NORTHUMBRIAN WATER LIMITED

FINANCIAL STATEMENTS

FOR THE YEAR ENDED 31 MARCH 2007

Registered no: 2366703

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FINANCIAL STATEMENTS
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DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW
For the year ended 31 March 2007

The directors present their report and operating and financial review and the audited financial statements for the year ended 31 March 2007.

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 – as at 1 April 2006, Sir Derek was a Non-Executive Director of the Board and succeeded Sir Fred Holliday as Chairman on 27 July 2006
J A Cuthbert	Executive Managing Director
C M Green	Executive Finance Director
G Neave	Executive Operations Director
A C Jones	Executive Regulation and Scientific Services Director
A G Balls	Independent Non-Executive Director
A M Frew	Independent Non-Executive Director
A J Scott-Barrett	Non-Executive Director
Dr S Lyster	Independent Non-Executive Director – appointed 26 September 2006
Sir A P Brown	Non-Executive Director
M A B Nègre	Non-Executive Director
J M Williams	Non-Executive Director
C R Lamoureux	Non-Executive Director – appointed 1 December 2006
Professor Sir F G T Holliday CBE	Non-Executive Chairman – retired 27 July 2006
R K Lepin	Non-Executive Director – resigned 1 December 2006

BUSINESS OVERVIEW

Operating Environment

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

In the north east the business comprises the supply of both potable and raw water and the collection, treatment and disposal of sewage and sewage sludge to 2.6 million people. This is a region of modest economic growth, which is considerably stronger now than in recent years. It has a declining industrial customer base and industrial demand for water, but a growing demand from domestic customers. It has well developed resources, such as Kielder Water, and these, coupled with above average rainfall in the region, enable it to meet expected demand. In addition to its sewerage services, NWL continues to provide expert industrial effluent treatment services through its major treatment works at Bran Sands on Teesside.

Operating Environment (continued)

In the south the business supplies potable water to 1.7 million people. The southern operating area is in a region of rapid economic and population growth, although it too has seen a reduction in demand from heavy industry. This emphasises the importance of the company's well developed plans for resource development to meet additional water demand in a region where water resources are already constrained.

Regulatory Environment

The UK water industry is highly regulated and NWL's success as a business depends on efficient delivery of its services and of quality improvements required by the Water Services Regulation Authority (Ofwat) in order to outperform the regulatory financial settlement.

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

NWL is an active member of Water UK, the industry association that represents all UK water and waste water service suppliers at national and European level. It provides a positive framework for the industry to engage with Government, regulators, stakeholder organisations and the public and helps to develop policy and improve understanding of the industry.

BUSINESS STRATEGY AND OBJECTIVES

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

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

To maintain a strong reputation and relationships by:
- creating shareholder value for the Group;
- delivering excellent service to customers;
- delivering regulatory outputs; and
- involving the company's main stakeholder groups.

To ensure a stable financial profile by:
- maximising revenue;
- delivering operational efficiency; and
- securing low cost long term funds.

To develop a culture of continuous improvement by:
- maintaining a rigorous risk management process;
- promoting a flexible and proactive attitude;
- embracing a sustainable and responsible approach;
- ensuring a focus on safety; and
- encouraging employees to fulfil their potential.

Business planning is central to delivery of the company's long term objectives, identifying how the objectives will be achieved and establishing the targets and principal actions against which business units are measured. Measurement focuses on key performance indicators ("KPIs") set during the business planning process, which are linked to regulatory and business targets. Performance against the most significant KPIs is monitored by the NWL management team and is reported below.

DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

FINANCIAL PERFORMANCE

Key Performance Indicators

The definition, purpose and source of each KPI are shown on page 16.

KPI	Target	Performance	
		Current year	Previous year
Gearing to RCV – NWL Group (note 11)	<70%	65%	66%
Gearing to RCV – Appointed business only	<65%	57%	58%
Cash interest cover	>3.0x	3.6x	3.3x
Cash flow to net debt	>13%	16%	17%

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

The company's profit and loss account and balance sheet are set out on pages 18 to 19. The financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. The key accounting policies are summarised in note 1 to the statutory accounts on pages 20 to 23 and these have been applied consistently throughout the current and preceding periods, with the exception of the early adoption of amendments to FRS 17 Pension Costs (see note 1h).

Profit after tax for the year was £126.4m (2006: £96.5m).

Turnover increased from £550.5m in 2005/06 to £581.2m for the year to 31 March 2007. This increase is mainly due to the application of new regulatory pricing which resulted in an average price increase to tariff income of 6.1% in April 2006, which included an uplift for RPI of 2.4%.

Operating costs, excluding capital maintenance costs, have increased from £228.4m to £246.6m, principally reflecting a significant increase in energy market prices and the full year impact of increased pension costs following an actuarial review of the pension scheme, in addition to the impact of inflation. These increases have been partially offset by efficiency savings. Operating costs for the appointed business in 2006/07 are £7.2m higher than those estimated in the 2004 final determination for the year due to energy costs.

Capital maintenance costs have increased from £93.2m to £95.7m, reflecting additional depreciation charges arising from the commissioning of new assets.

Net interest payable increased from £77.7m in 2005/06 to £82.0m in 2006/07 due to the increase in average net debt from £1,487m in 2005/06 to £1,558m in 2006/07. The increase in net debt was required to fund the capital investment programme for which £242.9m was invested during the year delivering a wide range of improvements.

The company completed significant improvements to water treatment works at Whittle Dene and Horsley on Tyneside and Chigwell in Essex to remove pesticides from raw water. Comprehensive repairs to the two water mains supplying Hexham in Northumberland, which had been washed away during the severe weather in 2005, were completed. In Essex, 10.5km of pipeline were laid to triplicate the strategic mains taking water from Layer-de-la-Haye water treatment works and to improve the overall infrastructure. In addition, 477km of mains were renewed or relined. The current rehabilitation programme in the south is now complete and the work in the north is due to be finished in 2008. This work will help reduce incidents of discoloured water and also help further reduce leakage.

In the waste water business, 129 properties were removed from the register of properties at risk of flooding as a result of investment in improving the sewerage system. This takes the total to 228 properties, effectively delivering three years' outputs in two years. During the year, 98 unsatisfactory sewerage overflows have been improved which will improve local water courses, enhance their visual appearance and reduce pollution incidents.

DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

Key Performance Indicators (continued)

The directors recommend a final ordinary dividend amounting to £38.8m (2006: £36.9m) which, together with the interim dividend of £38.7m (2006: £36.9m), makes a total for the year of £77.5m (2006: £73.8m). This continues the stated dividend policy for the appointed business of 1.9% real annual growth (see note 9 to the statutory accounts).

OPERATIONAL PERFORMANCE

Key Performance Indicators

The definition, purpose and source of the KPIs are shown on pages 16 to 17.

North (N)		Target	Target	Performance	
South (S)		**2007/08**	**2006/07**	**Current year**	**Previous year**
Water					
Water quality (%)	N/S	maintain >99.9	maintain >99.9	99.9	99.9
Leakage (Ml/d)	N	≤154.5	≤156.0	145.92	157.1
(Ml/d)	S	≤67.5	≤68.3	67.99	66.64
Environment					
Sewage treatment works (%)	N	100	100	99.8	100
Bathing waters (%)	N	100	100	100	97
Pollution incidents	N	116	181	142	201
Customer – levels of service					
Properties at risk of low pressure	N	274	274	298	312
	S	126	126	130	136
Properties subject to unplanned interruption of 6 hours or more (%)	N	0.14	0.14	4.57 [1]	0.39
	S	0.14	0.14	0.57	0.17
Properties subject to hosepipe bans at any time during the year	N/S	0	0	0	0
Properties subject to sewer flooding incidents (overloaded sewers and other causes)	N	260	260	313	1,077
Properties at risk of sewer flooding incidents (once in ten years)	N	78	95	116	142
Properties at risk of sewer flooding incidents (twice in ten years)	N	51	60	229	162
Billing contact responded to (within five working days) (%)	N	99.0	99.0	99.3	99.2
	S	99.0	99.0	99.2	99.1
Written complaints responded to (within ten working days) (%)	N	99.8	99.8	99.9	99.9
	S	99.8	99.8	99.9	99.9
Bills based on meter readings (%)	N	99.95	99.95	99.84	99.95
	S	99.95	99.95	99.94	99.97
All telephone lines busy (%)	N	2.0	5.0	0.2	0.8
	S	2.0	5.0	0.0	0.0
Abandoned telephone calls (%)	N	2.5	1.5	3.2	2.3
	S	2.5	1.5	2.3	1.2
Customer satisfaction					
Overall service (%)	N/S	maintain	maintain	91.75	93.00
Value for money (%)	N/S	maintain	maintain	87.00	88.50
Employees					
Lost time reportable accidents (per 1000 employees)	N/S	6	8	8	7
Sickness absence (%)	N/S	2.95	3.00	3.01	3.12
Employee turnover (rolling %) [2]	N/S	-	Industry average 10.3	8.2	6.7

Notes:

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

Key Performance Indicators (continued)

The company maintained its high standards on water and waste water compliance, achieving its best ever drinking water quality results in 2006, continuing to meet leakage targets in both regions and achieving 100% compliance on the EU Mandatory Standard for bathing waters.

The company also maintained its high levels of customer service and, based on information provided to Ofwat for 2006/07, should remain in the top category for each Ofwat level of service indicator, with the exception of DG3 which covers unplanned interruptions to supply. Performance here was affected by two major bursts, one in Middlesbrough on Teesside and one in Bedlington in Northumberland.

NWL carries out regular quarterly tracking surveys and during the year customer satisfaction levels remained very high, with 91.75% of customers satisfied or very satisfied with the service NWL provides and 87% feeling it provides value for money. Employee turnover and sickness absence remain below the industry average.

The future focus of the company continues to be improving efficiency levels and driving down operating costs, whilst maintaining high standards of customer service and compliance and developing the skills and effectiveness of its employees. Continuous improvement will be necessary to ensure the company is successful in meeting the targets set by Ofwat in its final determination of price limits for 2005 to 2010.

TRANSFER OF AES BUSINESS

The board of NWG agreed to merge the business of Analytical & Environmental Services Limited ("AES") with the company at 31 March 2007. AES is a subsidiary of the Group which provided environmental monitoring services, analysis and technical consultancy to the company as well as major industrial groups, environmental regulators and local authorities throughout the UK and Ireland. AES will continue to operate as a trading division of the company, as part of its newly created Scientific Services division, which also includes the company's water and waste water compliance teams.

FUTURE DEVELOPMENTS

Future revenue and expenditure

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

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

For the second year of this five year period NWL's appointed business operating costs were £7.2m above Ofwat's assumptions, due to the increase in energy costs. Energy prices have since fallen by around 35% from their peak and, if this level is maintained, the company expects to achieve Ofwat's efficiency targets in the remaining years to 2010.

Customers' bills increased by 3.7% before inflation in 2006/07, reflecting the full amount allowed by Ofwat in the final determination. For the next three years price limits will be applied as shown in the table below, which represents a reduction in the price limits set by Ofwat.

	2007/08	2008/09	2009/10
NWL application	2.8%	0.0%	0.0%
Ofwat allowance	3.2%	1.0%	0.6%

Future revenue and expenditure (continued)

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

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

The price limit for 2007/08 of 3.2% has already been reduced to 2.8% and this is reflected in current bills. The price limits for 2008/09 and 2009/10, of 1% and 0.6% respectively, include financeability adjustments introduced to ensure companies could finance their functions with adequate financial ratios throughout the 2005 to 2010 period. These adjustments were to assist financing and were not available for distribution.

In respect of capital investment, over the five years to 2010, the company will invest around £1 billion.

Future trends and factors

There are a number of known changes, both short term and longer term, that may have an impact on the future development, performance and position of the company. The most significant changes are discussed below. In addition there are a number of risks and uncertainties facing the business which are identified in the following section.

<u>Regulatory and legislative factors</u>

The introduction of new UK and EU legislation, such as the Traffic Management Bill and Water Framework Directive (WFD), and proposals for future legislation, such as the transfer of private sewers, will have a significant impact on the business.

