NORTHUMBRIAN WATER GROUP

ANNUAL REPORT & FINANCIAL STATEMENTS 2008

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Our mission

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

NWG at a glance

Northumbrian Water Group plc
Northumbrian Water Group plc (NWG) owns a number of companies which, together with NWG, form the Group. The largest of these companies, Northumbrian Water Limited (NWL), is one of the ten regulated water and sewerage businesses in England and Wales. The emphasis given to NWL, throughout this report, reflects its importance to the overall performance of the Group.

Northumbrian Water Limited
NWL operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water. Northumbrian Water currently provides water and sewerage services to 2.6 million people and Essex & Suffolk Water provides water services to 1.8 million people.

Water and waste water contracts
NWG controls a number of special purpose companies which have water and waste water contracts in Scotland, Ireland and Gibraltar.

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

Contents

Highlights

Revenue 2008 *(2007: £633.5m)*

£670.4m

Profit before interest 2008 *(2007: £247.7m)*

£277.8m

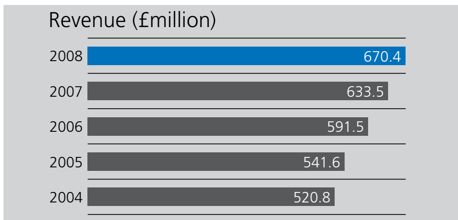
Profit before tax 2008 *(2007: £147.8m)*

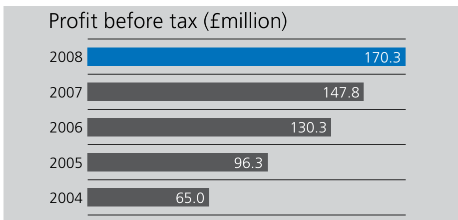
£170.3m

Profit for the year 2008 *(2007: £111.2m)*

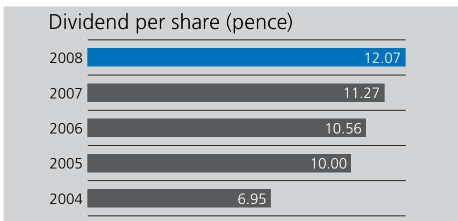
£158.3m

- Revenue increase mainly reflects the uplift in tariffs to support continuing high capital investment
- Regulated capital investment for the year of £232.6 million (2007: £225.0 million)
- Funding secured for capital programme to 2011
- Highest levels of customer satisfaction in England and Wales
- Leakage targets achieved
- Excellent drinking water and environmental performance
- Proposed final dividend of 8.07 pence (2007: 7.52 pence) per share to be paid on 12 September 2008, giving a full year ordinary dividend of 12.07 pence per share, an increase of 7.1%





(2004 – pro forma before exceptionals)



(2006 – excludes special dividend 2.82 pence)

Chairman's statement

Sir Derek Wanless.

"Our performance is in line with our targets and we are in a sound position to take the business forward"

The water industry demands careful long term planning and investment. That was brought home to us this year as we celebrated the 50th anniversary of Hanningfield reservoir in Essex, the 40th for Derwent and the 25th for Kielder, our largest reservoirs in the north east.

These anniversaries were important reminders to us of previous planning and of major investment programmes designed to secure water supplies for our customers, using our knowledge, experience and the best forecasts available at the time. There have been major changes in the world around us since the opening of Hanningfield reservoir and even Kielder. Many of these changes our predecessors could not have predicted and many new challenges need to be faced. Our current investment programmes build on their work as we deal with new standards, changing demand and the inevitable uncertainty created by external influences.

The Group continues to have a strong reputation, one that the Board believes has a significant impact on the Group's ability to raise finance, carry out its business, providing both water and waste water services, and deliver its investment programme.

During the year, the Group has successfully delivered its plans and performed well against a broad range of internal and external measures. Our performance is in line with our targets and we are in a sound position to take the business forward, without the need to increase prices by the full amount allowed by Ofwat.

We aim to continue our high levels of investment while making sure water and waste water services are affordable. We expect bills in the south to continue to be relatively low while in our northern operating area, we believe they will be the lowest in the country by 2009/10.

Every employee within the Group has contributed to these results and I would like to record my thanks to them all, for their efforts and commitment. We will continue to support them by investing in their training and development at all levels.

Sir Derek Wanless, John Mowbray and partners at the regional launch of 'Water@work' in Essex.

Another milestone was passed this year when we submitted for planning permission our plans to extend Abberton reservoir, near Colchester, in our southern operating area. This marked the culmination of over a decade of extensive investigation, consultation and working with partners to identify a solution both to the pressure on existing water resources and also to the predicted impact of increased demand.

At Abberton, and throughout our operating areas, the Group has a significant impact on the environment and we are determined to continue to improve our environmental performance to safeguard the sustainability of both our own resources and the environment where we and our customers live and work.

A constant feature of our work is our commitment to give our customers and stakeholders an excellent service and good value for money. That commitment guided our planning as we prepared our proposed strategy, as required, for the next 25 years or so. Our Strategic Direction Statements have been published as consultation documents, 'Looking to the future', with separate versions for each of our operating areas. The two regions are very different in terms of supply and demand for water, and in the services we offer, and it is right that we tailor our strategies to meet the needs of the customers and stakeholders accordingly. We have consulted widely and I am pleased to report that our proposals have been widely welcomed. We are now in the process of refining the strategy and preparing a detailed plan for the next five year price review period (2010-2015). That plan will set out the first steps towards achieving our long term goals.

'Looking to the future' builds on what has already been achieved. Our business has a firm foundation. As we go forward, our priority remains long term sustainability and we will do all we can to achieve that for the business, our investors, customers and the environment.

Sir Derek Wanless
Chairman
3 June 2008

Directors' report and business review

The NWG directors are pleased to present their report on the affairs of the Company, along with the audited financial statements and the auditors' report for the year ended 31 March 2008.

Directors
The directors are Sir Derek Wanless, Sir Patrick Brown, John Cuthbert, Chris Green, Claude Lamoureux, Martin Nègre, Alex Scott-Barrett and Jenny Williams. All were directors of the Company as at 31 March 2008 and served throughout the year.

In accordance with the Combined Code on Corporate Governance (the Combined Code) and the Company's Articles of Association (the Articles), two directors will retire by rotation and offer themselves for re-appointment at this year's annual general meeting (AGM). Those directors are Sir Patrick Brown and Martin Nègre. The directors' biographies are set out on pages 38 and 39.

