of the function, although some costs require apportionment on an appropriate basis. Support departments are apportioned to direct departments either based upon a specific analysis of the costs or by apportionment by an appropriate cost driver. Once allocated to the direct departments the costs are then allocated to service activities pro rata to the direct cost allocations of the direct department costs.

3. OPERATING COSTS (Continued)

	Water services			Sewerage services			Sewerage service subtotal
	Resources & treatment	Distribution	Water services subtotal	Sewerage	Sewage treatment	Sludge treatment & disposal	
	£'m	£'m	£'m	£'m	£'m	£'m	£'m
Direct Costs							
Employment costs	11.4	10.8	22.2	4.4	6.3	3.7	14.4
Power	7.8	9.4	17.2	3.6	9.7	0.4	13.7
Hired & contracted services	4.0	8.8	12.8	1.8	2.3	8.6	12.7
Associated companies	0.5	1.1	1.6	0.3	0.3	0.5	1.1
Materials and consumables	8.8	1.4	10.2	0.4	1.3	2.6	4.3
Service charges (EA)	20.1	-	20.1	1.2	1.4	-	2.6
Bulk supply imports	2.0	-	2.0	-	-	-	-
Other direct costs	0.5	3.5	4.0	1.7	0.3	0.1	2.1
Total direct costs	55.1	35.0	90.1	13.4	21.6	15.9	50.9
General and support expenditure	8.2	11.3	19.5	2.9	5.2	3.4	11.5
Total functional expenditure	63.3	46.3	109.6	16.3	26.8	19.3	62.4
Business analysis							
Customer services			17.0				7.4
Scientific services			6.4				2.9
Other business activities			1.5				0.8
Business activities subtotal			24.9				11.1
Local authority rates			17.8				6.4
Doubtful debts			10.3				7.5
Total opex less third party services			162.6				87.4
Third party services – opex			11.8				6.9
Total operating expenditure			174.4				94.3
Capital maintenance							
Infrastructure renewals charge	-	30.8	30.8	11.5	-	-	11.5
Current cost depreciation – service activities	31.5	17.9	49.4	7.4	47.3	13.1	67.8
– business activities			10.6				5.7
Amortisation of grants			(1.1)				(1.8)
Total capital maintenance			89.7				83.2
Total operating costs			264.1				177.5
CCA (MEA) Values							
Service activities			6,888.2				6,943.1
Business activities			119.1				55.2
Total			7,007.3				6,998.3

4. TANGIBLE FIXED ASSETS

Water services	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
Gross Replacement Cost					
At 1 April 2009	1,669.6	60.9	5,674.4	199.0	7,603.9
AMP adjustment	0.2	-	6.4	(5.0)	1.6
RPI adjustment	74.1	2.9	255.7	5.3	338.0
Disposals	(0.1)	-	-	-	(0.1)
Additions	17.1	16.5	25.3	17.0	75.9
At 31 March 2010	1,760.9	80.3	5,961.8	216.3	8,019.3
Depreciation					
At 1 April 2009	778.1	41.0	-	80.6	899.7
AMP adjustment	8.3	-	-	3.2	11.5
RPI adjustment	36.1	1.9	-	2.8	40.8
Disposals	-	-	-	-	-
Charge for year	48.6	0.8	-	10.6	60.0
At 31 March 2010	871.1	43.7	-	97.2	1,012.0
Net book value at 31 March 2010	889.8	36.6	5,961.8	119.1	7,007.3
Net book value at 31 March 2009	891.5	19.9	5,674.4	118.4	6,704.2
Sewerage services					
Sewerage services	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
Gross Replacement Cost					
At 1 April 2009	1,917.4	49.5	5,501.7	82.4	7,551.0
AMP adjustment	0.8	-	(0.7)	(2.7)	(2.6)
RPI adjustment	81.2	2.3	245.9	2.9	332.3
Disposals	-	-	-	-	-
Additions	29.1	9.3	36.7	9.3	84.4
At 31 March 2010	2,028.5	61.1	5,783.6	91.9	7,965.1
Depreciation					
At 1 April 2009	790.5	29.7	-	30.3	850.5
AMP adjustment	5.1	-	-	(0.9)	4.2
RPI adjustment	35.7	1.4	-	1.5	38.6
Disposals	-	-	-	-	-
Charge for year	67.3	0.5	-	5.7	73.5
At 31 March 2010	898.6	31.6	-	36.6	966.8
Net book value at 31 March 2010	1,129.9	29.5	5,783.6	55.3	6,998.3
Net book value at 31 March 2009	1,126.9	19.8	5,501.7	52.1	6,700.5