The company is working with the EA to consider the drivers for investment beyond 2010, including the WFD. The quality of rivers and bathing waters in the north east is among the best in the country and the company's initial view is that the investment required to comply with the WFD will be less than in many other regions.

The proposal to transfer private sewers to the ownership of the regulated water and sewerage businesses would increase the sewers owned and maintained by the company by about 50%. This is currently under consultation.

The company has applied to the EA to have the consents for six coastal sewage treatment works amended to restrict the requirement for ultraviolet (UV) disinfection to the summer months. UV treatment is the final, energy-intensive, treatment process and the company's modelling concludes that bathing waters in the vicinity would meet not only EU Mandatory but also the stricter Guideline Standard, without UV treatment. This application raises important issues about achieving the right environmental balance and a decision is awaited.

The Water Supply Licensing regime has been slow to develop and Ofwat is currently consulting on proposals that may help the current system to work more effectively. The company will continue to make a full contribution to the debate on the role of competition in water and waste water services.

<u>Periodic Review 2009</u>

Ofwat currently reviews prices on a five-yearly cycle. The current regulatory review period covers the period from April 2005 to March 2010. The company is now involved in preparing for the next periodic review for which the final determination of prices will be published in 2009.

The company is currently preparing its Strategic Direction Statement which will outline a 25 year vision for the company, as well as the key objectives for the next five years. This Statement will be published in the autumn and will be used as the basis for a stakeholder consultation exercise in each operating area, which will in turn help inform the periodic review of prices in 2009.

RISKS & UNCERTAINTIES

Financial risks

The principal financial risks, including energy prices, have been described above. The management of financial risks relating to liquidity and treasury policies are covered below under Capital Structure.

Non-financial risks

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

The NWL management team reviews the model in detail every year to ensure that the inclusion and assessment of each risk is still appropriate. The NWG and NWL Audit Committees consider the outcome of this review. In addition, the NWL Board considers the management of significant risks at each of its meetings.

The principal non-financial risks identified are summarised below.

<u>Changes to the regulatory environment and to legislation</u>

Significant changes are occurring in economic, environmental and quality regulation and the EA and DWI are both moving towards a risk-based regulatory approach. The known and proposed significant changes to regulation and legislation have been described above.

<u>Changes to weather patterns and their impact</u>

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

As part of the company's corporate responsibility model, research has been carried out into the impact of climate change on assets and water resources and a Climate Change Policy has been developed. The company is monitoring its carbon footprint and opportunities to reduce this are being pursued.

<u>Social, environmental and ethical risks</u>

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

<u>Water resources</u>

The company has sufficient water reserves in its northern area, largely due to Kielder Water and the ability it provides to augment its major rivers during periods of drought. However, the southern area is in one of the driest parts of the UK and rainfall, until recently, has been low since November 2004.

In Essex, the company did not need to introduce a hosepipe ban during the drought which affected supplies across much of south east England during 2006. The company's investment to reduce leakage, the ability to pump water from Norfolk via the Ely Ouse to Essex Transfer Scheme and the water available from the innovative Langford Recycling Scheme, helped maintain reservoir levels In addition, the company's ongoing and long running water efficiency promotions and good relationship with customers produced a positive response to requests for additional efforts on water saving and a consequent significant reduction in demand.

However, alongside these important measures to manage demand, the company believes that water resources in the south need to be augmented to secure water supplies for customers. During 2007, an application will be made for planning permission for a project that will increase the capacity of the Abberton reservoir by 60%.

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.

In June 2006, the company issued two £100m guaranteed index linked Eurobonds through its subsidiary Northumbrian Water Finance plc ("NWF") with maturities of 2049 and 2053 respectively.

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

As a result of the debt raised in the year the company has sufficient funds in place to meet its obligation to the end of the current regulatory period in 2010.

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 company's Board is responsible for the financing strategy of the company which is determined within treasury policies set by the company's ultimate parent company, NWG. The aim of this strategy is to assess the ongoing capital requirement of the company and to raise funding on a timely basis, taking advantage of any favourable market opportunities.

The Treasury department of NWG carries out treasury operations on behalf of the company. Surplus funds are invested based upon forecast requirements, in accordance with the treasury policy. On occasion, derivatives are used as part of this process but the treasury policies prohibit their use for speculation.

Risks arising from the company's financial instruments

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

Liquidity risk

As regards day to day liquidity, the company is responsible for cash management and has sufficient committed facilities to cover 3 years forecast cash outflow. The Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0m and with a bank agreement availability period of no less than 3 months. At 31 March 2007, NWL had £75.0m (2006: £275.0m) available in standby committed bank facilities.

Interest rate risk

The company finances its operations through a mixture of retained profits and borrowings. It borrows at both fixed and floating rates of interest and, as noted above, on occasion uses derivatives to generate the desired interest profile and to manage its exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2007, 65% (2006: 80%) of the borrowings of the Group were at fixed rates of interest.

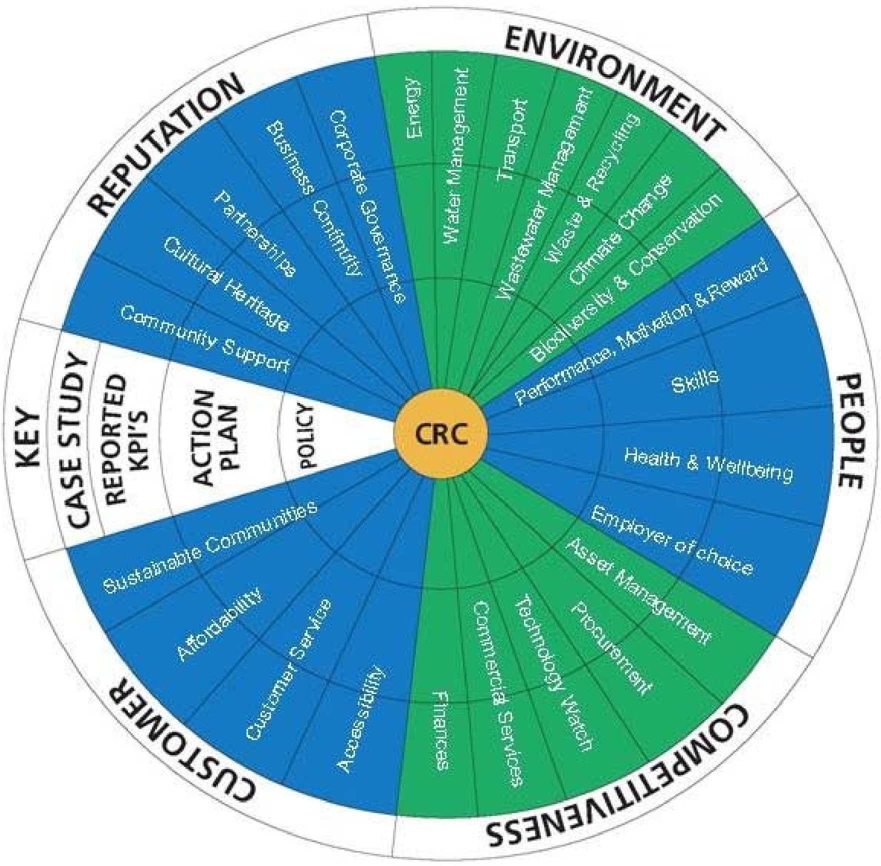
Foreign currency risk

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 2007, the company had no currency exposures (2006: nil).

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

CORPORATE RESPONSIBILITY

Corporate responsibility
The company takes its corporate responsibilities seriously, aiming to balance social and environmental priorities. This approach underpins all of the company's activities and is integral to the way that the company does business. During the year, the company developed a model to help the business to focus on corporate responsibility as part of normal business practice.



The company also set up a new Corporate Responsibility Committee ("CRC") which will review policies, agree targets and the framework for activity in the model. Specialist working groups are responsible for investigating and advising on specific environmental, workplace, marketplace and community projects, such as climate change, energy use, transport and waste. The Managing Director is accountable to the NWL and NWG Boards for the environment and sustainable development policies.

Corporate responsibility (continued)

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

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

Environmental partnerships
The company has developed key partnerships to help the conservation of biodiversity on its sites. These involve agreed action plans and objectives for biodiversity and catchment management for individual sites. NWL's contribution to the partnerships includes funding of project officers. Current partnerships include Northumberland Wildlife Trust, Durham Wildlife Trust, Essex Wildlife Trust, Broads Authority and Davy Down Trust.

Social and Community Issues

The company has significant resources in its assets and employees and believes that it has a responsibility to use the resources for the benefit of customers and the wider communities.

The company helps its communities in a number of different ways and these are covered in different parts of the model shown above. As well as financial support, employees are encouraged to volunteer and facilities are provided to help the communities in which the company operates. Examples of support provided are given below.

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

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

Water for health
NWL is playing a leading role in the 'Water for Health Alliance' which is encouraging people to drink more tap water for their health. Over £200,000 has been provided to date for water coolers in schools and over 410 have been supplied to date in nearly 300 schools. The trials, and associated research, with water coolers in a day centre and care home for older people, as well as two prisons, have continued. NWL also assisted Water UK and Unison in the national launch of 'Water@Work' which encourages employers to ensure that employees have adequate access to drinking water.

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

Social and Community Issues (continued)

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

NWL was again ranked as one of the top 100 'Companies for corporate responsibility' based on an assessment of the widely recognised Business in the Community ("BITC") indices and achieved the highest possible award, platinum, for its community activities. These indices enable NWL to measure, manage and report its responsible business practice underpinned by a rigorous external review process. NWL has a 'Big Tick' Award for Excellence from BITC for integrating responsible business practice into mainstream operations for the 'Just an hour' scheme (Healthy Communities).

Charitable donations
During the year, the company made charitable donations of £128,505 (2006: £122,411).

RELATIONSHIPS

Employees and Employment Policies

One of the strengths of NWL is employee loyalty, evidenced by the fact that employee turnover is relatively low at 8.2%, well below the UK water industry average of 10.3%. NWL continues to seek the views of employees and this year's survey was completed by 56%, an increase of 7%, who gave their views on their working life, training, communications, managers and the company. The results were reported back to all employees and discussed with representative bodies. Overall, employee satisfaction levels remain very high with over 72% of respondents stating they are proud to work for the company.

The key employment policies in operation are outlined below.

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

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

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

Most recently this has included consultation on proposed changes to the Group final salary pension scheme. Following the announcement by the NWG board of a review of the scheme a Pensions Working Group was formed, comprising employee representatives, management representatives, and full-time union officers to discuss options. The views from the Pensions Working Group were presented to the NWG board in January 2007 and at the end of March 2007, the company proposed pension scheme changes for current members and a defined contribution scheme for new entrants from 1 January 2008.

Employees and Employment Policies (continued)

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.

The company has introduced a Management Development Framework with Newcastle Business School, part of Northumbria University, to develop leadership skills in current and potential managers. The company is also recruiting for its new apprentice programme for electrical and mechanical apprentices. The four year partially funded programme will guarantee permanent jobs for apprentices who have successfully completed the scheme.

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

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

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 unethical. The Audit Committee monitors the effectiveness of the Disclosure Policy and receives reports on any incidents.

Health and Safety
A safe working environment is given a high priority in the business. The health and safety policy is maintained and implemented through the company's health and safety team. The Group's medical advisor, Grosvenor Health, provides occupational health services.

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

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

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

Customers

Domestic customers
NWL's relationship with its customers is central to the success of its services. The company's reputation for providing value for money and working to maintain high levels of customer satisfaction helped to achieve a positive response to appeals to use water carefully in the southern operating area and, as a result, no restrictions on water use were imposed during 2006.

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

NWL also communicates with local communities through public meetings and written material when it needs to explain the impact of work due to be carried out.

Business customers
The company has regular meetings with the business community and its representative groups such as the CBI and Chambers of Commerce.

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

Research and development
The company maintains a programme of research and development linked to its operations. This includes the provision of technical solutions for water and waste water management and developing partnerships with academic and research organisations. During the year, the company invested £2.1m (2006: £2.3m) in research and development.