Activities
The principal activities of the Group during the year were the provision of water and waste water management.


Water

1. Business strategy

Don Robson CBE and Deputy Lord Lieutenant with John Cuthbert, Managing Director, celebrating Derwent reservoir's 40th birthday.

Strategic direction

Our strategy is to focus on the Group's core competences of water and waste water management and deliver value to all our stakeholders. This provides a clear focus for our activities and our priorities are directed to achieving our mission to be the national leader in the provision of sustainable water and waste water services. Our three priorities are:

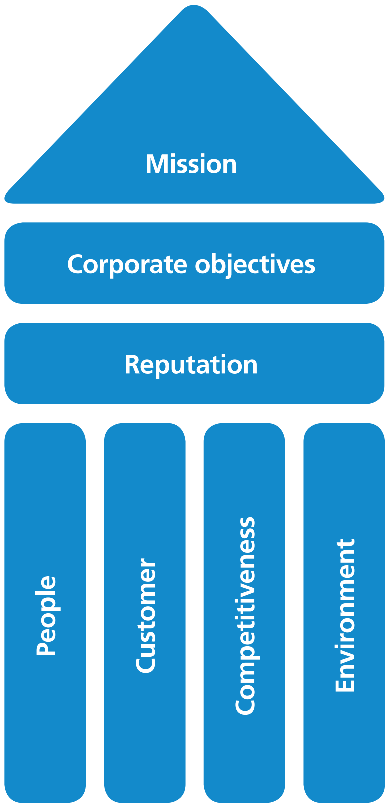
to maintain our strong reputation and relationships by:
- delivering excellent service to customers;
- delivering regulatory outputs;
- creating shareholder value; and
- involving our main stakeholder groups.

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

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

A clear framework

Our core business, NWL, has identified five key strategic themes: People, Customer, Competitiveness and Environment are important individually and also contribute to the fifth theme, Reputation. These themes drive performance and delivery of our corporate objectives. The themes are mutually supportive and achieving the right balance between them is an essential part of our success.



People
Our people are the key to business success.

Customer
Our overriding objective is to meet the needs of our customers.

Competitiveness
To grow our business and meet the challenges of a developing market we need to be competitive.

Environment
Our business is founded on water and environmental engineering and a great deal of what we do influences the environment. We recognise the impact we have on the environment and also on economic and social factors. We will seek to deliver sustainable outputs from our activities.

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

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

NWL's corporate objectives are:
- to deliver industry leading customer service;
- to be the most efficient water company;
- to be recognised as a great company to work for;
- to be the company of choice for investors; and
- to protect and enhance the natural environment.

Looking to the future

NWL consulted key stakeholders before publishing 'Looking to the future', our long term operational strategy for the next 25 years. We published two versions, one for each operational area, and they have been well received by a range of stakeholders.

In our strategy, we set out our long term aims for NWL as well as intermediate targets for the period to 2015 for the key areas of:
- customer satisfaction;
- water quality;
- availability of water;
- waste water services;
- sustainability, the environment and climate change;
- finance; and
- employees.

The strategy builds on our achievements of the past 20 years and re-affirms our commitment to long term planning and investment to deliver value to all our stakeholders.

We identified three key challenges for the future:
- maintaining and, where appropriate, improving services whilst keeping bills affordable;
- maintaining healthy and stable finances to ensure we can continue to borrow money to meet the investment needed in the business; and
- dealing with climate change. We need to further reduce greenhouse gas emissions and also future-proof our operations against a changing climate.

The full versions of 'Looking to the future' are available on our websites at www.nwl.co.uk and www.eswater.co.uk

2. Operating environment

Our external environment

The largest of NWG's businesses, NWL, operates in the north east and south east of England, each of which has its own economic profile.

The north east of England is undergoing a period of modest economic growth. There is a declining industrial customer base and, consequently, a reducing industrial demand for water but a growing demand from domestic customers. NWL, with resources such as Kielder Water, has sufficient water to meet anticipated demand and, compared to the rest of England and Wales, benefits from above average rainfall in the region.

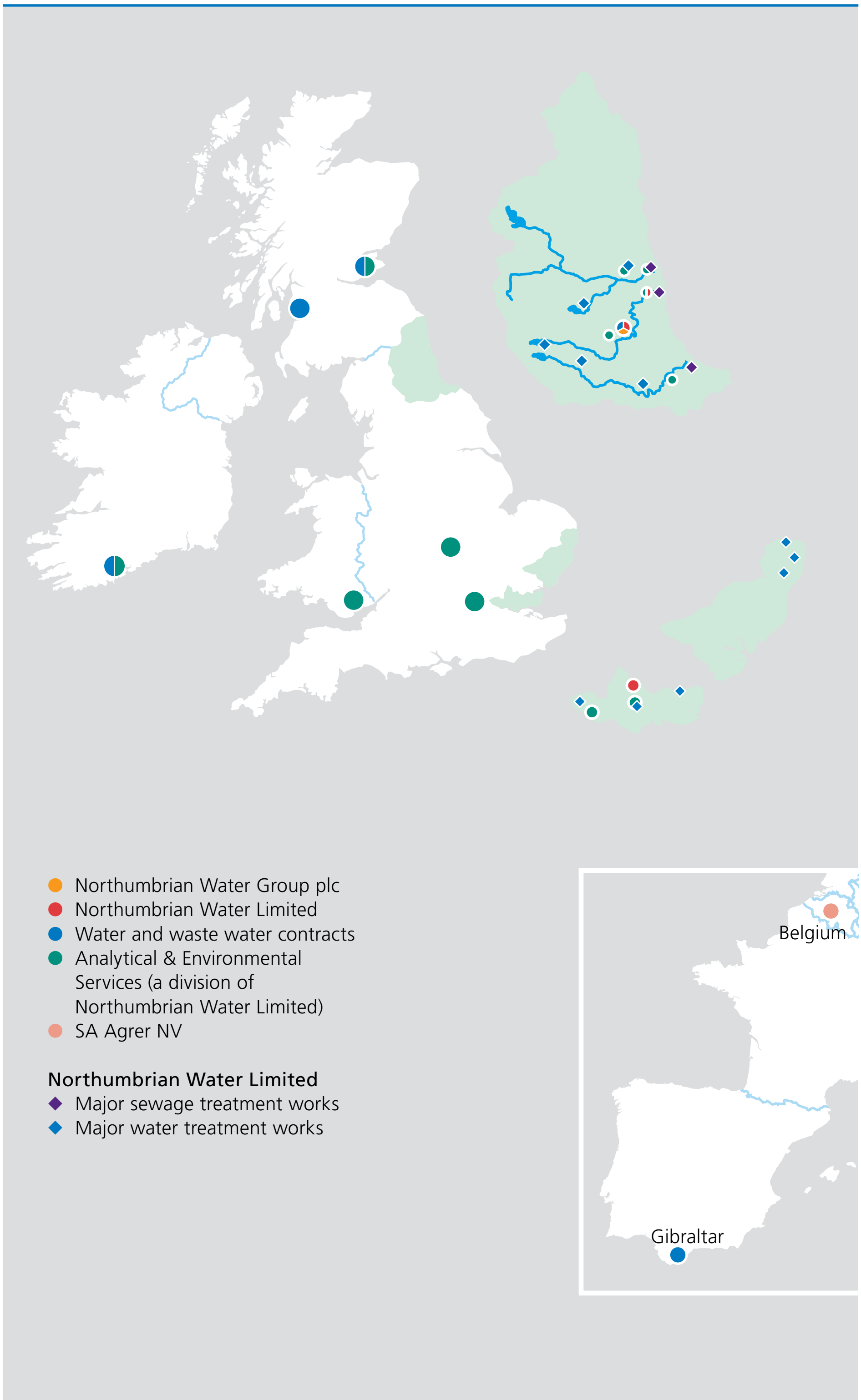
In contrast, NWL's southern operating area is in a region that is continuing to experience economic and population growth although it, too, has seen a reduction in demand from heavy industry. NWL has been implementing long term plans to maintain the availability of water supplies to meet additional demand in a region where water resources are already constrained.