4. TANGIBLE FIXED ASSETS (continued)

Total	Specialised operational assets	Non- specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	
Gross Replacement Cost					
At 1 April 2009	3,587 0	110 4	11,176 1	281 4	15,154 9
AMP adjustment	1 0	-	5 7	(7 7)	(1 0)
RPI adjustment	155 3	5 2	501 6	8 2	670 3
Disposals	(0 1)	-	-	-	(0 1)
Additions	46 2	25 8	62 0	26 3	160 3
At 31 March 2010	3,789 4	141 4	11,745 4	308 2	15,984 4
Depreciation					
At 1 April 2009	1,568 6	70 7	-	110 9	1,750 2
AMP adjustment	13 4	-	-	2 3	15 7
RPI adjustment	71 8	3 3	-	4 3	79 4
Disposals	-	-	-	-	-
Charge for year	115 9	1 3	-	16 3	133 5
At 31 March 2010	1,769 7	75 3	-	133 8	1,978 8
Net book value at 31 March 2010	2,019 7	66 1	11,745 4	174 4	14,005 6
Net book value at 31 March 2009	2,018 4	39 7	11,176 1	170 5	13,404 7

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

5. WORKING CAPITAL

	2010 £'m	2009 £'m
Stocks	2 5	2 4
Trade debtors		
- measured household	12 1	12 0
- unmeasured household	32 7	33 0
- measured non-household	9 3	10 4
- unmeasured non-household	0 5	0 6
- other	3 5	4 8
Measured income accrual	40 8	37 2
Prepayments and other debtors	23 3	22 7
Trade creditors	(5 9)	(6 4)
Deferred income – customer advance receipts	(12 2)	(13 4)
Capital creditors	(31 6)	(37 8)
Accruals and other creditors	(44 9)	(42 7)
Total working capital	30 1	22 8

6. MOVEMENT ON CURRENT COST RESERVE

	<u>2010</u>	<u>2009</u>
	£'m	£'m
At 1 April	10,716 5	10,737 0
AMP adjustment	(16 7)	26 2
RPI adjustments		
- fixed assets	590 9	(51 8)
- working capital	1 0	-
- financing	(66 6)	4 8
- grants and third party contributions	(4 3)	0 3
At 31 March	<u>11,220 8</u>	<u>10,716 5</u>

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

	<u>2010</u>	<u>2009</u>
	£'m	£'m
Current cost operating profit	180 9	185 8
Working capital adjustment	1 0	-
Movement in working capital	(1 1)	(7 5)
Current cost depreciation	130 6	127 6
Current cost profit on sale of fixed assets	(0 1)	(1 2)
Infrastructure renewals charge	42 3	41 2
Other non-cash profit and loss items	9 0	8 3
Net cash flow from operating activities	<u>362 6</u>	<u>354 2</u>

8. ANALYSIS OF NET DEBT FOR THE APPOINTED BUSINESS

	Interest rate risk profile			Total
	Fixed rate	Floating rate	Index linked	
	<u>£'m</u>	<u>£'m</u>	<u>£'m</u>	<u>£'m</u>
Maturity profile				
Less than one year	17 8	2 5	-	20 3
Between one and two years	24 1	1 2	-	25 3
Between two and five years	59 3	75 5	-	134 8
Between five and twenty years	771 9	130 7	-	902 6
In more than twenty years	345 0	41 7	455 4	842 1
Total borrowings	<u>1,218 1</u>	<u>251 6</u>	<u>455 4</u>	<u>1,925 1</u>
Overdraft				21 0
Short term deposits				<u>(88 2)</u>
Net debt at 31 March 2010				<u>1,857 9</u>

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

Associate	Service	December 2009 or March 2010		Terms of Supply	2009/10 Value
		Turnover			
		£'m			
Vehicle Lease and Service Limited (VLS)	Rental of garage and service charges	13.7		Negotiated	0.1

Services supplied to the appointee by associated companies

Associate	Service	December 2009 or March 2010		Terms of Supply	2009/10 Value
		Turnover			
		£'m			
Northumbrian Water Group plc	Holding company charges	5.9		No market	0.6
Three Rivers Insurance Company Limited	Public liability insurance (deductible infill policy)	0.4		No market	0.4
Vehicle Lease and Service Limited	Vehicle maintenance and capital finance charge	13.7		Competitive letting	6.8

Information in relation to allocations and apportionments

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

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

Overhead costs incurred in the appointed business which relate to the non-appointed business have been allocated using an activity based approach to comply with RAG 5.04.

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

Amounts borrowed by the appointee from associated companies

The Company has loans amounting to £1,451.7m due to NWF, a subsidiary company. Details of these loans and the associated guarantees are provided in note 20 of the statutory financial statements.