Political contributions

The company does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. However, the wide definition of donations in the Political Parties, Elections and Referendums Act 2000 (PPERA 2000) covers activities which form part of the necessary relationship between the company and political organisations. These activities include attending Party Conferences, as these provide the best opportunity to meet a range of stakeholders, both national and local, to explain the company's activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during the year were as follows (2006: £3,857):

Organisation	**Donations for the period** £
Labour	3,793
Liberal Democrats	1,147
Conservative	1,152
Total	**6,092**

The expenditure reflects the representation of political parties in the company's areas of supply.

NWG shareholder authority to permit the Group to continue with these activities until the 2008 AGM will be sought at this year's AGM.

Company payment policy

The company's policy is to agree and adhere to payment terms with suppliers when agreeing the terms of each transaction, also ensuring that suppliers are made aware of, and comply with, the terms of payment. The year end trade creditors expressed as a number of days of purchases made during the year is 19 days (2006: 18 days).

Fixed assets

Freehold land and buildings are carried in the financial statements at historical cost with a net book value of £61.8m (2006: £57.9m). In the opinion of the directors, at 31 March 2007, 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

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

Directors' remuneration

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

Indemnification of directors

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

Financial statements preparation and going concern

The directors consider it is appropriate to prepare the financial statements for the financial year on the going concern basis. The directors have arrived at their decision based on consideration of the company's detailed budget for 2007/08 and the business plan for the period to 31 March 2010. Their analysis included a review of the capital expenditure and investment plans, the anticipated funding requirements and facilities available, and the reasonableness of the underlying assumptions of both the budget and the forecast.

Directors' declaration

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

Auditors

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

DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW (continued)

Statement of Directors' responsibilities

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

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

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

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

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

BY ORDER OF THE BOARD

M Parker
Company Secretary
29 June 2007

Appendix to the directors' report and operating and financial review

DEFINITION OF KEY PERFORMANCE INDICATORS

Financial KPIs

Gearing to RCV

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

Regulatory gearing

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

Cash interest cover

Definition and calculation: Net cash flow from operating activities less advanced contributions in respect of retirement benefits less tax paid 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: Net cash flow from operating activities less advanced contributions in respect of retirement benefits 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

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 DWI.

Leakage

Definition and calculation: Total leakage from the water network (including customer pipes)
Purpose: To monitor compliance with Ofwat leakage targets
Source of underlying data: Information recorded by NWL and audited by Ofwat

ENVIRONMENT

Sewage treatment works

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

Pollution incidents

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

CUSTOMER

Customer – levels of service

Definition and calculation: Customer service standards are established by Ofwat, the economic regulator, and calculated using source data from the company.
Purpose: To monitor performance of the company.
Source of underlying data: Information collected by the company and submitted to Ofwat. It is independently certified.

Customer satisfaction

Definition and calculation: Domestic customers' satisfaction with overall service and overall value for money, expressed as satisfaction averaged over the surveys carried out during the year.
Purpose: To enable tracking of perception of reputation, service and value for money over time.
Source of underlying data: Independent surveys of 500 customers (300 north, 200 south) chosen at random, but representative of the customer base, carried out each quarter – a total of 2,000 customers.

EMPLOYEE

Lost time reportable accidents

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

Sickness absence

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

Employee turnover

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

PROFIT AND LOSS ACCOUNT
for the year ended 31 March 2007

	Note	2007	2006
		£'m	£'m
Turnover	2	581.2	550.5
Operating costs	3(a)	(246.6)	(228.4)
Capital maintenance costs	3(b)	(95.7)	(93.2)
Total operating costs		(342.3)	(321.6)
OPERATING PROFIT		238.9	228.9
Net interest payable	4	(82.0)	(77.7)
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION	3(c)	156.9	151.2
Taxation	8(a)	(30.5)	(54.7)
PROFIT FOR THE FINANCIAL YEAR	24	126.4	96.5

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2007

There are no recognised gains and losses other than the profit attributable to shareholders of the company of £126.4m for the year ended 31 March 2007 and the profit of £96.5m for the year ended 31 March 2006.

BALANCE SHEET
at 31 March 2007

	Note	2007	2006
		£'m	£'m
FIXED ASSETS			
Tangible assets	10	3,008.0	2,866.8
Investments	11	160.7	160.6
		3,168.7	3,027.4
CURRENT ASSETS			
Stocks	12	2.9	2.8
Debtors due in less than one year	13	131.1	102.8
Debtors due in more than one year	14	3.5	3.6
Investments	15	253.9	57.7
Cash at bank and in hand		1.0	1.9
		392.4	168.8
CREDITORS			
Amounts falling due within one year	16	(186.0)	(181.9)
NET CURRENT ASSETS / (LIABILITIES)		206.4	(13.1)
TOTAL ASSETS LESS CURRENT LIABILITIES		3,375.1	3,014.3
CREDITORS: Amounts falling due after more than one year	17	(1,832.3)	(1,540.3)
PROVISIONS FOR LIABILITIES AND CHARGES	21	(214.4)	(204.7)
ACCRUALS AND DEFERRED INCOME	22	(381.3)	(373.3)
		(2,428.0)	(2,118.3)
NET ASSETS		947.1	896.0
CAPITAL AND RESERVES			
Called up share capital	23	122.7	122.7
Profit and loss account	24	824.4	773.3
EQUITY SHAREHOLDERS' FUNDS	24	947.1	896.0

Approved on behalf of the board

J A Cuthbert

C M Green

29 June 2007

NOTES TO THE STATUTORY FINANCIAL STATEMENTS
for the year ended 31 March 2007

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, with the exception of the early adoption of amendments to FRS 17 Retirement Benefits (see note 1h). This change has no impact on the profit and loss account and balance sheet, however the FRS 17 information in note 26 has been restated to reflect the amendment.

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

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

(c) Cash flow statement
The directors have taken advantage of the exemption in Financial Reporting Standard No.1 (revised) and have not included a cash flow statement on the grounds that the company is wholly owned and its ultimate parent company publishes a consolidated cash flow statement.

(d) Tangible fixed assets and depreciation
Tangible fixed assets comprise:

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

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

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

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

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

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(d) Tangible fixed assets and depreciation (continued)
(ii) Non-infrastructure assets (continued)

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

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

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

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

(e) Grants and contributions
Revenue grants are credited to the profit and loss account when received.

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

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

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

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

(h) Pension costs
The company has adopted early the amendment to FRS17 issued by the Accounting Standards Board in December 2006.

The company is a member of the Northumbrian Water Pension Scheme (which is a multi-employer scheme) and the assets cannot be apportioned to individual companies. Accordingly, these financial statements account for pension costs as a defined contribution scheme and charges are made as incurred.

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

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(i) Taxation

The charge for current UK corporation tax is based on the profit for the year as adjusted for taxation purposes using the rates of tax enacted 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 measured 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 FRS19, the company has decided to adopt a policy of discounting deferred tax assets and liabilities to reflect the time value of money over the period between the balance sheet date and the dates on which it is estimated that the underlying timing differences will reverse. The discount rates used reflect the post-tax yields to maturity that can be obtained at the balance sheet date on UK government bonds with similar maturity dates to those of the deferred tax assets or liabilities.

(j) Foreign currency

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

(k) Research and development

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

(l) Investments

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

(m) Derivative financial instruments

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

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

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

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

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

(n) Liquid resources

Liquid resources comprise external deposits.

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(o) Bad debt provisioning

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

(p) Share based payments

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

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

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

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

2. TURNOVER, PROFIT BEFORE TAX AND NET ASSETS

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

3. OPERATING COSTS, CAPITAL MAINTENANCE COSTS AND PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION

(a) Operating costs comprise:

	2007	2006
	£'m	£'m
Materials and consumables	14.9	14.9
Other external charges	69.2	56.7
Net manpower costs (note 7)	82.8	80.7
Other operating charges	103.8	98.1
Own work capitalised	(24.1)	(22.0)
	246.6	228.4

3. OPERATING COSTS, CAPITAL MAINTENANCE COSTS AND PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION (continued)

(b) Capital maintenance costs comprise:

	2007	2006
	£'m	£'m
Depreciation:		
Non-infrastructure assets	64.1	61.5
Non-infrastructure assets held under finance leases	3.3	3.9
Infrastructure assets	34.2	32.9
Amortisation of capital grants and contributions	(3.8)	(3.5)
Profit on disposal of fixed assets	(2.1)	(1.6)
	95.7	93.2

(c) Profit on ordinary activities before taxation:

	2007	2006
	£'m	£'m
Profit on ordinary activities before taxation is stated after charging:		
Operating leases: Plant and machinery	0.1	0.1
Other assets	0.9	0.8
Costs of research and development	2.1	2.3
Directors' emoluments (note 5)	1.1	1.0

Auditors' remuneration in respect of the statutory audit amounted to £95,134 (2006: £91,917). Auditors' remuneration for the regulatory audit amounted to £15,944 (2006: £15,405). Fees of £13,147 and £14,049 (2006: £26,702 and £12,324) 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

	2007	2006
	£'m	£'m
Net interest payable comprises:		
Interest payable:		
Bank loans and overdrafts	16.7	19.7
Group loans	81.6	66.4
Debenture stock interest	-	0.5
Financing charges payable under finance leases	2.8	3.0
Total interest payable	101.1	89.6
Interest receivable:		
Group interest	(9.2)	(9.9)
External interest	(9.9)	(2.0)
Net interest payable	82.0	77.7

5. DIRECTORS' EMOLUMENTS

(a) Directors' remuneration

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

	2007	2006
	£'000	£'000
Emoluments (including benefits in kind)	1,127.1	991.3

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 2007 were members of a defined benefit pension scheme where the company makes contributions towards the cost (2006: 4).

The directors who held office as at 31 March 2007 held the following conditional interests in Ordinary 10p shares of the Group, awarded in accordance with the terms of its Long Term Incentive Plan (LTIP):

Name of Director	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2007
J A Cuthbert	27.1.04[1]	85,603	-	23,866	61,737[2]	-
	22.12.04[3]	67,001	-	-	-	67,001
	9.12.05[4]	75,903	-	-	-	75,903
	21.12.06[5]	-	66,721	-	-	66,721
Totals		228,507	66,721	23,866	61,737	209,625
C M Green	27.1.04[1]	56,618	-	15,785	40,833[2]	-
	22.12.04[3]	44,221	-	-	-	44,221
	9.12.05[4]	50,602	-	-	-	50,602
	21.12.06[5]	-	49,423	-	-	49,423
Totals		151,441	49,423	15,785	40,833	144,246
A C Jones	27.1.04[1]	22,463	-	6,262	16,201[6]	-
	22.12.04[3]	20,100	-	-	-	20,100
	9.12.05[4]	26,506	-	-	-	26,506
	21.12.06[5]	-	25,899	-	-	25,899
Totals		69,069	25,899	6,262	16,201	72,505
G Neave	27.1.04[1]	40,000	-	11,152	28,848[7]	-
	22.12.04[3]	25,125	-	-	-	25,125
	9.12.05[4]	32,530	-	-	-	32,530
	21.12.06[5]	-	32,374	-	-	32,374
Totals		97,655	32,374	11,152	28,848	90,029

The directors who held office as at 31 March 2007 held the following interests in the Ordinary 10p shares of NWG, purchased and held in accordance with the terms of the Share Incentive Plan:

Name of Director	Class of Shares	Number of shares held as at 1 April 2006	Number of shares held as at 31 March 2007
J A Cuthbert	Ordinary 10p	2,780	3,565
C M Green	Ordinary 10p	2,780	3,565
A C Jones	Ordinary 10p	2,780	3,565

5. DIRECTORS' EMOLUMENTS (continued)

(a) Directors' remuneration (continued)

Notes

1. The market value of the shares on the date of the award was 113.50 pence per share. The three year performance period ran from 1 October 2003 to 30 September 2006 and shares became available to vest on 27 January 2007.
2. Shares vested on 29 January 2007 and the closing price on that date was 294.5 pence per share.
3. The market value of the shares on the date of the award was 174.50 pence per share. The three year performance period runs from 1 October 2004 to 30 September 2007.
4. The market value of the shares on the date of the award was 252.00 pence per share. The three year performance period runs from 1 October 2005 to 30 September 2008.
5. The market value of the shares on the date of the award was 302.75 pence per share. The three year performance period runs from 1 October 2006 to 30 September 2009.
6. Shares vested on 6 February 2007 and the closing price on that date was 305.25 pence per share.
7. Shares vested on 8 March 2007 and the closing price on that date was 296.25 pence per share.
8. The cost of conditional awards is charged to the income statement over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.3m was charged to equity.
9. Details of the performance conditions are shown at note 11 to the Regulatory Accounts.
10. The market price of the shares on 31 March 2007 was 310.00 pence per share. During the year, the highest market price was 320.00 pence per share and the lowest market price was 231.50 pence per share.
11. Aggregate gross gains made by directors on exercise of awards at date of vesting was £436,984 (2006: £nil).