Regulatory environment

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

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

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



Hanningfield reservoir in Essex.

Putting customers first

We have only increased our prices by inflation for 2008/09 and have not used the 1% real increase that Ofwat's price limits allow. This is the second consecutive year in which we have not implemented the maximum price increase.

We have already stated that we do not intend to use the increase allowed by Ofwat in 2009/10 and average bills will, again, only rise by inflation.

By 2010, we expect our combined water and sewerage bill in the north east to be the lowest in the country and, in our Essex and Suffolk region, our water bills will compare favourably with other local suppliers.

We will submit our draft business plan covering the period from April 2010 to March 2015 to Ofwat in August 2008 and this will set out the short term actions to deliver our 25 year strategy published in 'Looking to the future'.

Our significant investment programme will continue to deliver high levels of service to our customers and value to our stakeholders. However, there will be a significant switch from achieving new quality standards to maintaining the high standards already achieved. We will also be working to tackle the challenges posed by climate change and also to improve the resilience of our assets. We believe we are well placed to deliver these objectives and aim to keep prices low without compromising our ability to deliver safe and secure water supplies and our commitment to protect the environment.

There was a recurrent theme of long term planning last year and we welcome the Department for Environment, Food and Rural Affairs' (Defra) 'Future Water' strategy document. This reinforces the need to plan for the long term, in order to address climate change and sustainability, while still maintaining the ability to deliver a service to customers at an affordable price.

During the year, many parts of the country suffered from significant flooding. We support Defra's call for an integrated approach to flooding in the UK, with the relevant agencies working together more closely to produce a sustainable response to this increasing problem. We also support the proposal in the Defra strategy to ban phosphates from domestic detergents and agree that more action is needed on diffuse pollution.

Our regulators have a key role to play in securing the sustainable future of water services and we would welcome a regulatory framework that sufficiently incentivises companies to invest in securing future water objectives.

The current pressures within the financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance (such as index linked bonds) and a significant increase in the cost of corporate debt. It is not clear how long current difficult market conditions will persist. Given the financing we have in place, we are well placed to ride out short term volatility in debt markets. We do not need to raise new debt before 2011 although we would consider raising debt earlier if favourable market conditions returned. However, even when liquidity is restored and more normal conditions prevail, it is highly unlikely that there will be any return to the exceptionally low cost of debt experienced from late 2005 to early 2007.

We welcome Ofwat's decision to launch a wider review of the opportunities for extending the scope for competition and also the review commissioned by Defra. These reviews are likely to consider the possibility of new legislation and more radical structural measures. We believe it is right to engage in a full public debate on these issues.

2. Operating environment continued

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

Protecting supplies to customers is a high priority and we are making good progress with the development of our 'Water Safety Plan'. This is required by the DWI in October 2008 and will further reinforce our commitment to maintain high standards throughout NWL.


One of NWL's distribution technicians, Allan Southern, using a hand-held computer in the field.

With increasing emphasis being given to climate change and the need to reduce carbon, NWL applied to the EA to reduce ultraviolet (UV) disinfection at a number of waste water treatment works outside the bathing water season.

These treatment works discharge intensively treated effluent through long sea outfalls. The final stage of the treatment is UV disinfection which is an energy intensive process that produces significant CO_2 emissions. Our detailed modelling demonstrates that the highest EU Bathing Water standards can still be achieved without UV treatment. Since beaches are used much less in winter, and there is virtually no bathing, we applied to amend our consents to implement UV disinfection only in the summer months.

The EA has recently confirmed the consents to be amended following a detailed study that has been reviewed by leading independent experts. We welcome this decision and see it as an example of good regulation which takes into account the wider environmental impact.

The EA will need to consider similar issues reconciling the conflicting demands of water quality with climate change issues in applying the Water Framework Directive.

Another feature of good regulation is the move to risk based approaches. We are keen to move forward with the EA's Operator Self Monitoring scheme from April 2009. This will allow us to sample and analyse results from sewage treatment works, as we already do with water treatment works. We believe this is consistent with 'Better Regulation' principles and will be a more efficient way of working.

We continue to play a part in policy groups and those working on implementation and, for example, are an active member of the Northumbria River Basin Liaison Panel.

Our customers

Domestic customers

Our relationship with our customers is vital to the success of our business. Our reputation for providing value for money and working to maintain high levels of customer satisfaction has undoubtedly helped achieve a positive response to our appeals to use water carefully.

We keep our customers informed about our activities through leaflets sent out with bills and also through an annual magazine called 'Source'. Customers also have access to a range of information about our services and any supply issues on our websites at www.nwl.co.uk and www.eswater.co.uk

Customers directly affected by our work receive prior notification explaining the need for, and timing of, the work. We also communicate with local communities through public meetings and written material when we need to explain the impact of work we are planning to start.