The Company acquires vehicles from VLS, an associated company, on a finance lease basis. During the year, new finance leases of £3.3m were entered into and capital repayments of £3.0m were made. The year end finance lease creditor was £8.7m. All leases are at a fixed interest rate of 6%.

Amounts lent by the appointee to associated companies

NWL had short-term deposits amounting to £88.2m with NSL at the year end, representing surplus cash invested via the Group's treasury function.

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

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

Dividends paid and proposed

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

	£'m
Dividends paid	
Final paid for the year ended 31 March 2009	39 0
Interim paid for the year ended 31 March 2010	39 9
Total dividends paid in the year	<u>78 9</u>
Dividends proposed	
Final proposed for year ended 31 March 2010	<u>40 3</u>

The dividends for the year, comprising the interim dividend of £39 9m and the final dividend of £40 3m, total £80 2m (2009 £78 4m) This continues the stated dividend policy of 1 9% real annual growth

Omission of right

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

Waivers

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

The information in this note has been produced to comply with the requirements of RAG 5 04, 'Transfer Pricing in the Water Industry' and the disclosures required by paragraph 6 of Condition F of the Company's operating licence

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

10. REGULATORY CAPITAL VALUE AT 2009/10 PRICES

Data from the 2005-10 Final Determination	2009/10 £'m
Closing Regulatory Value at 31 March 2009 (March 2009 prices)	2,997 9
RPI from March 2009 to March 2010 (4.4%)	133 4
Opening regulatory capital value at 1 April 2009	3,131 3
Infrastructure renewals expenditure (IRE)	37 1
Infrastructure renewals charge (IRC)	(41 3)
Capital expenditure (excluding IRE)	142 7
Grants and contributions	(11 6)
Current cost depreciation	(120 6)
Outperformance adjustment	(2 1)
Closing regulatory capital value at 31 March 2010	<u>3,135 5</u>
Year average regulatory capital value	<u>3,063 8</u>

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

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

The 2009 Periodic Review then applied the following adjustments to arrive at the opening Regulatory Capital Value for 1 April 2010

Data from the 2010-15 Final Determination	2009/10 £'m
Closing Regulatory Capital Value as at 31 March 2010 per above	3,135 5
Adjustments	
Construction Output Price Index (COPI)	39 6
Land Sales adjustment	(5 1)
Logging up/down & shortfalling	(75 4)
Regulatory Capital Value at 1 April 2010	<u>3,094 6</u>

The figures above are consistent with Appendix 4 of the Ofwat publication "Future Water and Sewerage Charges 2010-15 Final Determinations"

11. STATEMENT ON DIRECTORS' PAY AND STANDARDS OF PERFORMANCE

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

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

- that the setting of base salaries is largely influenced by individual contributions and internal relativities rather than external comparators (although for 2009/10 the Committee has been influenced by general economic conditions),
- that the annual bonus plan recognises the interests of all of NWG's stakeholders (shareholders, customers and employees) rather than being focused solely on profit, and
- that management shares in the longer term value created for NWG's investors and the serviceability of the Company's regulated assets.

During the year the Committee:

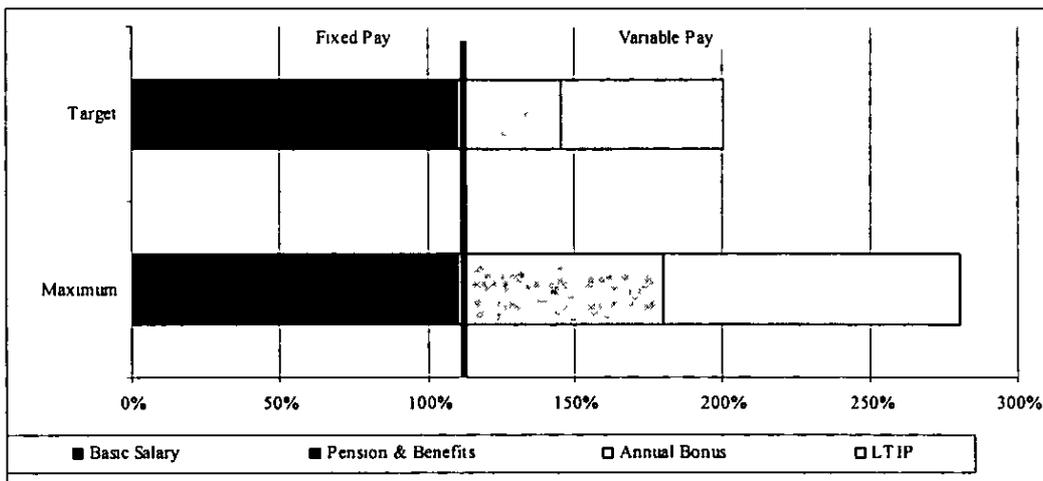
- set the remuneration package for the new Chief Executive Officer,
- agreed bonuses for 2008/09,
- agreed salaries for 2010/11,
- determined the vesting percentage to be applied to the LTIP awards made on 21 December 2006, which vested on 21 December 2009,
- granted LTIP awards on 4 January 2010 (to vest in January 2013), and
- set performance targets for executive directors and senior managers.