Some or all of the shares will vest only if specified performance targets are achieved during the three year performance period. The performance conditions are complex but, in essence, shares can vest depending on NWG's Total Shareholder Return ("TSR") in the three year period compared with the TSR of a group of other water companies (in respect of 70% of the shares awarded) and, for the awards made in 2004, with the FTSE 250 Total Return Index (in respect of 30% of the shares awarded) and, for the awards made in 2005, with a FTSE 250 comparator group (in respect of 30% of the shares awarded). For further information, please refer to the Directors' Remuneration Report in the NWG accounts and to note 11 to the Regulatory Accounts.

As at 31 March 2007, no directors hold any other interests required to be disclosed, in accordance with Schedule 7 of the Companies Act 1985.

(b) Highest paid director

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

	2007	2006
	£'000	£'000
Emoluments (including benefits in kind)	310.0	278.5

The accrued pension entitlement under the company's defined benefit scheme of the highest paid director at 31 March 2007 was £133,800 (2006: £125,900).

6. TRANSACTIONS WITH DIRECTORS AND OFFICERS

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

7. EMPLOYEE INFORMATION

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

	2007	2006
	£'m	£'m
Gross costs charged to the profit and loss account:		
Wages and salaries	48.2	50.3
Social security costs	4.2	4.2
Other pension costs	7.9	5.8
	60.3	60.3
Costs recharged to other group companies:		
Wages and salaries	1.1	1.0
Social security costs	0.1	0.1
Other pension costs	0.2	0.1
	1.4	1.2
Net costs charged to the profit and loss account:		
Wages and salaries	47.1	49.3
Social security costs	4.1	4.1
Other pension costs	7.7	5.7
	58.9	59.1
Costs charged to capital schemes:		
Wages and salaries	19.1	18.0
Social security costs	1.7	1.5
Other pension costs	3.1	2.1
	23.9	21.6
Total net employee costs	82.8	80.7

The average monthly number of employees on the payroll during the financial year was 2,554 (2006: 2,541) and the total at the year end was 2,862 (2006: 2,553). The year end total includes 308 staff transferred from AES on 31 March 2007.

8. TAXATION

(a) Analysis of tax charge for the financial year:

	2007	2006
	£'m	£'m
Current tax:		
UK corporation tax on profits for the year at 30% (2006:30%)	21.1	15.6
Adjustments in respect of prior years	(12.5)	(0.6)
Payable in respect of group relief for the current year at 30% (2006:30%)	6.6	10.3
Adjustments in respect of prior years	5.5	0.6
Total current tax charge (note 8b)	20.7	25.9
Deferred tax:		
Origination and reversal of timing differences in the year	18.3	18.3
Adjustments in respect of prior periods	4.9	0.7
	23.2	19.0
(Increase) / decrease in discount	(13.4)	9.8
Total deferred tax (note 21)	9.8	28.8
Tax on profit on ordinary activities	30.5	54.7

Tax losses have provisionally been claimed from other Group companies in the current year of £20.7m (2006: £33.0m) for which payment will be made at the rate of 30% (2006:30%).
Post-tax yields on UK government gilts have risen during the year such that the total discount on deferred tax has increased (note 21).

(b) Reconciliation of the current tax charge:

	2007	2006
	£'m	£'m
Profit on ordinary activities before tax	156.9	151.2
Profit on ordinary activities multiplied by standard rate of UK corporation tax 30% (2006: 30%)	47.1	45.4
Effects of:		
Expenses not deductible for tax purposes	0.3	0.3
Non-taxable income	(2.5)	(2.6)
Depreciation in respect of non-qualifying items	1.1	1.1
Capital allowances in excess of depreciation	(17.5)	(19.2)
Other timing differences	(0.8)	0.9
Adjustments in respect of previous years	(7.0)	-
Transfer pricing adjustments	(0.4)	(0.4)
Balancing payment payable	0.4	0.4
Current tax charge (note 8a)	20.7	25.9

8. TAXATION (continued)

(c) Factors that may affect future tax charges:

The company expects to continue to incur high levels of capital expenditure and accordingly it expects to be able to claim capital allowances in excess of depreciation.

The 2007 Finance Bill includes proposals to reduce the UK Corporation Tax rate from 30% to 28% with effect from 1 April 2008 and to remove potential balancing adjustments in respect of assets on which industrial buildings allowances are being claimed. It has also been announced that industrial buildings allowances will be phased out by 31 March 2011. These changes had not been enacted or substantively enacted by the date of these financial statements.

In the directors' view, had the above changes been enacted, the Company's discounted deferred tax liability at 31 March 2007 would have been reduced by approximately £26 million.

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

9. DIVIDENDS

	2007	2006
	£'m	£'m
Equity:		
Dividends paid:		
Final paid for the year ended 31 March 2006 of 30.07p (year ended 31 March 2005: 20.95p) per share on an aggregated basis	36.9	25.7
Interim paid of 31.55p (2006: 30.07p) per share on an aggregated basis	38.7	36.9
Total dividends paid in the year	75.6	62.6
Dividends proposed:		
Final proposed for year ended 31 March 2007 of 31.62p (year ended 31 March 2006: 30.07p) per share on an aggregated basis	38.8	36.9

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

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

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

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

10. TANGIBLE FIXED ASSETS

	Freehold land and buildings	Infra-structure assets	Operational structures, plant and machinery	Fixtures, fittings, tools and equipment	Assets in the course of construction	Total
	£'m	£'m	£'m	£'m	£'m	£'m
Cost:						
At 1 April 2006	85.7	1,575.3	1,770.2	122.9	86.0	3,640.1
Additions	-	-	-	-	242.9	242.9
Assets acquired from AES	-	-	-	2.6	(2.6)	-
Schemes commissioned	3.9	115.4	96.9	4.4	(220.6)	-
Reclassifications	2.3	0.6	(2.9)	-	-	-
Disposals	(0.2)	(9.9)	-	-	-	(10.1)
At 31 March 2007	91.7	1,681.4	1,864.2	129.9	105.7	3,872.9
Depreciation:						
At 1 April 2006	27.8	199.6	456.5	89.4	-	773.3
Charge for year	2.2	34.2	57.5	7.7	-	101.6
Disposals	(0.1)	(9.9)	-	-	-	(10.0)
At 31 March 2007	29.9	223.9	514.0	97.1	-	864.9
Net book value:						
At 31 March 2007	61.8	1,457.5	1,350.2	32.8	105.7	3,008.0
At 31 March 2006	57.9	1,375.7	1,313.7	33.5	86.0	2,866.8
Leased assets included above:						
Net book value:						
At 31 March 2007	-	-	23.2	-	-	23.2
At 31 March 2006	-	2.2	24.0	-	-	26.2

11. FIXED ASSET INVESTMENTS

	Loans to Group Companies
	£'m
At 1 April 2006	160.6
Capitalised interest	0.1
At 31 March 2007	160.7

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

The company has a wholly owned subsidiary undertaking, Northumbrian Water Finance plc, 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

	2007	2006
	£'m	£'m
Raw materials and consumables	2.9	2.8

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

13. DEBTORS DUE IN LESS THAN ONE YEAR

	2007	2006
	£'m	£'m
Trade debtors	54.3	48.4
Amounts owed by other group companies	5.9	4.2
Other debtors	8.4	6.6
Prepayments and accrued income	62.5	43.6
	131.1	102.8

Trade debtors are shown net of bills raised in advance.

14. DEBTORS DUE IN MORE THAN ONE YEAR

	2007	2006
	£'m	£'m
Interest rate hedge	3.5	3.6

15. INVESTMENTS

	2007	2006
	£'m	£'m
Short term deposits with group company	253.9	57.7

16. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2007	2006
	£'m	£'m
Obligations under finance leases (note 19)	4.8	4.5
Loans (note 18)	20.0	29.2
Trade creditors	5.4	7.8
Amounts owed to other group companies	46.5	15.1
Taxation and social security	1.9	1.7
Corporation tax	4.4	9.7
Other creditors	10.5	11.2
Receipts in advance	19.2	18.7
Accruals and deferred income	73.3	84.0
	186.0	181.9

Accruals and deferred income includes accruals related to capital projects of £46.3m (2006: £33.2m).

Included in amounts owed to other group companies is £10.2m (2006: £10.1m) payable in respect of tax losses surrendered from fellow group companies.

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

	2007	2006
	£'m	£'m
Obligations under hire purchase contracts and finance leases (note 19)	56.4	56.7
Loans (note 18)	356.0	276.0
Amounts owed to other group companies (note 20)	1,419.4	1,207.3
Other creditors	0.5	0.3
	1,832.3	1,540.3

18. LOANS

	2007	2006
	£'m	£'m
Loans are repayable as follows:		
Within one year (note 16)	20.0	29.2
Between one and two years	94.6	20.0
Between two and five years	51.4	131.2
After five years	210.0	124.8
	376.0	305.2

In March 2007 the company fully drew down the £100.0m EIB facility. The loan was drawn on a variable interest rate basis with a 15 year maturity and an amortising principal repayment profile.

Loans wholly repayable within 5 years amount to £117.6m (2006: £96.3m).

Loans not wholly repayable within 5 years amount to £258.4m (2006: £208.9m) and bear interest rates in the range 5.16% to 7.27%.

19. OBLIGATIONS UNDER FINANCE LEASES

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

	2007	2006
	£'m	£'m
Amounts due:		
Within one year	4.8	4.5
Between one and two years	5.1	4.3
Between two and five years	16.1	13.3
After five years	53.5	58.0
	79.5	80.1
Less:		
Finance charge allocated to future periods	(18.3)	(18.9)
	61.2	61.2
Disclosed as due:		
Within one year (note 16)	4.8	4.5
After more than one year (note 17)	56.4	56.7
	61.2	61.2

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 £79.5m (2006: £80.1m).

20. AMOUNTS DUE TO OTHER GROUP COMPANIES

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

	2007	2006
	£'m	£'m
After five years	1,419.4	1,207.3
	1,419.4	1,207.3

NWF issued £200.0m and £150.0m Guaranteed Eurobonds in February 1998 and September 2001 respectively, maturing 6 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 £156.2m respectively. Finance costs allocated during the year amounted to £0.2m (2006: £0.2m). Amortisation of loan issue receipts during the year amounted to £0.3m (2006: £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. Amortisation of loan receipts during the year amounted to £0.1m (2006: £0.1m).

NWF issued £250.0m Guaranteed Eurobonds during December 2002, maturing April 2033, with an annual coupon of 5.625%. NWF issued a further £100.0m Guaranteed Eurobonds during 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 an inter-company loan. Finance costs allocated during the year amounted to £0.2m (2006: £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. Indexation accretion during the year amounted to £5.0m (2006: £2.6m).

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. Indexation accretion during the year amounted to £2.0m (2006: £0.1m).

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. Indexation accretion during the year amounted to £5.4m.

21. PROVISIONS FOR LIABILITIES AND CHARGES

	£'m
Pension provision for former directors:	
At 1 April 2006	3.4
Utilised during the year	(0.3)
At 31 March 2007	3.1
Deferred tax :	
At 1 April 2006	201.3
Transfer in from other group company	0.2
Movement in the year (note 8a)	9.8
At 31 March 2007	211.3
Provisions for liabilities and charges	214.4

The pension provision for former directors relates to pensions payable to former directors of water-only companies which have since merged with the company. The provision of £3.1m represents the full future amounts payable, based on an actuarial assessment, for which the company is directly liable.