We carry out regular surveys and focus group research to understand our customers' needs, their perceptions of our service and its value for money. Affordability and value for money are important to our customers and are, therefore, key issues for the business.

Business customers

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

NWL has long-standing relationships with its key industrial and commercial customers in the areas in which it serves. The north east, in particular, has a strong industrial base and existing customers and potential investors in the region value the availability of not only high quality potable and raw water but also access to reliable effluent treatment services.

Stakeholder relations

NWG has a code of ethics, 'Our Code of Conduct', covering its relationships with customers, employees, suppliers, local communities, shareholders, other investors and regulators. NWG meets with its stakeholders regularly and also communicates by printed and electronic forms of communication and through the media.

National

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

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

Political

We do not support any political party and we do not, directly or through any subsidiary, make what are commonly regarded as donations to any political party or other political organisations. 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 parties and political organisations. These activities include attending Party Conferences, as these provide the best opportunity to meet a range of stakeholders, both national and local, to explain our activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during 2007/08 were as follows:

Name of political party/political organisation other than political party	£
Labour	7,420
Liberal Democrat	1,236
Conservative	3,615
Total	12,271

Shareholder authority to permit the Company to continue with these activities until the 2009 AGM will be sought at this year's AGM. During the year, the Group's work with politicians of all parties, officials and opinion formers included making representations on issues which NWG feels are important to our customers and communities such as abstraction charges, Water for health, climate change, the Water Framework Directive and legislative issues which could affect our customers.

Doug Henderson MP finds out more about Northumbrian Water's GLOBE programme from Director of Corporate Affairs John Mowbray and pupils of Gosforth High School, Newcastle.

DIRECTORS' REPORT AND BUSINESS REVIEW

2. Operating environment continued

Kriss Akabusi at NWL's southern area Skills Awards, celebrating employees' academic achievements.

Our investors

Our main communication with shareholders is through the publication of the annual report and financial statements, half yearly reports, interim management statements and through information on the Company's website. In addition, the executive directors have regular contact with the Company's large institutional investors, as well as giving presentations to analysts and stockbrokers. During the year, the executive directors met 25 times with a range of institutional investors. Further information on NWG's shareholder relations is contained in the corporate governance report on page 45.

Employees

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

Northern customer advisor Anne-Marie Burke receiving her NVQ from Kriss Akabusi and John Cuthbert.

Equal opportunities

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

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

Consultation

Each company engages with its employees through formal consultation processes. These ensure that all employees understand and have the opportunity to discuss issues which affect the company. NWL has recently adopted a new, more representative, employee relations framework.

Training and development

All Group companies train and develop their 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 Group's goals and policies.

Communication

The Group uses a wide range of communication methods, including team briefing, magazines, newsletters, intranet, noticeboards and regular team meetings. 'Unplugged', the Group magazine, contains articles on activities and news from across the business, focusing on employees and their achievements.

Disclosure (Whistleblowing)

The Group encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be illegal or unethical. During the year, the Audit Committee reviewed and updated its Disclosure Policy in accordance with best practice. The

Committee continues to monitor the effectiveness of the policy.

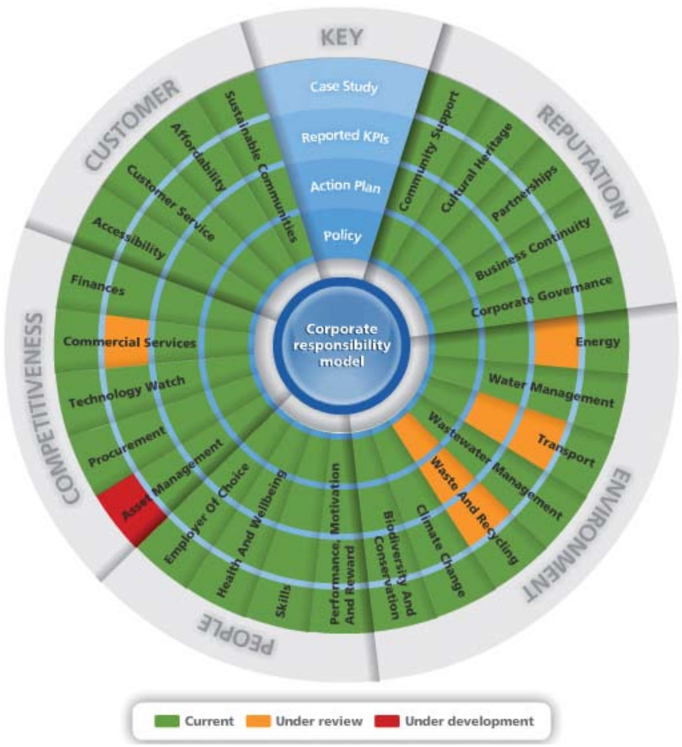
Health and safety
A safe working environment is given high priority across the Group. The health and safety policy is maintained and implemented through each subsidiary's individual health and safety team.

Employee Share Incentive Plan (SIP)
The directors believe that employee investment strengthens the ties between the Group and its employees. More than a third participate in the SIP, with an interest in 0.4% of the issued share capital. The scheme provides one free matching share for every three shares bought by an employee. Shares for the SIP are purchased at market price by the Trustee, and dividends are paid in cash directly to participants. There are no performance conditions attached to the SIP, but free shares not held in trust for at least 12 months are forfeited.

Corporate responsibility
NWL is expected to provide a secure supply of water – a basic necessity for health – and to protect or enhance the environment when we return waste to it. However, our stakeholders also expect us to:
- behave fairly and responsibly;
- use resources wisely;
- improve quality of life; and
- contribute to economic development.

NWG takes its corporate responsibilities seriously. Our aim of balancing social and environmental priorities underpins all our activities and is an integral part of the way we do business.

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



NWL's corporate responsibility model.

The Managing Director is directly accountable to the NWL and NWG boards for both the environment and sustainable development policies.

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

The Corporate Responsibility Committee (CRC) is a subcommittee of the NWL board and comprises non-executive directors, management team members and senior managers from the business. The CRC is responsible for policy review and agreeing and monitoring the targets and activities for our corporate responsibility themes.