Elements of remuneration

The remuneration of the executive directors comprises:

- basic salary,
- benefits (including pension and participation in the SIP),
- a performance related annual bonus, and
- annual LTIP awards.

In addition to reviewing each constituent element, the Committee reviews the remuneration packages as a whole to ensure that they remain appropriate in terms of structure and quantum. The chart below shows the composition of the Chief Executive Officer's remuneration (as a percentage of basic salary) both at 'target' and 'maximum' levels of performance. Maximum performance assumes the achievement of maximum bonus and full vesting of LTIP awards.



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

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

	Basic pay	Bonus	Other benefits	Fees	Total remuneration
	£'000	£'000	£'000	£'000	£'000
Sir D Wanless	-	-	-	78.8	78.8
J A Cuthbert	206.5	79.5	14.0	-	300.0
H Mottram	18.7	7.2	0.6	-	26.5
C M Green	157.5	60.6	8.2	-	226.3
A C Jones	141.5	57.3	5.7	-	204.5
G Neave	171.0	60.7	10.3	-	242.0
A G Balls	-	-	-	31.5	31.5
A M Frew	-	-	-	31.5	31.5
Dr S Lyster	-	-	-	31.5	31.5
Total remuneration	695.2	265.3	38.8	173.3	1,172.6

(i) Executive directors: basic salary and benefits

Basic salary is the only pensionable element of the executive directors' remuneration package. The basic salaries payable to directors of NWL are not directly linked to standards of performance in connection with the carrying out of functions of a "relevant undertaker". Basic salary is reviewed annually based on individual contributions and internal relativities. The committee also has regard to market practice in other quoted water companies and similar sized companies more generally. The basic salaries of the executive directors were not increased for 2009/10. For 2010/11 salaries for senior executives have been increased by 1.3% (except for John Cuthbert who retired on 31 March 2010 and for Heidi Mottram who was appointed on 1 March 2010). This is the same as for all other employees. Benefits provided to the executive directors comprise membership of pension schemes, car allowance and healthcare.

(ii) Annual bonus

The bonus arrangements for executive directors of NWL for 2009/10 were linked to NWL's predicted performance in the Overall Performance Assessment (OPA), as well as the other measures described below.

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

- up to 40% related to the profit before tax performance of NWG,
- up to 5% related to NWL's predicted current year performance against industry performance taken from the latest published OPA results. The scale for calculating the 2009/10 bonus was 343 to 428 points, which was the reported industry performance for 2008/09,
- up to 5% related to lost time through sickness. The actual sickness absence rate was 3.18% and bonus is calculated on a linear scale between 2.7% and 2.99% with a published target for the Company of 2.85%, and
- up to 20% related to bespoke personal targets.

The potential 5% bonus in respect of predicted OPA performance is considered to be linked to NWL's performance as a "relevant undertaker". The Remuneration Committee confirmed on 26 May that 1% would be payable against this measure reflecting the forecast score of 363 against a range between 343 to 428 points. The Remuneration Committee also confirmed that nothing would be payable in respect of time lost through sickness.

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

All the executive directors had some personal targets directly linked to NWL's performance as a "relevant undertaker" Their targets were as follows

- Mr Cuthbert's personal targets related to managing the PR09 process, maintaining financial ratios, maintaining relationships with investors, succession planning, delivery of the investment programme and implementing cost efficiencies
- Mr Green's personal targets related to managing the PR09 process, maintaining financial ratios, maintaining good relationships with investors, addressing Ofwat's proposals for accounting separation and competition, delivery of the investment programme, implementing cost efficiencies and ensuring an appropriate balance of risk and reward in the management of the Group Treasury
- Mr Neave's personal targets related to managing the PR09 process, realising the benefits of the Work Management Programme, ensuring that NWL is a high performer in the industry for levels of service, reputation, safety and efficiency, delivery of the investment programme and implementing cost efficiencies
- Mr Jones' personal targets related to managing the PR09 process, business planning and efficiency improvements within Scientific Services, business continuity and health and safety

Of the 20% available in respect of personal targets, Mr Cuthbert and Mr Green were each awarded 18%, Mr Neave was awarded 15% and Mr Jones 20%

Taking account of performance against personal targets and the OPA, PBT and lost time performance, Mr Cuthbert and Mr Green were awarded bonuses equal to 38.5% of their respective basic salaries. Mr Neave and Mr Jones were awarded bonuses equal to 35.5% and 40.5% of their respective basic salaries. In accordance with the terms agreed on her appointment, Mrs Mottram was awarded a bonus in respect of March 2010 equal to 38.5% of her salary for that month.