The provision for deferred tax comprises:

	2007	2006
	£'m	£'m
Accelerated capital allowances	546.2	524.1
Other timing differences	(52.5)	(53.8)
Undiscounted provision for deferred tax	493.7	470.3
Discount	(282.4)	(269.0)
Discounted provision for deferred tax	211.3	201.3

22. ACCRUALS AND DEFERRED INCOME

	Gilt lock	Capital grants and contributions	Proceeds from Kielder Securitisation	Total
	£'m	£'m	£'m	£'m
At 1 April	-	174.8	198.5	373.3
Additions	0.5	18.7	-	19.2
Disposal	-	(0.3)	-	(0.3)
Amortised during the year	-	(3.9)	(7.0)	(10.9)
At 31 March	0.5	189.3	191.5	381.3

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 transaction.

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

23. CALLED UP SHARE CAPITAL

	2007	2006
	£'m	£'m
Authorised:		
122,650,000 Ordinary Shares of £1 each (2006: 122,650,000)	122.7	122.7

	2007	2006
	£'m	£'m
Allotted, called-up and fully paid:		
122,650,000 Ordinary Shares of £1 each (2006: 122,650,000)	122.7	122.7

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

	Profit and loss account	Total share-holders' funds
	£'m	£'m
At 31 March 2006	773.3	896.0
Profit for the year	126.4	126.4
Share based payment	0.3	0.3
Dividends paid (note 9)	(75.6)	(75.6)
At 31 March 2007	824.4	947.1

25. COMMITMENTS

(a) Capital expenditure:

	2007	2006
	£'m	£'m
Expenditure contracted for but not provided for	109.0	96.8

(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:-

	2007	2006
	£'m	£'m
Land and buildings:		
Leases which expire:		
Within one year	-	0.1
In five years or more	0.6	0.5
	0.6	0.6

	2007	2006
	£'m	£'m
Other:		
Leases which expire:		
Within one year	0.1	-
Between two and five years	0.1	-
	0.2	-

26. PENSIONS

The Group operates a defined benefit pension scheme providing benefits based on final pensionable remuneration to 2,310 active members at 31 March 2007 (2006: 2,351). The Scheme, the Northumbrian Water Pension Scheme (NWPS), comprises four unitised sub-funds - WPS, Northumbrian Water (North), Northumbrian Water (South) and MIS.

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

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

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

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

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

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

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

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

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

The employers’ proposals were accepted by the NWPS Trustee.

The contributions paid to the NWPS in the year by the company totalled £25.9m (2006: £14.8m), which includes £21.4m made as an advance payment. A further pension prepayment of £1.0m was acquired on the purchase of the net assets and liabilities of AES.

The Group also contributes to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP). Members and employers contribute 3% and 6% of salary respectively. The NWGPPP is provided by an insurance company and members have their own individual policy. There were 248 contributing members throughout the Group at 31 March 2007 (2006: 258). The contributions paid to the NWGPPP in the year by the company totalled £0.1m (2006: £0.1m). The outstanding company contributions to be paid over to the NWGPPP at 31 March 2007 totalled £nil (2006: £nil).

In accordance with FRS 17, the company accounts for its contributions to the relevant sub-funds of the NWPS as if it were a defined contribution scheme because it is not possible to identify the company’s share of the net assets and liabilities in the NWPS on a consistent and reasonable basis.

26. PENSIONS (continued)

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

A qualified actuary, using revised assumptions consistent with the requirements of FRS 17, has updated the actuarial valuation described above at 31 December 2004. Investments have been valued, for this purpose, at fair value.

FRS 17 actuarial assumptions :

	Group	
	2007 %	2006 %
Pay increases*	4.1	3.9
Pension increases	3.1	2.9
Price inflation	3.1	2.9
Discount rate	5.3	4.9
Mortality assumptions	PMA/PFA92	PMA/PFA92
- Life expectancy for an active member – female (years)	27.6	27.5
- Life expectancy for an active member – male (years)	24.6	24.5

* including promotional salary scale

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

	Long term expected rate of return 2007	2007	Long term expected rate of return 2006	2006 (restated)
	%	£'m	%	£'m
Equities	7.5	498.5	7.2	451.6
Corporate bonds	5.3	50.3	4.9	48.2
Government bonds	4.5	65.9	4.2	60.5
Property	6.0	86.7	5.7	65.1
Cash	5.3	9.4	4.5	34.4
Total fair value of assets		710.8		659.8
Present value of liabilities		(668.1)		(663.5)
Surplus/(Deficit)		42.7		(3.7)
Related deferred tax asset		(12.8)		1.1
Net pension asset/(liability)		29.9		(2.6)

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

	2007	2006
	£'m	£'m
Current service cost	15.6	12.0
Past service cost	0.4	-
Curtailments and settlements	-	0.3
Total operating charge	16.0	12.3

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

26. PENSIONS (continued)

Analysis of the amount that would have been charged to net finance payable under FRS 17:

	2007	2006 (restated)
	£'m	£'m
Expected return on assets	42.9	36.5
Interest on liabilities	(32.4)	(32.3)
Net credit	10.5	4.2

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

	2007	2006 (restated)
	£'m	£'m
Net actuarial gains recognised in the statement of total recognised gains and losses	25.0	52.7

History of experience gains and losses:

	2007	2006 (restated)	2005 (restated)	2004 (restated)
Fair value of assets	710.8	659.8	523.8	472.1
Present value of defined benefit obligation	(668.1)	(663.5)	(600.2)	(565.7)
Surplus / (deficit)	42.7	(3.7)	(76.4)	(93.6)
Experience adjustments arising on plan assets	0.6	87.1	25.6	28.5
Experience adjustments arising on plan liabilities	24.4	(34.4)	(4.4)	8.0

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

	2007	2006
	£'m	£'m
At 1 April	663.5	600.2
Current service cost	15.6	12.0
Past service cost	0.4	-
Interest cost	32.4	32.3
Contributions by plan participants	0.3	3.3
Actuarial (gains) / losses on obligations	(24.4)	34.4
Income which increases liabilities	-	(0.7)
Benefits paid	(19.7)	(18.3)
Losses on curtailments and settlements	-	0.3
At 31 March	668.1	663.5

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

	2007	2006 (restated)
	£'m	£'m
At 1 April	659.8	523.8
Expected return on plan assets	42.9	36.5
Actuarial gains on plan assets	0.6	87.1
Contributions by employer	26.9	28.1
Contributions by plan participants	0.3	3.3
Income which increases liabilities	-	(0.7)
Benefits paid	(19.7)	(18.3)
At 31 March	710.8	659.8

27. SHARE INCENTIVE PLANS

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

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

	March 2007 Number	March 2006 Number
Outstanding at 1 April	1,216,320	915,784
Granted during the year	360,022	374,615
Forfeited/lapsed during the year	(131,876)	(44,451)
Exercised	(329,751)	(29,628)
Outstanding at 31 March	1,114,715	1,216,320
Exercisable at 31 March	11,418	-

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

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

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

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

	March 2007	March 2006
Dividend yield	4.0%	4.5%
Expected share price volatility	22%	23%
Expected comparators' share price volatility	n/a	16%-21%
Share price at award	302.75p	252.00p
Expected FTSE 250 index volatility	12%	11%
Risk free interest rate %	5.01%	4.33%
Expected life of option (years)	3	3

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

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

27. SHARE INCENTIVE PLANS (continued)

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

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

	March 2007 Number	March 2006 Number
Outstanding at 1 April	136,168	212,119
Granted during the year	118,625	154,478
Forfeited during the year	(3,358)	(5,425)
Exercised	(136,216)	(225,004)
Outstanding at 31 March	115,219	136,168

28. ACQUISITION OF THE BUSINESS OF AES AT FAIR VALUE

On 31 March 2007, the business of AES, another subsidiary of the Group, was merged with the company. The net assets were acquired by the company at their fair value for a total consideration of £3.8m. The following table provides an analysis of the assets and liabilities acquired and their fair value.

	Book value and fair value
	£'m
Tangible fixed assets	2.6
Prepayments and accrued income	1.5
Other debtors	0.2
Corporation tax	(0.1)
Accruals and deferred income	(0.4)
	(3.8)

There was no goodwill arising on acquisition.

29. 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 Financial Reporting Standard No 8 "Related Party Disclosures" from disclosing transactions with other members of the group headed by NWG.

30. ULTIMATE PARENT COMPANY

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

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

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF NORTHUMBRIAN WATER LIMITED

We have audited the company's financial statements for the year ended 31 March 2007 which comprise the Profit and Loss Account, Statement of Total Recognised Gains and Losses, Balance Sheet and the related notes 1 to 30. These financial statements have been prepared under the accounting policies set out therein.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

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

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

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

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

Basis of audit opinion

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

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

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 March 2007 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report and Operating and Financial Review is consistent with the financial statements.

Ernst & Young LLP
Registered Auditor
Newcastle upon Tyne

29 June 2007

HISTORICAL COST PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2007

	Note	2007 Appointed business	2007 Non-appointed business	2007 Aggregated basis	2006 Appointed business	2006 Non-appointed business	2006 Aggregated basis
		£'m	£'m	£'m	£'m	£'m	£'m
Turnover	2	560.7	20.5	581.2	532.0	18.5	550.5
Operating costs		(276.0)	(7.9)	(283.9)	(258.2)	(6.3)	(264.5)
Historical cost depreciation		(64.5)	(0.4)	(64.9)	(62.5)	(0.4)	(62.9)
Operating income		2.0	0.1	2.1	1.6	-	1.6
OPERATING PROFIT		222.2	12.3	234.5	212.9	11.8	224.7
Net interest (payable) / receivable		(92.1)	10.0	(82.1)	(87.8)	10.1	(77.7)
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		130.1	22.3	152.4	125.1	21.9	147.0
Taxation – current		(15.9)	(4.8)	(20.7)	(22.5)	(3.3)	(25.8)
- deferred	a	(5.3)	(0.2)	(5.5)	(23.6)	(1.0)	(24.6)
PROFIT FOR THE FINANCIAL YEAR		108.9	17.3	126.2	79.0	17.6	96.6
Dividends		(68.6)	(7.0)	(75.6)	(33.4)	(3.5)	(36.9)
RETAINED PROFIT FOR THE YEAR		40.3	10.3	50.6	45.6	14.1	59.7

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2007

There are no recognised gains and losses other than the profit attributable to shareholders of the company of £126.2m for the year ended 31 March 2007 and the profit of £96.6m for the year ended 31 March 2006.

HISTORICAL COST BALANCE SHEET
At 31 March 2007

		2007			2006		
	Note	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis
		£'m	£'m	£'m	£'m	£'m	£'m
FIXED ASSETS							
Tangible assets	a	2,730.4	99.8	2,830.2	2,612.3	99.0	2,711.3
Investments – loans to group companies		-	160.7	160.7	-	160.6	160.6
TOTAL FIXED ASSETS		2,730.4	260.5	2,990.9	2,612.3	259.6	2,871.9
CURRENT ASSETS							
Stocks		2.7	0.2	2.9	2.6	0.2	2.8
Debtors		129.4	5.2	134.6	102.5	3.9	106.4
Cash		-	6.4	6.4	-	7.1	7.1
Short term deposits		253.9	-	253.9	57.7	-	57.7
TOTAL CURRENT ASSETS		386.0	11.8	397.8	162.8	11.2	174.0
CREDITORS: Amounts falling due within one year							
Overdrafts		(5.4)	-	(5.4)	(5.2)	-	(5.2)
Infrastructure renewals accrual		(0.7)	(1.7)	(2.4)	(4.2)	(1.6)	(5.8)
Creditors		(153.0)	(3.7)	(156.7)	(132.5)	(5.9)	(138.4)
Borrowings		(24.8)	-	(24.8)	(33.7)	-	(33.7)
Corporation tax payable		(4.4)	-	(4.4)	(9.7)	-	(9.7)
TOTAL CREDITORS		(188.3)	(5.4)	(193.7)	(185.3)	(7.5)	(192.8)
NET CURRENT ASSETS / (LIABILITIES)		197.7	6.4	204.1	(22.5)	3.7	(18.8)
TOTAL ASSETS LESS CURRENT LIABILITIES		2,928.1	266.9	3,195.0	2,589.8	263.3	2,853.1
CREDITORS: Amounts falling due after more than one year							
Borrowings		(1,831.8)	-	(1,831.8)	(1,540.0)	-	(1,540.0)
Other creditors		(0.5)	-	(0.5)	(0.3)	-	(0.3)
TOTAL CREDITORS		(1,832.3)	-	(1,832.3)	(1,540.3)	-	(1,540.3)
PROVISIONS FOR LIABILITIES AND CHARGES							
Deferred tax provision	a	(188.6)	(8.0)	(196.6)	(183.1)	(7.7)	(190.8)
Deferred income – grants and contributions	a	(54.9)	(0.5)	(55.4)	(54.9)	(0.5)	(55.4)
Other provisions		(3.1)	-	(3.1)	(3.4)	-	(3.4)
Other deferred income		(0.5)	(191.5)	(192.0)	-	(198.5)	(198.5)
NET ASSETS EMPLOYED		848.7	66.9	915.6	808.1	56.6	864.7
CAPITAL AND RESERVES							
Called up share capital		92.1	30.6	122.7	92.1	30.6	122.7
Profit and loss account		756.6	36.3	792.9	716.0	26.0	742.0
CAPITAL AND RESERVES		848.7	66.9	915.6	808.1	56.6	864.7