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

DIRECTORS' REPORT AND BUSINESS REVIEW

3. Financial performance

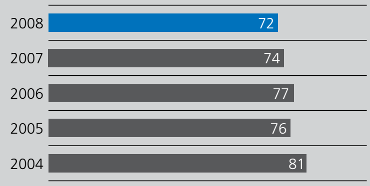
NWG and its subsidiaries use a range of indicators to monitor performance. For NWG, the key performance indicators (KPIs) are all financial. The non-financial KPIs relating to NWL are summarised on page 31. The definition, purpose and source of each KPI are shown on pages 36 and 37.

Performance against the financial KPIs is set out below:

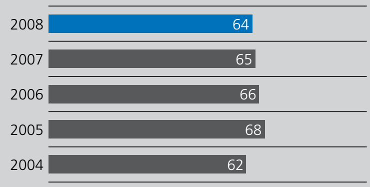
			Performance			
	Target		Current year		Previous year	
KPI	NWG	NWL	NWG	NWL	NWG	NWL
Gearing to RCV[2]	<80%	<70%[1]	72%	64%	74%	65%
Cash interest cover	>2.5x	>3.0x	3.1x	3.9x	2.9x	3.6x
Cash flow to net debt	>13%	>13%	16%	17%	15%	16%

Notes:
1. Less than 65% for the regulated business of NWL.
2. NWL's Regulatory Capital Value (RCV), as advised by Ofwat, at 31 March 2008 was £2,976 million (2007: £2,817 million).

NWG's gearing to RCV (%)



NWL's gearing to RCV (%)



The increase in cash interest cover for the year reflects the positive cash effects of the index linked bond issuance since September 2005.

The Group's gearing has decreased from 74% to 72% of NWL's RCV, with net debt increasing by £70.8 million to £2,150.4 million over the year. The decrease in the Group's gearing is principally due to the growth in the RCV over the year from £2,817 million to £2,976 million at 31 March 2008. For the regulated business within NWL, gearing remained stable at 58%.

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

The Group also prepares detailed medium term business plans and annual budgets, which are reviewed and submitted to the Board for approval. Targets are set to measure performance and regular financial forecasts are made. Business plans and budgets include an assessment of the key risks and success factors facing each business unit. On a monthly basis, management compares the actual operational and financial performance of each business with plan and budget and this is reported to the Board.

Financial results and dividends

	Year to 31.3.2008 £m
Profit for the year	158.3
Interim dividend paid (ordinary – 4.00 pence per share)	20.7
Final dividend proposed (ordinary – 8.07 pence per share)	41.8

Revenue for the year to 31 March 2008 was £670.4 million (2007: £633.5 million). This 5.8% increase is mainly due to the uplift in water and sewerage tariffs at NWL, the Group's principal subsidiary.

"gearing remained stable"

"minimise energy usage"

Lamesley reed beds near Gateshead.

Profit on ordinary activities before interest for the year was £277.8 million (2007: £247.7 million). Operating costs increased by £6.8 million (1.8%) to £392.6 million. At NWL, operating costs have increased from £353.1 million to £356.0 million. This increase reflects the impact of inflation on operating costs and increased depreciation due to the capital investment programme, although these have been partially offset by reduced energy costs and other efficiencies. Operating costs for the appointed business in 2007/08 are £1.4 million lower than those estimated in the 2004 final determination for the year. Within water and waste water contracts, the results for 2007 included a credit of £3.0 million in respect of gas indexation on tariffs.

Operating costs continue to be dominated by energy prices and, in particular, by the volatility in prices seen over recent years. Energy prices for 2007/08 fell back from the previous year to levels close to those assumed by Ofwat when setting prices. However, there has subsequently been a dramatic increase in energy prices – almost doubling from the low point of February 2007. This will add more than £8.0 million to NWL's operating costs in 2008/09, despite continuous efforts to minimise energy usage.

The net interest charge was £108.0 million (2007: £100.7 million). This charge includes a credit of £6.1 million (2007: £7.7 million) in respect of the amortisation of the debt fair value. The 2007 charge includes a gain of £2.9 million from the cancellation of a financial instrument.

DIRECTORS' REPORT AND BUSINESS REVIEW

3. Financial performance continued

Managing Director John Cuthbert presenting at our 'Water for living' conference.

Profit on ordinary activities before tax for the year was £170.3 million, 15.2% higher than the previous year (2007: £147.8 million). The current tax charge of £25.6 million (2007: £8.6 million) reflects increased profitability and the impact of changes in tax rules on capitalised maintenance expenditure, offset by tax relief for the prepayment of pension contributions between March 2006 and April 2007. The deferred tax credit was £13.6 million (2007: charge, £28.0 million). During the year, the tax rate change from 30% to 28% was enacted and this results in a one-off credit to the income statement of £35.4 million. Excluding this one-off credit, the effective tax rate for the year to 31 March 2008 was 28% (2007: 25%).

Earnings per share and dividend cover

Basic and diluted earnings per share were 30.52 pence (2007: 21.42 pence) and 30.48 pence (2007: 21.38 pence) respectively. Earnings per share from continuing operations, adjusted for IAS 39, deferred tax and the amortisation of debt fair value, were 26.72 pence (2007: 24.95 pence).

A final dividend of 8.07 pence per share for the year ended 31 March 2008 will be recommended by the Board to shareholders at the AGM on 31 July 2008 and, if approved, will be paid on 12 September 2008 to shareholders on the Company's Register of Members at the close of business on 15 August 2008. Together with the ordinary interim dividend of 4.00 pence per share, the ordinary dividends paid and proposed for the year will be 12.07 pence per share (2007: 11.27 pence per share). This represents an increase of 7.1% on the ordinary dividend for the previous year and is consistent with the Board's decision to maintain a progressive dividend policy with real increases of around 3% per annum. The board of our main subsidiary, NWL, has proposed a dividend policy consistent with the underlying assumptions adopted by Ofwat at its price review in 2004.

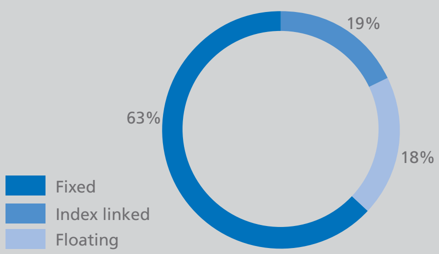
The dividend cover for the year is 2.7x (2007: 1.9x) and 2.3x (2007: 2.3x) excluding deferred tax and the amortisation of debt fair value.

Northumbrian Water Share Scheme Trustees Limited, which at the date of this report held 443,507 shares to be used in the future to satisfy the vesting and exercise of awards under the Company's Long Term Incentive Plan (LTIP), has waived the right to all dividends on the shares it holds. Further details of the LTIP can be found in the directors' remuneration report on page 48.