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

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

(iii) Pension

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

Mrs Mottram receives an employer contribution of 8% of salary to the money purchase section of the Northumbrian Water Pension Scheme. She makes an employee contribution of 5%. The employer's contribution of 8% is the same as is available to any other employee making a 5% contribution.

(iv) Long Term Incentive Plan

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Committee, annual conditional awards of shares in NWG.

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

Details of the levels of award and performance conditions are shown in the table below

Summary of LTIP awards and performance conditions

LTIP AWARD MADE 21 DECEMBER 2006	
Maximum award	75% of salary permitted Actual grants to executive directors related to shares worth up to 70% of salary
Performance conditions	(1) 50% of award depends on NWL's return on capital employed relative to that of the other water and sewerage companies of England and Wales (2) 50% of award depends on the Company's TSR performance against the FTSE 250 Index, excluding investment trusts
Vesting schedules	(1) 30% vests at median performance At upper quartile or above, all of that half of the award will vest Between median and upper quartile, straight line pro-rating will apply Where the return on capital employed performance is below the median, none of this element of the award will vest (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance Where the Company's TSR performance is below the median, none of this element of the award will vest
LTIP AWARDS MADE 13 DECEMBER 2007 AND 15 DECEMBER 2008	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth up to 100% of salary
Performance conditions and vesting schedules	As per LTIP award made 21 December 2006
LTIP AWARD MADE 4 JANUARY 2010	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth up to 100% of salary
Performance conditions and vesting schedules	See table below

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

Performance metric	Weighting	Description	Calibration
TSR	50%	Relative TSR against the FTSE 250 excluding investment trusts and companies in the following sectors: Banks, Financial Services, Life Insurance, Non-Life Insurance, Real Estate Investment & Services and Real Estate Investment Trusts, Oil & Gas Producers and Oil Equipment & Services. 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.	30% of this part of an award (i.e. 15% of the total award) will vest for median performance increasing on a straight line so that 100% (i.e. 50% of the total award) vests for upper quartile performance.
ROCE	20%	Average absolute ROCE over the three financial years starting from 1 April immediately preceding grant date.	For the 2009/10 awards, 30% of this part of an award (i.e. 6% of the total award) will vest for average three-year ROCE of 6.30%, increasing on a straight line so that 50% (i.e. 10% of the total award) will vest for average three-year ROCE of 6.45% and on a straight line so that 100% (i.e. 20% of the total award) will vest for an average ROCE of 6.75%.
Serviceability	20%	Ofwat serviceability targets for the four asset classes (i.e. water non-infrastructure, water infrastructure, sewerage non-infrastructure and sewerage infrastructure) in the final year of the relevant three-year performance period. Serviceability is measured by Ofwat based on a number of indicators which include asset performance indicators, water quality compliance, environmental compliance and consumer service.	50% of this part of an award (i.e. 10% of the total award) will vest for 'stable' assessments in three out of the four asset classes. 100% of this part of an award (i.e. 20% of the total award) will vest for 'stable' assessments in all four asset classes. No awards would vest under this part of an award for less than three 'stable' assessments.
Customer	10%	Results of NWL's independently run customer satisfaction index, measured in the final quarter of the relevant three-year performance period.	For the 2009/10 awards, 30% of this part of an award (i.e. 3% of the total award) will vest for a customer satisfaction index of 83%, increasing on a straight line so that 100% of this part of an award (i.e. 10% of the total award) vests for a customer satisfaction index of 93% or above.

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

(iv) Long Term Incentive Plan (continued)

All awards have three year pre-vesting performance conditions. For the three annual awards granted from December 2006 to December 2008 the vesting of up to half of an award is subject to relative total shareholder return (TSR) performance against the FTSE 250 (excluding investment trusts) and the other half is subject to a relative return on capital employed (ROCE) target as monitored by Ofwat.