Approved on behalf of the board
J A Cuthbert C M Green
29 June 2007

(a) RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST REGULATORY ACCOUNTS
For the year ended 31 March 2007

	Statutory UK GAAP	Regulatory	Explanation of difference
	£'m	£'m	
PROFIT AND LOSS ACCOUNT			
Operating Profit	238.9	234.5	Adjustment relating to Section 19 "overlap" (£3.2m) (see note 1(a)(i)) and amortisation of infrastructure income(£1.2m)(see note 1(a)(ii))
Deferred tax charge	9.8	5.5	Adjustment relating to infrastructure grants and contributions (£1.3m) and Section 19 "overlap" (£3.0m)
BALANCE SHEET			
Tangible fixed assets (net book value)	3,008.0	2,830.2	Adjustments relating to – infrastructure grants and contributions netted off (£149.3m), Section 19 "overlap" (£30.8m) and infrastructure renewals provision (£2.4m).
Provisions for liabilities and charges – deferred tax	211.3	196.6	Adjustment relating to infrastructure grants and contributions (£4.9m) and Section 19 "overlap" (£9.8m)
Deferred income – grants and contributions	189.3	55.4	Adjustment relating to gross up (£149.3m) and amortisation (£15.4m) of infrastructure grants and contributions.

CURRENT COST PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2007

	Note	2007 £'m	2006 £'m
Turnover	2	560.7	532.0
Current cost operating costs	3	(387.8)	(363.8)
Operating income	2	2.0	1.6
Working capital adjustment	2	(0.2)	1.7
CURRENT COST OPERATING PROFIT		174.7	171.5
Net interest payable		(92.0)	(87.8)
Financing adjustment		65.5	37.6
CURRENT COST PROFIT BEFORE TAXATION		148.2	121.3
Taxation:			
Current tax		(15.9)	(22.5)
Deferred tax		(5.3)	(23.6)
CURRENT COST PROFIT ATTRIBUTABLE TO SHAREHOLDERS		127.0	75.2
Dividends		(68.6)	(33.4)
CURRENT COST PROFIT RETAINED		58.4	41.8

All note references to the summary current cost financial statements on pages 49 to 63 refer to the notes to the current cost accounts.

CURRENT COST BALANCE SHEET
At 31 March 2007

	Note	2007	2006
		£'m	£'m
FIXED ASSETS			
Tangible assets	4	12,723.2	12,075.6
Third party contributions since 1989/90		(91.5)	(86.8)
		12,631.7	11,988.8
Working capital	5	12.3	4.3
Short term deposits		253.9	57.7
Overdraft		(5.4)	(5.2)
Infrastructure renewals accrual		(0.7)	(4.2)
NET OPERATING ASSETS		12,891.8	12,041.4
NON OPERATING ASSETS AND LIABILITES			
Borrowings		(24.8)	(33.7)
Non trade debtors		5.2	3.8
Non trade creditors due within on year		(38.4)	(35.5)
Corporation tax payable		(4.4)	(9.7)
Total non operating liabilities		(62.4)	(75.1)
CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR			
Borrowings		(1,831.8)	(1,540.0)
Other creditors		(0.5)	(0.3)
Total creditors due after more than one year		(1,832.3)	(1,540.3)
PROVISIONS FOR LIABILITIES AND CHARGES			
Deferred tax provision		(188.6)	(183.1)
Other provisions		(3.1)	(3.4)
Total provisions		(191.7)	(186.5)
NET ASSETS		10,805.4	10,239.5
CAPITAL AND RESERVES			
Called up share capital		92.1	92.1
Profit and loss account		491.5	432.8
Current cost reserve	6	10,221.8	9,714.6
TOTAL CAPITAL AND RESERVES		10,805.4	10,239.5

CURRENT COST CASH FLOW STATEMENT
For the year ended 31 March 2007

	Note	2007 Appointed business	2007 Non-appointed business	2007 Aggregated basis	2006 Appointed business	2006 Non-appointed business	2006 Aggregated basis
		£'m	£'m	£'m	£'m	£'m	£'m
NET CASH FLOW FROM OPERATING ACTIVITIES	7	301.3	1.3	302.6	295.8	3.5	299.3
Returns on investments and servicing of finance							
Interest received		8.0	10.0	18.0	1.6	10.1	11.7
Interest paid		(83.3)	-	(83.3)	(85.6)	-	(85.6)
Interest in finance lease rentals		(2.8)	-	(2.8)	(2.3)	-	(2.3)
Net cashflow from returns on investments and servicing of finance		(78.1)	10.0	(68.1)	(86.3)	10.1	(76.2)
Taxation paid		(21.6)	(4.0)	(25.6)	(10.4)	(3.9)	(14.3)
Capital expenditure and financial investment							
Gross cost of purchase of fixed assets		(185.2)	(1.2)	(186.4)	(187.2)	(0.6)	(187.8)
Receipt of grants and contributions		18.6	-	18.6	21.6	-	21.6
Infrastructure renewals expenditure		(40.7)	-	(40.7)	(32.0)	-	(32.0)
Disposal of fixed assets		2.0	0.2	2.2	2.0	-	2.0
Net cash outflow from investing activities		(205.3)	(1.0)	(206.3)	(195.6)	(0.6)	(196.2)
Equity dividend paid		(68.6)	(7.0)	(75.6)	(56.4)	(6.2)	(62.6)
Management of liquid resources							
Net cash flow from management of liquid resources		(196.2)	-	(196.2)	(57.7)	-	(57.7)
NET CASH FLOW BEFORE FINANCING		(268.5)	(0.7)	(269.2)	(110.6)	2.9	(107.7)
Financing							
Capital element in finance lease rentals		(2.5)	-	(2.5)	(2.9)	-	(2.9)
New bank loans		300.0	-	300.0	210.0	-	210.0
Repayment of bank loans & debentures		(29.2)	-	(29.2)	(99.6)	-	(99.6)
Net cash inflow from financing		268.3	-	268.3	107.5	-	107.5
(DECREASE)/INCREASE IN CASH		(0.2)	(0.7)	(0.9)	(3.1)	2.9	(0.2)

NOTES TO THE REGULATORY FINANCIAL INFORMATION
For the year ended 31 March 2007

1. STATEMENT OF REGULATORY ACCOUNTING POLICIES

(a) Historical cost information

The financial statements have been prepared in accordance with regulatory accounting guidelines ("RAG") published by Ofwat. RAGs 1.04, 3.06 and 4.03 were revised in February 2007. This has resulted in revised analyses of historical cost and current cost balance sheet figures and the comparatives for 2006 have been revised to meet the new guidance.

The accounting policies set out on pages 20 to 23 apply to the historical cost regulatory financial information, with the exception of:

- capital grants and contributions to infrastructure assets which is not in accordance with the Companies Act 1985 (as described in (ii) below).
- infrastructure renewals accounting which, in accordance with RAG 3.06, has been accounted for in accordance with RAG 2.03, "Classification of Infrastructure Expenditure". RAG 2.03 is not in accordance with Financial Reporting Standard No. 12, "Provisions, Contingent Liabilities and Contingent Assets" and Financial Reporting Standard No. 15, "Tangible Fixed Assets" as described in section (i) below.

(i) Infrastructure assets

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

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

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

In accordance with RAG 3.06 the company has not applied Financial Reporting Standard No. 12, "Provisions, Contingent Liabilities and Contingent Assets" ("FRS12") and Financial Reporting Standard No. 15, "Tangible Fixed Assets" ("FRS15") in respect of infrastructure renewals accounting and has continued to charge infrastructure renewal costs (calculated in accordance with their Asset Management Plan) to the profit and loss account. Expenditure during the year is charged to the provision.

Under FRS12 it is not permitted to recognise a provision for the costs of renewals expenditure. Adoption of FRS12, taken together with FRS15, 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 2006 and 31 March 2007 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 these pipes or replacing them where relining is not possible. The "overlap" represents the extra cost of replacing pipes rather than relining them where their structural condition is insufficient to withstand the relining process. Such expenditure is included in the infrastructure renewals charge in the regulatory financial statements. The statutory financial statements classify such expenditure as capital in nature and include this under infrastructure assets in the fixed asset note, resulting in a higher profit in the statutory financial statements.

1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)

(a) Historical cost information (continued)

(ii) Grants and contributions

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

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

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

(b) Current cost information

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

(i) Tangible fixed assets

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

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

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

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

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

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

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

1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)

(b) Current cost information (continued)

(ii) Real financial capital maintenance adjustments

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

(iii) Working capital adjustment

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

(iv) Financing adjustment

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

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

	2007			2006		
	Water services	Sewerage services	Appointed business	Water services	Sewerage services	Appointed business
	£'m	£'m	£'m	£'m	£'m	£'m
Unmeasured	178.9	141.9	320.8	175.3	143.3	318.6
Measured	98.6	74.3	172.9	82.4	56.2	138.6
Trade effluent	-	2.5	2.5	-	2.4	2.4
Large user and special agreement	24.2	24.7	48.9	28.0	29.0	57.0
Non-potable large user and special agreement	9.7	-	9.7	10.2	-	10.2
Rechargeable works	0.6	0.1	0.7	0.4	-	0.4
Bulk supplies/inter company payments	0.4	-	0.4	0.4	-	0.4
Other appointed business (third party)	2.7	0.3	3.0	2.1	0.4	2.5
Other sources	0.8	1.0	1.8	0.9	1.0	1.9
Total turnover	315.9	244.8	560.7	299.7	232.3	532.0
Operating income:						
Current cost profit on disposal of fixed assets	1.9	0.1	2.0	1.4	0.2	1.6
Working capital adjustment	(0.1)	(0.1)	(0.2)	1.0	0.7	1.7

3. OPERATING COSTS

	Water services			Sewerage services			
	Resources & treatment	Distribution	**Water services subtotal**	Sewerage	Sewage treatment	Sludge treatment & disposal	**Sewerage service subtotal**
	£'m	£'m	**£'m**	£'m	£'m	£'m	**£'m**
Direct Costs							
Employment costs	8.3	7.5	**15.8**	3.8	4.3	3.2	**11.3**
Power	8.0	6.8	**14.8**	2.7	7.6	3.1	**13.4**
Hired & contracted services	1.3	6.0	**7.3**	2.3	1.0	7.9	**11.2**
Associated companies	-	-	-	-	-	0.2	**0.2**
Materials and consumables	6.4	1.0	**7.4**	0.1	0.7	1.7	**2.5**
Service charges (EA)	18.7	-	**18.7**	1.1	1.6	-	**2.7**
Bulk supply imports	0.8	-	**0.8**	-	-	-	-
Other direct costs	0.3	2.9	**3.2**	0.9	0.2	-	**1.1**
Total direct costs	43.8	24.2	**68.0**	10.9	15.4	16.1	**42.4**
General and support expenditure	10.4	14.6	**25.0**	4.4	8.4	3.0	**15.8**
Total functional expenditure	54.2	38.8	**93.0**	15.3	23.8	19.1	**58.2**
Business analysis							
Customer services			**14.3**				**6.3**
Scientific services			**6.8**				**3.1**
Other business activities			**1.2**				**0.6**
Business activities sub total			**22.3**				**10.0**
Local authority rates			**15.8**				**6.5**
Doubtful debts			**6.8**				**6.4**
Total opex less third party services			**137.9**				**81.1**
Third party services – opex			**12.1**				**7.7**
Total operating expenditure			**150.0**				**88.8**
Capital maintenance							
Infrastructure renewals charge	1.2	24.8	**26.0**	11.2	-	-	**11.2**
Current cost depreciation – service activities	7.4	34.1	**41.5**	6.2	40.8	11.8	**58.8**
- business activities			**9.2**				**4.9**
Amortisation of grants			**(0.9)**				**(1.7)**
Total capital maintenance			**75.8**				**73.2**
Total operating costs			**225.8**				**162.0**
CCA (MEA) Values							
Service activities			**6,249.7**				**6,339.2**
Business activities			**94.5**				**39.8**
Total			**6,344.2**				**6,379.0**