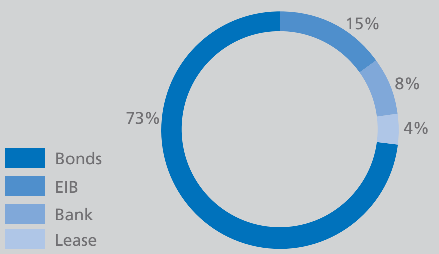
Accounting policies

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS). This is consistent with IFRS as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2008.

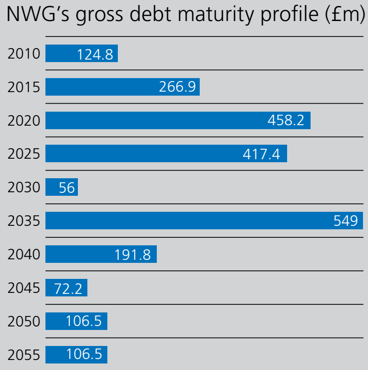
NWG interest structure



NWG funding source



NWG's gross debt maturity profile (£m)



Capital structure

In March 2008, NWL entered into a new £28.6 million long term finance lease for relined infrastructure assets. The lease is at variable rates linked to RPI and has a final maturity of March 2043.

In May 2008, the European Investment Bank (EIB) agreed an additional £120.0 million facility with NWL. This offers NWL attractive funding and will be drawn before May 2009.

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 policy

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

It also invests any surplus funds the Group may have, based on its forecast requirements and in accordance with the Group's treasury policy. On occasions, derivatives are used as part of this process, but the Group's policies prohibit their use for speculation. Full details are provided in note 20 to the financial statements. The Group is operating in compliance with its policies.

Cash flow/liquidity

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

Pensions

The Group operates a defined benefit pension scheme providing benefits based on pensionable remuneration. As at 31 March 2008, there were 2,391 (2007: 2,310) active members.

After consultation with employees and the trade unions, NWG closed the final salary scheme to new entrants on 1 January 2008, raised the employee contribution for existing members by 2% in April 2008 and changed the benefit structure. This will reduce the risk associated with the scheme. In addition, on 1 January 2008, a defined contribution scheme was introduced which will be offered to new employees. The pension scheme surplus under IAS 19, at 31 March 2008, was £90.5 million (2007: £42.7 million).

Creditors

The Company's policy is to agree payment terms with suppliers and to pay on time according to those agreed terms. In the absence of alternative agreement, the policy is to make payment not more than 30 days after receipt of a valid invoice. The ratio, expressed in days, between the amount invoiced by its suppliers during the year and the amount owed to its trade creditors at 31 March 2008, was 13 days (2007: 5 days).

Structure of the Company's share capital

The authorised share capital of the Company is £70,000,000 divided into 700,000,000 ordinary shares of 10 pence each. As at 31 March 2008, the Company had 518,623,845 ordinary 10 pence shares admitted to trading.

Rights and obligations attaching to the shares

The rights attaching to the shares in the Company are set out in the Articles, which may be changed with the approval of the shareholders. Subject to the provisions of the Companies Acts, shares may be issued with or have attached thereto such preferred, deferred, qualified or other rights or such restrictions, whether in regard to

3. Financial performance continued

dividend, voting, return of capital or otherwise, as the Company may by ordinary resolution determine or, if there has not been any such determination, as the Board may determine.

Shareholders are entitled to requisition a general meeting of the Company and to attend, vote and speak at general meetings, in accordance with the Companies Acts and the Articles. Shareholders have the right to appoint proxies.

Restrictions on the transfer of shares

Any shareholder may transfer a Certificated Share, as defined in the Articles, by an instrument of transfer in the usual form or in such other form as the Board may approve. However, the transfer of an Uncertificated Share, as defined in the Articles, need not be in writing and shall comply with any rules adopted by the Board under Article 13.7. The Board may, however, in its absolute discretion and without assigning any reason, decline to register any transfer of any share that is not a fully paid up share or on which the Company has a lien, provided that such discretion may not be exercised in such a way as to prevent dealings in the shares from taking place on an open and proper basis. The Board may also decline to register any transfer unless:

1. in the case of a certificated share, the instrument of transfer, duly stamped, is lodged with the Company accompanied by the certificate for the shares to which it relates, and such other evidence as the Board may reasonably require to show the right of the transferor to make the transfer;
2. in the case of a certificated share, the instrument of transfer is in respect of only one class of share; and
3. in the case of a transfer to joint holders of a certificated or uncertificated share, the number of joint holders to whom the share is to be transferred does not exceed four.

If the share to be transferred is an uncertificated share, the Board may refuse to register a transfer if the Uncertificated Securities Regulations 2001 allow it to do so.

Additionally, where a member or other person on whom a Disclosure Notice has been served (pursuant to s793 of the Companies Act 2006) and has not, within the period specified, supplied to the Company the information required in respect of any shares, the Board may impose a sanction declining to register any transfer of shares, other than a sale to a bona fide unconnected third party.

Significant shareholdings

Details of shareholders with significant holdings in the Company's issued share capital are set out below:

	Number of shares at 31 March 2008	**% share capital**	Number of shares at 3 June 2008	% share capital
Ontario Teachers' Pension Plan Board	**135,076,222**	**26.05**	135,076,222	26.05
Amvescap PLC	**70,426,175**	**13.58**	66,740,469	12.87
Pictet Asset Management SA	**35,951,056**	**6.93**	35,811,320	6.91
Legal & General Investment Management Ltd	**17,817,398**	**3.44**	18,311,394	3.53

SIP voting rights

Employees participating in the SIP are given the opportunity to exercise their voting rights through the Trustee of the SIP.

Restrictions on voting rights

In accordance with the Company's Articles, no member shall, unless the Board otherwise determines, be entitled to be present or to vote, either personally or by proxy, unless all calls or other sums presently payable by him in respect of shares in the Company have been paid.

Additionally, where a member or other person on whom a Disclosure Notice (pursuant to s793 of the Companies Act 2006) has been served and has not, within the period specified, supplied to the Company the information required in respect of any shares, the Board may impose a sanction preventing the member from attending and voting at any general meeting.

Shares required to fulfil vested awards made under the Northumbrian Water Group plc Employee Trust are acquired through Northumbrian Water Share Scheme Trustees Limited. In line with ABI guidelines, dividends and voting rights are waived on these shares. At 31 March 2008, the Employee Trust held a total of 443,507 shares.