In the latter half of 2009 the Committee reviewed its policy on the pre-vesting performance conditions that should apply to LTIP awards. The Committee, with advice from HNBS, came to two conclusions that led to changes being made to its policy on performance conditions, namely:

- (a) The volatility in the share prices of companies in the Financials and Oil & Gas FTSE sectors had increased dramatically and this was no longer correlated with NWG's share price movements. This means that these companies are not the best comparators in a relative TSR performance condition, statistically they are more likely to be grouped at the top or the bottom of the list. Accordingly, for LTIP awards made in 2009/10 and future years, the TSR comparator group will exclude companies from these defined FTSE sectors.
- (b) The work undertaken on drawing up the business plan for 2010-15 showed that there were other long term performance measures, in addition to ROCE, that should be measured and potentially rewarded. These are performance against Ofwat's serviceability targets and customer satisfaction levels. As such, they have been incorporated as LTIP performance metrics.

These changes were discussed with NWG's top shareholders and received their support.

The advantages of using these targets include:

- the continued use of TSR provides consistency with past awards, alignment with investors and, as a result of the less correlated and volatile sectors now being excluded, provides an improved line of sight for executives,
- the use of an absolute ROCE target ensures that reward is directly linked to the management's delivery of the business plan,
- they recognise that the maintenance of NWL's regulated assets (through the serviceability targets) is critical to the longer term returns for shareholders, and
- customer satisfaction is a key objective for NWL and customers are important stakeholders.

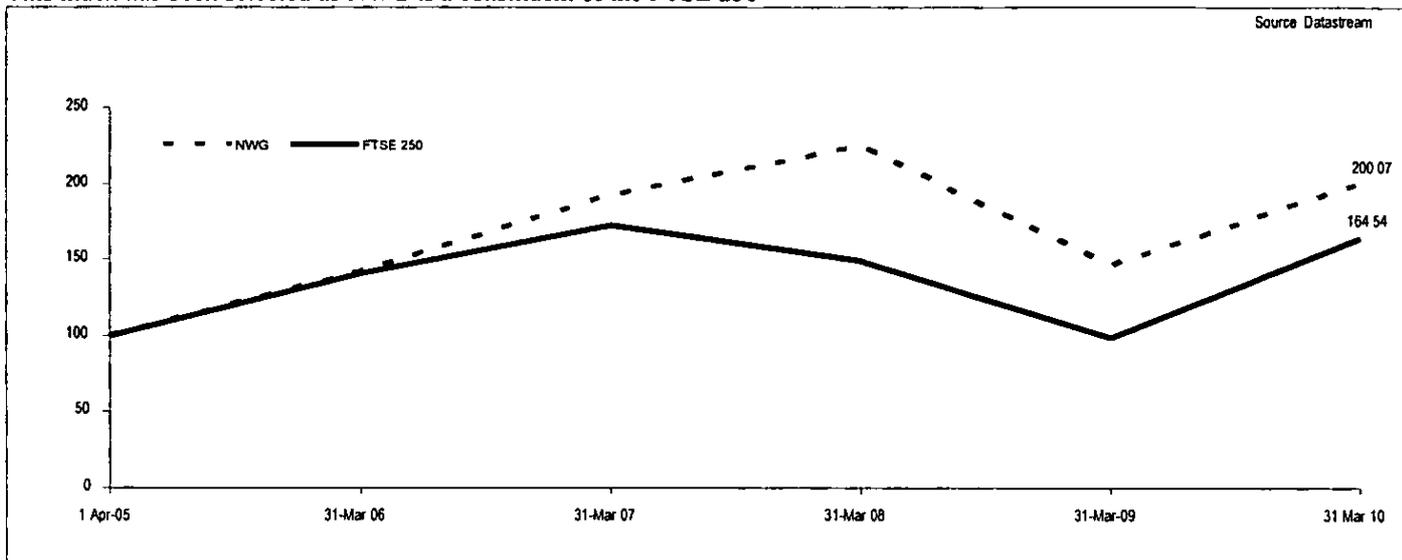
In the event of a change of control, the Committee would determine the extent to which the performance conditions had been met and the proportion of the performance period that had elapsed in deciding whether or not any vesting of awards would take place.

The LTIP award, granted on 21 December 2006, became available to vest on 21 December 2009. The Committee instructed PricewaterhouseCoopers (PwC) to assess the level of vesting of this award. PwC reported that 33.2% of the award was available to vest (being 66.5% of the award relating to the Company's TSR performance against the FTSE 250 Index and 0% of the award relating to the Company's ROCE performance against the other water companies). Prior to vesting, the Committee satisfied itself that the recorded TSR performance was a genuine reflection of the Company's underlying performance. Details of the number of awards which lapsed and those which were exercised by the directors of the Company are shown in the table on page 36.

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

Performance graph

The graph below shows a comparison between the TSR for NWG's shares for the five year period to 31 March 2010, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as NWG is a constituent of the FTSE 250.