3. 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 2006	1,465.4	52.0	5,189.8	134.6	6,841.8
AMP adjustment	(68.2)	0.7	(55.4)	13.7	(109.2)
RPI adjustment	67.9	2.5	248.1	4.5	323.0
Disposals	-	(0.1)	-	(0.1)	(0.2)
Additions	55.0	0.5	39.8	15.4	110.7
At 31 March 2007	1,520.1	55.6	5,422.3	168.1	7,166.1
Depreciation:					
At 1 April 2006	771.7	23.4	-	81.2	876.3
AMP adjustment	(130.5)	2.8	-	(19.5)	(147.2)
RPI adjustment	38.0	1.4	-	2.8	42.2
Disposals	-	-	-	(0.1)	(0.1)
Charge for year	39.9	1.6	-	9.2	50.7
At 31 March 2007	719.1	29.2	-	73.6	821.9
Net book value at 31 March 2007	801.0	26.4	5,422.3	94.5	6,344.2
Net book value at 31 March 2006	693.7	28.6	5,189.8	53.4	5,965.5

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 2006	1,738.5	32.7	5,031.7	46.7	6,849.6
AMP adjustment	(125.3)	11.2	(28.2)	8.7	(133.6)
RPI adjustment	76.8	2.1	242.0	2.4	323.3
Disposals	-	-	-	-	-
Additions	43.2		23.2	8.3	74.7
At 31 March 2007	1,733.2	46.0	5,268.7	66.1	7,114.0
Depreciation:					
At 1 April 2006	694.4	15.2	-	29.9	739.5
AMP adjustment	(98.7)	4.9	-	(9.9)	(103.7)
RPI adjustment	33.4	0.7	-	1.4	35.5
Disposals	-	-	-	-	-
Charge for year	57.6	1.2	-	4.9	63.7
At 31 March 2007	686.7	22.0	-	26.3	735.0
Net book value at 31 March 2007	1,046.5	24.0	5,268.7	39.8	6,379.0
Net book value at 31 March 2006	1,044.1	17.5	5,031.7	16.8	6,110.1

4. TANGIBLE FIXED ASSETS (continued)

Total	Specialised operational assets	Non specialised properties	Infrastructure assets	Other tangible assets	Total
	£'m	£'m	£'m	£'m	£'m
Gross Replacement Cost:					
At 1 April 2006	3,203.9	84.7	10,221.5	181.3	13,691.4
AMP adjustment	(193.5)	11.9	(83.6)	22.4	(242.8)
RPI adjustment	144.7	4.6	490.1	6.9	646.3
Disposals	-	(0.1)	-	(0.1)	(0.2)
Additions	98.2	0.5	63.0	23.7	185.4
At 31 March 2007	3,253.3	101.6	10,691.0	234.2	14,280.1
Depreciation:					
At 1 April 2006	1,466.1	38.6	-	111.1	1,615.8
AMP adjustment	(229.2)	7.7	-	(29.4)	(250.9)
RPI adjustment	71.4	2.1	-	4.2	77.7
Disposals	-	-	-	(0.1)	(0.1)
Charge for year	97.5	2.8	-	14.1	114.4
At 31 March 2007	1,405.8	51.2	-	99.9	1,556.9
Net book value at 31 March 2007	1,847.5	50.4	10,691.0	134.3	12,723.2
Net book value at 31 March 2006	1,737.8	46.1	10,221.5	70.2	12,075.6

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

5. WORKING CAPITAL

	2007	2006
	£'m	£'m
Stocks	2.7	2.6
Trade debtors:		
- measured household	12.7	7.6
- unmeasured household	22.6	24.0
- measured non-household	11.2	9.6
- unmeasured non-household	0.5	0.7
- other	5.6	5.6
Measured income accrual	32.4	28.8
Prepayments and other debtors	39.2	22.4
Trade creditors	(5.3)	(7.4)
Deferred income – customer advance receipts	(19.2)	(18.7)
Capital creditors	(46.1)	(33.1)
Accruals and other creditors	(44.0)	(37.8)
Total working capital	12.3	4.3

6. MOVEMENT ON CURRENT COST RESERVE

	2007	2006
	£'m	£'m
At 1 April	9,714.6	9,570.4
AMP adjustment	8.1	(93.1)
RPI adjustments:		
- fixed assets	568.6	278.4
- working capital	0.2	(1.7)
- financing	(65.5)	(37.6)
- grants and third party contributions	(4.2)	(1.8)
At 31 March	10,221.8	9,714.6

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

	2007	2006
	£'m	£'m
Current cost operating profit	174.7	171.5
Working capital adjustment	0.2	(1.7)
Movement in working capital	(8.0)	(0.9)
Current cost depreciation	111.8	105.5
Current cost profit on sale of fixed assets	(2.0)	(1.6)
Infrastructure renewals charge	37.2	35.9
Other non cash profit and loss items	(12.6)	(12.9)
Net cash flow from operating activities	301.3	295.8

8. ANALYSIS OF NET DEBT FOR THE APPOINTED BUSINESS

	Interest rate risk profile			
	Fixed rate	Floating rate	Index linked	Total
	£'m	£'m	£'m	£'m
Maturity profile:				
Less than one year	19.7	5.1	-	24.8
Between one and two years	18.8	80.9	-	99.7
Between two and five years	47.4	20.2	-	67.6
Between five and twenty years	716.2	180.5	-	896.7
In more than twenty years	344.4	-	423.4	767.8
Total borrowings	1,146.5	286.7	423.4	1,856.6
Cash				(5.4)
Short term deposits				(253.9)
Net debt at 31 March 2007				1,597.3

9. DISCLOSURE OF TRANSACTIONS WITH ASSOCIATES

Services supplied by the appointee to associated companies:

		December 2006 or March 2007		2006/07
Associate	Service	Turnover	Terms of Supply	Value
		£'m		£'m
Analytical & Environmental Services Limited	Rental of laboratories and service charges	14.1	Negotiated	0.5
Vehicle Lease and Service Limited	Rental of garage and service charges	11.4	Negotiated	0.1

Services supplied to the appointee by associated companies:

		December 2006 or March 2007		2006/07
Associate	Service	Turnover	Terms of Supply	Value
		£'m		£'m
Analytical & Environmental Services Limited	Analytical and operational services	14.1	No market	8.6
Analytical & Environmental Services Limited	Courier service	14.1	Competitive letting	0.1
Northumbrian Water Group plc	Holding company charges	6.3	No market	0.6
Three Rivers Insurance Company Limited	Public liability insurance (deductible infill policy)	0.5	No market	0.5
Vehicle Lease and Service Limited	Vehicle maintenance and capital finance charge	11.4	Competitive letting	5.4

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

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

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

Amounts borrowed by the appointee from associated companies

The company has loans amounting to £1,419.4m 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 £2.5m were entered into and capital repayments of £2.5m were made. The year end finance lease creditor was £6.2m. All leases are at a fixed interest rate of 7%.

Amounts lent by the appointee to associated companies

NWL had short-term deposits with £253.9m to 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 2006	33.4
Interim paid for the year ended 31 March 2007	35.2
Total dividends paid in the year	68.6
Dividends proposed:	
Final proposed for year ended 31 March 2007	35.3

The dividends for the year, comprising the interim dividend of £35.2m and the final dividend of £35.3m, total £70.5m (2006: £66.8m). This continues the stated dividend policy of 1.9% real annual growth.

Transfers of assets and liabilities

On 31 March 2007, the business of AES, an associated company, was merged with NWL. The net assets were acquired by the company at their fair value for a total consideration of £3.8m. The assets and liabilities were reviewed fully and allocated appropriately between the appointed and non-appointed businesses. The table below summarises the assets and liabilities acquired and shows the allocation between the appointed and non-appointed businesses.

	Appointed business	Non-appointed business	Total consideration
	£'m	£'m	£'m
Tangible fixed assets	2.0	0.6	2.6
Prepayments and accrued income	1.0	0.5	1.5
Other debtors	0.2	-	0.2
Corporation tax	(0.1)	-	(0.1)
Accruals and deferred income	(0.3)	(0.1)	(0.4)
	2.8	1.0	3.8

There was no goodwill arising on acquisition.

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 2006/07 PRICES

	2006/07
	£'m
Opening regulatory capital value	2,751.0
Capital expenditure (excluding IRE)	192.1
Infrastructure renewals expenditure	35.1
Infrastructure renewals charge	(37.6)
Grants and contributions	(10.7)
Current cost depreciation	(110.3)
Out-performance adjustment	(1.9)
Closing regulatory capital value	2,817.7
Average year regulatory capital value	2,728.5

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

The numbers included above are taken from the Ofwat publication "Future Water and Sewerage Charges 2005-10 Final Determinations" published in December 2004 and are consistent with the publications RD07/05, RD08/06 and RD09/07.

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

11. STATEMENT ON DIRECTORS' PAY AND STANDARDS OF PERFORMANCE

The following statement on Directors' remuneration is a requirement for the regulatory accounts in accordance with the Water Act 2003.

The Directors' remuneration policy is set by NWL's Remuneration Committee (the Remuneration Committee) in conjunction with the Remuneration Committee of the Company's ultimate parent company, Northumbrian Water Group plc ("the Committee"). Following a review of the remuneration policy by NWG's appointed recruitment consultants, New Bridge Street Consultants LLP (NBSC), the policy followed from 1 April 2006 is as follows:

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

During the year the Committee:

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

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

Elements of remuneration

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

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	0.0	0.0	0.0	35.0	35.0
Professor Sir F G T Holliday CBE	0.0	0.0	5.0	20.2	25.2
J A Cuthbert	189.0	117.2	3.8	0.0	310.0
C M Green	140.0	90.3	6.4	0.0	236.7
G Neave	150.0	93.0	6.0	0.0	249.0
A C Jones	120.0	74.4	7.0	0.0	201.4
A G Balls	0.0	0.0	0.0	25.0	25.0
A M Frew	0.0	0.0	0.0	25.0	25.0
A J Scott-Barrett	0.0	0.0	0.0	6.9	6.9
Dr S Lyster	0.0	0.0	0.0	12.9	12.9
Total remuneration	599.0	374.9	28.2	125.0	1,127.1

(i) Executive directors: basic salary and benefits

Basic salary is the only pensionable element of the executive directors' remuneration package. The basic salaries payable to directors of NWL are not directly linked to standards of performance in connection with the carrying out of functions of a "relevant undertaker". However, executive directors' basic salaries and benefits are reviewed annually by the Remuneration Committee, taking into account the overall performance of the Company, advice from NBSC on market comparators and individual performance. Data received from NBSC has indicated that the Managing Director's basic salary is less than the median paid to his counterparts at other quoted water companies. For the second year in succession, however, John Cuthbert has declined salary increases recommended by the Remuneration Committee. He has, therefore, had no increase in his basic salary in 2006 or 2007. Benefits include membership of a defined benefit pension scheme, car allowance and healthcare.

(ii) Annual bonus

The bonus arrangements for executive directors of NWL for 2006/07 were linked to NWL's predicted performance in the Overall Performance Assessment ("OPA"), as well as the other measures described below.