The deadline for delivering either written or electronic proxy voting forms is 48 hours before the appointed time of the meeting.

Appointment and replacement of directors

The Company may by ordinary resolution appoint any person to be a director. Any director appointed shall hold office only until the next following AGM and shall then be eligible for re-appointment, but shall not be taken into account in determining the number of directors who are to retire by rotation at such meeting. A director retiring by rotation at an AGM shall be eligible for re-appointment. Details of the directors retiring by rotation at this year's AGM are set out in the Notice of Meeting.

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The work of the Nomination Committee is described in the corporate governance report.

The Company may by special resolution, or by ordinary resolution of which special notice has been given in accordance with the provisions of the Companies Acts, remove any director before the expiration of his period of office and may by ordinary resolution appoint another person in his place. Any person so appointed shall be subject to retirement at the same time as if he had become a director on the day on which the director in whose place he is appointed was last appointed a director.

Amendments to the Company's Articles

The Company may amend its Articles by passing a special resolution of its members. The Company will be proposing a Special Resolution at this year's AGM to adopt new Articles. The proposed changes are explained in the Appendix to the Notice of Meeting.

Powers of the Board

The Articles provide that the business of the Company shall be managed by the Board, which may exercise all such powers of the Company as are not required (by the Companies Acts or the Articles) to be exercised by the Company in general meeting. Subject to the Companies Acts, the Memorandum of Association, the Articles and any directions given by special resolution, the Board may, inter alia:

- establish local or divisional boards or agencies to manage any of the Company's affairs and appoint any persons to be members of such local or divisional boards, or agents, and fix their remuneration;
- appoint attorney(s) for such purposes and with such powers, authorities and discretions and for such period and subject to such terms and conditions as it may think fit;
- delegate its powers to any director;
- sign, draw, accept, endorse or otherwise execute all cheques, promissory notes, drafts, bills of exchange and other instruments and all receipts for moneys paid to the Company in such manner as the Board shall from time to time determine;
- exercise all of the powers of the Company to grant and pay pensions, annuities, gratuities, superannuation or other allowances and benefits in favour of any person; and
- exercise all the powers of the Company to borrow money and to mortgage or charge all or any part of the undertaking, property and assets and uncalled capital of the Company and to issue debentures and other securities for any debt, liability or obligation of the Company or of any third party.

Allotment of shares

Subject to the provision of the Companies Acts, the Articles and any authorising resolutions passed in general meeting, the unissued shares of the Company shall be at the disposal of the Board, which may offer, allot, grant options over or otherwise dispose of them to such persons, at such times, for such consideration and upon such terms and conditions as the Board may determine. The directors are not currently authorised to allot shares and the Company will not be seeking authority from shareholders at this year's AGM for the directors to allot shares during the ensuing year.

Purchase of own shares

Subject to the provisions of the Companies Acts and the Articles and to any confirmation or consent required by law, the Company may from time to time purchase its own shares. The Company is not currently authorised to purchase its own shares and will not be seeking authority from shareholders at this year's AGM to purchase its own shares during the ensuing year.

Significant agreements

As at 31 March 2008, NWL had £356.0 million of loans provided by the EIB and the applicable terms include change of control clauses. If, after consultation with NWL, the EIB is of the opinion that a change of control has had or is likely to have a material adverse effect, then the EIB could seek early repayment of the loans plus, in certain circumstances, a premium.

DIRECTORS' REPORT AND BUSINESS REVIEW

4. Operational performance

NWL uses a range of indicators to monitor performance. In addition to the financial indicators shown on page 14, NWL also uses non-financial indicators throughout the business. Performance against these indicators is reviewed by the management team each month. The definition, purpose and source of the main KPIs are shown on pages 36 and 37.

NWL performance against non-financial KPIs (unaudited) is shown in each section.

Southern customer advisor, Hannah Turrell.

Customer satisfaction/attitudes

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Customer satisfaction					
Overall service (%)	N/S	90	Maintain	89	92
Value for money (%)	N/S	85	Maintain	83	87

NWL carries out regular quarterly tracking surveys of domestic customers and, during the year, customer satisfaction levels remained very high, with 91% of customers satisfied or very satisfied with the service NWL provides and 86% feeling it provides value for money.

CCWater has carried out its second annual survey for domestic customers on a number of key themes, including value for money. This year's survey again concluded that, of all water companies' customers, ours are the most satisfied with the fairness of charges and value for money.

During the year, NWL carried out specific research for the Periodic Review of prices which identified the 'stated preference' of customers for service improvement as well as willingness to pay for them. This research also confirmed that the level of customer satisfaction is very high with the following major points communicated from the research:

- Over 40% of customers do not require any improvements in service.
- Where customers would like to see improvements, the willingness to pay more to achieve these improvements is limited (for 2010 to 2015 this was on average about £13 per year above inflation, for the north, on the combined water and sewerage bill and about £10 above inflation, on the water bill for the south).
- This average is affected significantly by some customers, mainly those on higher incomes, who are willing to pay more.
- Around one in five customers are not willing to pay any more.

We will consider those points when we submit our 'Draft Business Plan', which is to be published in August 2008.

Domestic customers

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Customer – levels of service					
Properties at risk of low pressure	N	274	274	181	298
	S	126	126	60	130
Properties subject to unplanned interruption of 6 hours or more	N	3,000	3,000	3,318	20,389[1]
	S	2,000	2,000	3,405	3,967
Properties subject to hosepipe bans at any time during the year	N/S	0	0	0	0
Properties subject to sewer flooding incidents (other causes)	N	150	150	290	183
Properties at risk of sewer flooding incidents (once in ten years)	N	183	78	125	116
Properties at risk of sewer flooding incidents (twice in ten years)	N	331	51	329	229
Billing contacts responded to (within five working days) (%)	N	99.2	99.0	99.3	99.3
	S	99.2	99.0	99.6	99.2
Written complaints responded to (within ten working days) (%)	N	99.8	99.8	99.9	99.9
	S	99.8	99.8	99.7	99.9
Bills based on meter readings (%)	N	99.95	99.95	99.80	99.84
	S	99.95	99.95	99.96	99.94
All telephone lines busy (%)	N	0.25	0.25	0.03	0.20
	S	0.25	0.25	0	0
Abandoned telephone calls (%)	N	2.5	2.5	2.8	3.2
	S	2.5	2.5	3.3	2.3

Notes:
1. Performance affected by two major bursts, one in Middlesbrough on Teesside and one in Bedlington in Northumberland.