Note

This graph shows the value, by 31 March 2010, of £100 invested in NWG on 1 April 2005 compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

At its meeting on 18 November 2009, the Committee agreed to make conditional awards to Mr Green with a value equal to 100% of base salary, and to Mr Neave and Mr Jones with a value equal to 60% of base salaries. The level of the awards was previously agreed in principle by the Committee, following detailed advice from HNBS. The awards were made on 4 January 2010. The higher level of award to Mr Green recognises his additional role as an executive director of NWG.

(v) Contribution to Remuneration by NWG

NWG contributes 30% of the cost of the basic salaries, benefits, bonus and pension of Mr Cuthbert, Mr Green and Mrs Mottram. NWG also contributes 50% of the cost of basic salary and benefits of the Chairman.

(vi) Consideration of Ofwat Reports by Remuneration Committee

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

(vii) Future Targets

For 2010/11, all four executive directors have personal targets which relate to NWL's performance as a "relevant undertaker". Their targets, in summary, are as follows:

Mrs Mottram to maintain the key financial ratios and measures, to maintain good relationships with investors and analysts, to increase operating and capital maintenance efficiencies, to identify business development opportunities, to ensure that the overall investment needs of the business are properly quantified and to refresh the risk model and prepare a high level strategic risk matrix.

**11. STATEMENT ON DIRECTORS' PAY AND STANDARDS OF PERFORMANCE
(continued)**

(vii) Future Targets (continued)

Mr Green to maintain the key financial ratios and measures, to maintain good relationships with investors and analysts, to ensure treasury management achieves an appropriate balance between risk and reward, to review and develop strategy in relation to market reform and competition, to identify business development opportunities, to ensure that the overall investment needs of the business are properly quantified, to refresh the risk model and prepare a high level strategic risk matrix and to identify further opportunities to impact the cost base and investment programme of NWL

Mr Neave to successfully manage the implementation of the new Asset Planning team, to ensure NWL is recognised as a high performer in the industry for levels of service, reputation, safety and efficiency, to realise the anticipated benefits of the Work Management Programme, to identify further opportunities to impact the cost base and investment programme of NWL and to identify business development opportunities

Mr Jones to review and develop strategy in relation to market reform and competition, to develop NWL's approach to PR14, to ensure that effective communications are maintained with Ofwat, to refresh company-wide health and safety communication strategy and secure the renewal of OHSAS 18001, to ensure that first phase of three year plan to deliver efficiencies in laboratories is delivered, to develop succession planning in light of likely retirement of key personnel, to identify further opportunities to impact the cost base and investment programme of NWL and to identify business development opportunities

DIRECTORS' RESPONSIBILITIES AND DECLARATIONS
For the year ended 31 March 2010

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

- (a) ensuring that proper accounting records are maintained by the Appointee to enable compliance with the requirements of Condition F and having regard also to the terms of guidelines notified by the Water Services Regulation Authority ("the Authority") to the Appointee from time to time,
- (b) preparing on a consistent basis for each financial year regulatory financial statements in accordance with Condition F, having regard also to the terms of guidelines notified by the Authority from time to time, which so far as is reasonably practicable have the same content as the annual financial statements of the Appointee prepared under the Companies Act 2006 and which are prepared in accordance with the formats, accounting policies and principles which apply to those financial statements,
- (c) preparing financial statements on a current cost basis in respect of the same accounting period in accordance with guidelines issued by the Authority from time to time, and,
- (d) preparing such other financial and related information as is required by Condition F having regard also to the terms of guidelines issued by the Authority from time to time

RING FENCING

The directors confirm that, as at 31 March 2010, the Company was in compliance with paragraph 3 1 of Condition K of the Instrument of Appointment by which the Appointee had available to it sufficient rights and assets to enable a special administrator to manage the affairs, business and property of the Appointee, should a special administrative order be made

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

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

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

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

In providing this certificate, the Directors have taken into account

- the acceptance of the 2009 Final Determination by the Board,
- the financial strength of the Company at the balance sheet date and performance during 2009/10,
- the strength of the key financial ratios over the planning horizon of the Company's one year budget and five year medium term plan as reflected in strong investment grade credit ratings,
- the fact that the Company already has funding and facilities in place to meet all operational and capital investment requirements to the end of 2011 and is in advanced discussions with lenders to obtain substantial new long-term facilities to fund the investment programme through to and including 2013,
- its contractual arrangements with suppliers for key materials and support services and its capital framework arrangements,
- its robust People Plan for 2010-15 which underpins the employment resources to fulfil all operational requirements, and,
- the Company's formal risk and governance arrangements which are monitored by the Audit Committee and Board

ON BEHALF OF THE BOARD



M Parker
Company Secretary
7 July 2010

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

We have audited the regulatory financial statements of Northumbrian Water Limited (the Company) for the year ended 31 March 2010 which comprise