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

- up to 40% related to the profit before tax performance of NWG;
- up to 5% related to NWL's predicted current year performance against industry performance taken from the latest published OPA results. The scale for calculating the 2006/07 bonus was 323-416 points, which was the reported industry performance for 2005/06;
- up to 5% related to time lost through sickness, calculated on a linear scale around the published target for the Company of 3%; and
- up to 20% related to personal targets.

The potential 5% bonus in respect of predicted OPA performance is considered to be linked directly to NWL's performance as a "relevant undertaker". The Remuneration Committee confirmed on 29 May that 2% would be payable against this measure reflecting the forecast score of 364 against a minimum target of 323 points, on a range up to 416 points.

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

(ii) Annual bonus (continued)

Of the personal targets, only those of Mr Neave and Mr Jones included targets directly linked to NWL's performance as a "relevant undertaker". Mr Neave's targets related to the continued development of employee relations to improve performance and to ensuring that NWL is a high performer in the industry for levels of service, reputation and efficiency. Of the 20% available in respect of personal targets, Mr Neave was awarded 17.5%.

Mr Jones' personal targets included three relating to the management of changes to the regulatory contract, achieving safety accreditation and enhancing the continuity planning process. Taking account of overall performance against his personal targets, the Remuneration Committee awarded Mr Jones 17.5% out of the 20% available in respect of personal targets.

Mr Cuthbert's personal targets related principally to improving the sustainability of the pension scheme, business strategy, investor relations and succession planning, as well as a range of financial matters. Mr Green's personal targets were focused mainly on funding and credit rating, the maintenance of key financial ratios and measures, and the relationships with major debt and equity investors and analysts. Of the 20% available in respect of personal targets, Mr Cuthbert was awarded 17.5% and Mr Green was awarded 20%.

Taking account of performance against personal targets and the OPA, PBT and lost time performance, bonuses equal to the percentages of basic salary indicated were approved for payment to Mr Cuthbert of 62%, Mr Green of 64.5%, Mr Neave of 62% and Mr Jones of 62%.

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

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

(iii) Pension

Directors participate in a defined benefit pension scheme which is not linked directly to NWL's performance as a "relevant undertaker". It is intended that the executive directors' pensions will be modified with effect from 1 January 2008, in line with the changes proposed for the pension scheme as a whole. It is also proposed to close the existing executive pension arrangements to new entrants on that date.

(iv) Long Term Incentive Plan

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

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

Summary of LTIP awards and performance conditions

LTIP AWARDS MADE 27 JANUARY 2004 AND 22 DECEMBER 2004	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth up to 40% of salary.
Performance conditions	Comparison of TSR with 2 comparator groups over 3 years: (1) 70% of award depends on NWG's TSR performance against other listed water companies: AWG plc, Bristol Water Group plc, East Surrey Holdings plc, Kelda Group plc, Pennon Group plc, Severn Trent plc and United Utilities plc; and (2) 30% of award depends on NWG's TSR performance against the FTSE 250 Index, excluding investment trusts. East Surrey Holdings plc de-listed on 28 October 2005 and Bristol Water Group plc de-listed on 18 May 2006. These companies have been left in the comparator group for the purpose of the awards and their performance was frozen on the date each company de-listed. This means that a constant TSR has been applied at each date after the de-listing.

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

(iv) Long Term Incentive Plan (continued)

Summary of LTIP awards and performance conditions (continued)

LTIP AWARDS MADE 27 JANUARY 2004 AND 22 DECEMBER 2004 (continued)	
Vesting schedules	(1) 30% vests at median performance with sliding scale based on ranking to 100% if NWG tops the group. Where NWG's TSR performance is below the median performance of the comparator group, none of that element of the award will vest. (2) 30% vests if NWG's TSR equals the FTSE 250 Index, increasing to 100% if NWG's TSR outperforms the Index by at least 6%. Where NWG's TSR performance is less than that of the Index, none of that element of the award will vest.
LTIP AWARD MADE 9 DECEMBER 2005	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth up to 70% of salary.
Performance conditions	As above.
Vesting schedules	(1) as above, but between median and upper quartile, the vesting will be calculated on a straight line basis comparing NWG's TSR to that of the median and upper quartile positions, rather than ranking. (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance. Where NWG's TSR performance is below the median, none of that element of the award will vest.
LTIP AWARD MADE 21 DECEMBER 2006 AND FUTURE AWARDS	
Maximum award	75% of salary permitted. Actual grants to executive directors were over shares worth up to 70% of salary.
Performance conditions	50% of award depends on NWL's relative return on capital employed compared against the relative return on capital employed of the other water and sewerage companies of England and Wales. 50% of award depends on NWG's TSR performance against the FTSE 250 Index, excluding investment trusts.
Vesting schedules	30% vests at median performance. At upper quartile or above return on capital employed, all of that half of the award will vest. Between median and upper quartile straight line pro-rating will apply. Where NWL's return on capital employed performance is below the median, none of this element of the award will vest. 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 NWG's TSR performance is below the median, none of this element of the award will vest.

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

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

- it directly compares NWL's financial performance against that of its peers;
- it is objectively measured and verified by a third party (Ofwat);
- NWL is the largest company in the Group;

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

(iv) Long Term Incentive Plan (continued)

- relative measure to which quartile analysis is applied); and
- the comparative approach should be able to deal with the five year pricing reviews without the Remuneration Committee having to reset targets.

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

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

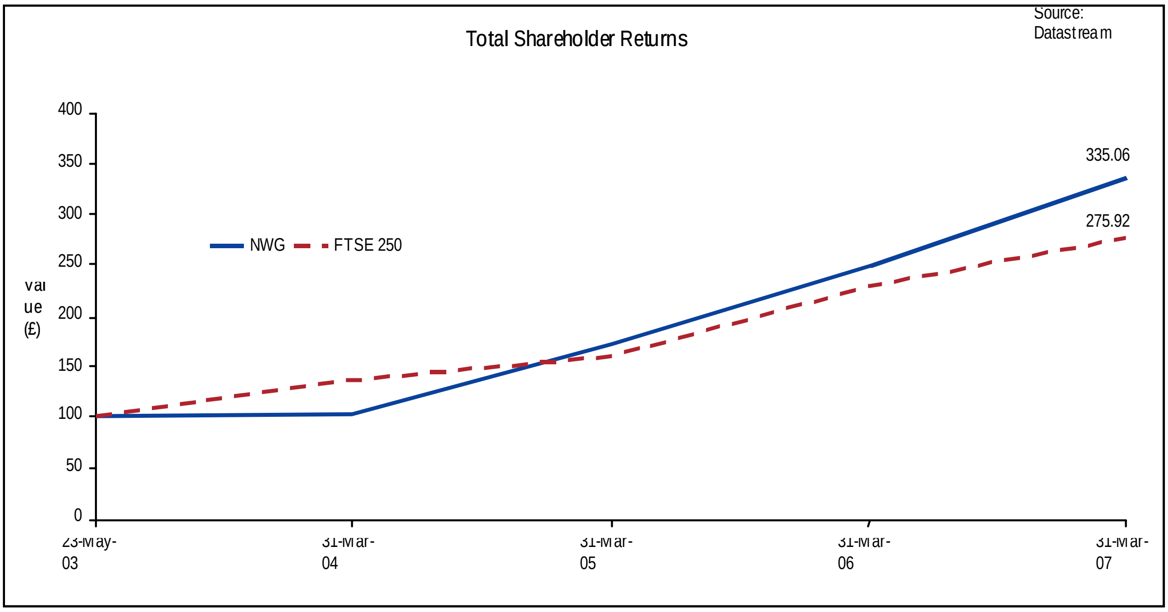
In the event of a change of control, the Committee would determine the extent to which the performance conditions had been met and the proportion of the performance period that had elapsed in deciding whether or not any vesting of awards would take place.

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

The first LTIP award, granted on 27 January 2004, became available to vest on 27 January 2007. The Committee instructed PricewaterhouseCoopers ("PWC") to assess the level of vesting of this award. PWC reported that 73% of the award was available to vest (being 100% of the award relating to NWG's TSR performance against the FTSE 250 Index and 61% of the award relating to NWG's TSR performance against the other listed water companies). Details of the number of awards which lapsed and those which were exercised by the directors of the company are shown in the table on page xx.

Performance graph

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



Note:
This graph shows the value, by 31 March 2007, of £100 invested in Northumbrian Water Group plc on 23 May 2003 compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

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

(iv) Long Term Incentive Plan (continued)

At its meeting on 30 November 2006, the Committee agreed to make conditional awards to Mr Cuthbert and Mr Green with a value equal to 70% of base salaries, and to Mr Neave and Mr Jones with a value equal to 60% of base salaries. The level of the awards was previously agreed in principle by the Committee, following detailed advice from New Bridge Street Consultants. The awards were made on 21 December 2006. The higher level of awards to Mr Cuthbert and Mr Green recognises their additional roles as executive directors of NWG.

(v) Contribution to Remuneration by NWG

NWG contributes 30% of the cost of the basic salaries, benefits, bonus and pension of Mr Cuthbert and Mr Green . NWG also contributes 50% of the cost of basic salary and benefits of the Chairman. The costs of the LTIP and SIP arrangements, for directors and all employees, are borne by NWL as the employing company, with NWG contributing a similar proportion as above for the Chairman, Mr Cuthbert and Mr Green.

(vi) Consideration of Ofwat Reports by Remuneration Committee

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

(vii) Future Targets

For 2007/08, Mr Neave and Mr Jones continue to have personal targets which relate directlyto NWL's performance as a "relevant undertaker". In Mr Neave's case this again relates to continued development of employee relations and ensuring NWL achieves high performance in the industry for levels of service, reputation and efficiency, reflected in OPA performance. Mr Jones' relevant targets relate to the June Return, the Strategic Direction Statement and the achievement of quality standards.

DIRECTORS' RESPONSIBILITIES AND DECLARATIONS
For the year ended 31 March 2007

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

(a) ensuring that proper accounting records are maintained by the Appointee to enable compliance with the requirements of Condition F and having regard also to the terms of guidelines notified by the Water Services Regulation Authority ("the Authority") to the Appointee from time to time;

(b) preparing on a consistent basis for each financial year regulatory financial statements in accordance with Condition F, having regard also to the terms of guidelines notified by the Authority from time to time, which so far as is reasonably practicable have the same content as the annual financial statements of the Appointee prepared under the Companies Act 1985 and which are prepared in accordance with the formats, accounting policies and principles which apply to those financial statements;

(c) preparing financial statements on a current cost basis in respect of the same accounting period in accordance with guidelines issued by the Authority from time to time;

(d) preparing such other financial and related information as is required by Condition F having regard also to the terms of guidelines issued by the Authority from time to time.

RING FENCING

The directors confirm that as at 31 March 2007 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 Final Determination, company performance during 2006/07, prospects for the period up to 2010, with particular reference to the next 12 months, and the fact that substantial pre-funding has been put in place in order to meet the capital investment programme in the period to 31 March 2010.

ON BEHALF OF THE BOARD

M Parker
Company Secretary

29 June 2007

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 2007 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 provided in the regulatory financial statements because the Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03 specify alternative treatment or disclosure in certain respects. Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, then they require UK GAAP to be followed. Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 1985.

Respective responsibilities of the WSRA, the directors and auditors

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

The directors' responsibilities for preparing the regulatory financial statements in accordance with the Regulatory Accounting Guidelines 1.04, 2.03, 3.06 and 4.03 are set out in the Statements of Directors' Responsibilities.

Our responsibility is to audit the regulatory financial statements in accordance with International Standards on Auditing (UK and Ireland), except as stated in the 'Basis of audit opinion' below and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities'.

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

We report our opinion as to whether the regulatory historic 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 have 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 Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06, and Regulatory Accounting Guideline 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, the Directors' Report and Operating and Financial Review and the Appendix to the Directors' Report and Operating and Financial Review.

Basis of audit opinion

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

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

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

The regulatory historical cost financial information 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 disapplied. The effect of this departure from Generally Accepted Accounting Principles and a reconciliation of the balance sheet drawn up on this basis with that drawn up under Companies Act 1985 is given in the reconciliation between the statutory financial statements and the regulatory historical cost financial information.

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 2007 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 2007 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

29 June, 2007