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

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

Basis of preparation

The regulatory financial statements have been prepared in accordance with Condition F of the Company's Instrument of Appointment as a water undertaker, the Regulatory Accounting Guidelines 1 04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 2 03 (Guideline for the classification of expenditure), Regulatory Accounting Guideline 3 06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4 03 (Guideline for the analysis of operating costs and assets), and the accounting policies set out in note 1(a) to the historical cost financial information and note 1(b) to the current cost financial information and in the case of the historical cost financial information under the historical cost convention

The regulatory financial statements are separate from the statutory financial statements of the Company There are differences between United Kingdom Generally Accepted Accounting Principles (UK GAAP) and the basis of preparation of information provided in the regulatory financial statements because the Regulatory Accounting Guidelines 1 04, 2 03, 3 06 and 4 03 specify alternative treatment or disclosure in certain respects Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, then they require UK GAAP to be followed Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a Company as shown in financial statements prepared in accordance with the Companies Act 2006

Respective responsibilities of the WSRA, the directors and auditors

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

The directors' responsibilities for preparing the regulatory financial statements in accordance with the Regulatory Accounting Guidelines 1 04, 2 03, 3 06 and 4 03 are set out in the Statements of Directors' Responsibilities Our responsibility is to audit the regulatory financial statements in accordance with International Standards on Auditing (UK and Ireland), except as stated in the 'Basis of audit opinion' below and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities'

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

We report our opinion as to whether the regulatory historical cost financial information present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the Company's Instrument of Appointment and Regulatory Accounting Guideline 2 03 (Guideline for the classification of expenditure), Regulatory Accounting Guideline 3 06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4 03 (Guideline for the analysis of operating costs and assets), and whether the regulatory current cost financial information has been properly prepared in accordance with Regulatory Accounting Guidelines 1 04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 3 06 and Regulatory Accounting Guideline 4 03. We also report to you if, in our opinion, the Company has not kept proper accounting records as required by paragraph 3 of Condition F and whether the information is in agreement with the appointees' accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guidelines 1 04, 2 03, 3 06 and 4 03.

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

Basis of audit opinion

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

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

Our opinion on the regulatory financial statements is separate from our opinion on the statutory financial statements of the Company on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory financial statements of the Company (our Statutory audit) was made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our Statutory audit work was undertaken so that we might state to the Company's members those matters that we are required to state to them in a Statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the Company and the Company's members as a body, for our Statutory audit work, for our Statutory audit report, or for the opinions we have formed in respect of that Statutory audit.

The regulatory historical cost financial statements have been drawn up in accordance with Regulatory Accounting Guideline 3 06 in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly that the relevant sections of Financial Reporting Standards 12 and 15 be disappplied. The effect of this departure from Generally Accepted Accounting Principles and a reconciliation of the balance sheet drawn up on this basis with that drawn up under Companies Act 2006 is given in the reconciliation between the statutory financial statements and the regulatory historical cost financial statements.

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

Opinion

In our opinion, the regulatory financial statements of the Company for the year ended 31 March 2010 fairly present in accordance with Condition F of the Company's Instrument of Appointment granted by the Secretary of State for the Environment to the Company as a water and sewerage undertaker under the Water Industry Act 1991, the Regulatory Accounting Guidelines 1 04, 2 03, 3 06 and 4 03 issued by the WSRA, and the accounting policies set out in note 1(a) to the historical cost financial information and note 1(b) to the current cost financial information, the state of the Company's affairs at 31 March 2010 on a regulatory historical cost and regulatory current cost basis, the regulatory historical cost and regulatory current cost profit for the year then ended and the regulatory current cost cash flow for the year the ended, and have been properly prepared in accordance with those conditions, guidelines and accounting policies

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

- a) proper accounting records have been kept by the Appointee as required by paragraph 3 of Condition F of the Instrument of Appointment,
- b) the information is in agreement with the Appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1 04, Regulatory Accounting Guideline 2 03, Regulatory Accounting Guideline 3 06 and Regulatory Accounting Guideline 4 03 issued by the WSRA,
- c) the regulatory historical cost financial information present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the Company's Instrument of Appointment and Regulatory Accounting Guideline 2 03, Regulatory Accounting Guideline 3 06 and Regulatory Accounting Guideline 4 03 issued by the WSRA,
- d) the regulatory current cost financial information has been properly prepared in accordance with Regulatory Accounting Guideline 1 04, Regulatory Accounting Guideline 3 06 and Regulatory Accounting Guideline 4 03 issued by the WSRA

Ernst & Young LLP
Registered auditors
Newcastle upon Tyne

9 July, 2010