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

During 2007/08, we responded to a total number of 11,312 written complaints, slightly fewer than the previous year. The number of complaints we received about operational concerns reduced significantly because no major incidents occurred throughout the year. As a consequence of heightened national media interest in utility bills, we did receive an increased number of complaints despite the fact that our charges remain among the lowest in the country. We also continue to maintain a robust approach to debt recovery which inevitably generates contact from customers in arrears. Overall, over 99.8% of all written complaints were answered in ten working days.

As a key part of its work representing customers, CCWater formally reviews the quality of complaints handling. During this process it audits procedures, tracks samples of complaints correspondence through our systems and assesses the quality of our responses. In 2007/08, 97% of all complaints assessed were rated as ‘good’.

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

Business customers

NWL continues to develop its business with major companies in the north east. We have worked closely with Newcastle International Airport to divert trunk mains to allow the airport’s further development. In addition, NWL’s Pipeline Solutions business completed a strategic mains replacement project for Durham Tees Valley Airport.

We also continue to provide expert industrial effluent treatment services through our major works at Bran Sands on Teesside and worked collaboratively with partners to deliver commercial and environmental outcomes. Huntsman Polyurethanes, an existing customer at Bran Sands, worked in conjunction with NWL and the EA to implement a process change at its Wilton site. This change will bring about major improvements in safe handling and in the environmental performance of the effluents discharged from the site.

NWL has also worked with Degussa, an existing customer, to assess the opportunities for the disposal of the liquid wastes generated on its site. We have assessed a number of these and two additional waste streams are now discharged via a pipeline to Bran Sands under the terms of its contract.

We successfully completed a project to provide a supplementary raw water supply service to Teesside Power Station at Wilton. The power station now has increased security of supply as a result of the new connection to NWL’s

DIRECTORS' REPORT AND BUSINESS REVIEW

4. Operational performance continued

network. The majority of the water NWL supplies is used for cooling the electricity generating equipment.

In another important area, NWL is working with the regional NHS Trusts to improve and extend contingency plans for hospitals and other medical sites in the region to protect water supplies in the event of an emergency.

In addition, we have held a number of seminars and briefing sessions to refresh customers' knowledge and awareness on issues such as water regulations and monitoring for legionella. This service, together with account management, has been widely commended by our customers.

On 31 March 2007, we created a new Scientific Services team within NWL by integrating the Analytical and Environmental Services (AES) business within the NWL water and waste water compliance teams. We retained the AES name for accreditation and commercial purposes. Scientific Services has continued to grow and, during the year, won new contracts with blue chip clients including the EA, the Spanish EPA, British Energy, Castle Cement, English Heritage, Durham University, local health trusts and Sembcorp.

Leisure customers

NWL is one of the founding members of Kielder Water and Forest Park Development Trust, which will replace the Kielder Partnership, which seeks to promote sustainable development, recreation, access and leisure, education, infrastructure and a range of other charitable purposes at Kielder and in the surrounding area. The Trust is seeking registration as a charity and it will be chaired by John Cuthbert, Managing Director.

The development of Kielder Water and Forest Park is supported by the Northumberland Strategic Partnership, Government Office Northeast and One NorthEast and, during 2007/08, nearly £5.0 million has been invested in mountain bike trails, a lakeside multi-user track, water access points and an observatory.

NWL has continued to develop its leisure facilities at strategic sites, investing in our fishing facilities, holiday accommodation and supporting 'Access for All'. This includes the new restaurant facilities at Tower Knowe in Kielder and Hanningfield in Essex.

NWL continues to develop ways of working with partners and we have formed a new arrangement with the North Pennines Area of Outstanding Natural Beauty (North Pennines AONB) to develop Derwent reservoir and introduce a new multi-user surface providing access for all abilities.

Water

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Water					
Water quality (%)	N/S	>99.9	Maintain >99.9	99.9	99.9
Leakage (Ml/d)	N	≤153.0	≤154.5	135.93	145.94
	S	≤67.3	≤67.9	68.26	67.99

The quality of the drinking water supplied by NWL remained excellent in 2007/08. One of the DWI's key measures is Mean Zonal Compliance and NWL achieved 99.98% in the south and 99.94% in the north. In addition, the DWI's Operational Performance Index was 99.98% in the south and 99.66% in the north while the Distribution Maintenance Index was 99.96% in the south and 99.47% in the north.

During 2007/08, we completed significant improvements to water treatment works at Honeyhill and Lartington, both in County Durham and at Warkworth in Northumberland, which now has an additional treatment process to remove pesticides from raw water. At Layer, in Essex, we made good progress on a project that will increase the reliable output by 20%, to 145 Ml/d.

One of NWL's key priorities is to reduce the amount of water lost from its networks and the leakage targets agreed with Ofwat have been met. The leakage in our southern operating area remains amongst the lowest in the country as it has been for many years. NWL aims to set best practice standards to manage leakage and is playing a leading role in a review of leakage methodologies with the EA and Ofwat.

Construction of a new 16km trunk main to serve customers in Newcastle is almost finished. This will enable 155km of trunk mains supplying South Northumberland and Newcastle to be cleaned over the next few years. We have rehabilitated 373km of water mains during the year.

Water resources

Our plan to increase the capacity of the Abberton reservoir near Colchester by around 60% reached a key milestone, in December 2007, when we submitted our applications for planning permission for the reservoir and two large pipelines. The submission was followed by a period of statutory consultation in the first three months of 2008. The applications are the culmination of extensive work with environmental scientists, lawyers and planners to produce the environmental statement and supporting documentation. We anticipate determination of the applications during the summer. The EA is preparing the application to vary its licences at Denver and Blackdyke which, together with the enhanced transfer facilities and the enlarged reservoir, will secure water supplies for customers in one of the driest areas in the United Kingdom.

Our long running water efficiency promotions and good relationship with our customers continue to produce a positive response with further reductions in demand.

Metering also has an important role to play in managing the demand for water. For several years we have been installing water meters on change of occupier in properties in the Essex area. This is in addition to our optional metering scheme and we now have about 40% of domestic customers in Essex and 54% in Suffolk on a metered supply.

Although supplies are plentiful in the north east, we believe it is still important to manage the demand for water so that it does not exceed levels that can be supplied in a sustainable way.

Environment

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Environment					
Sewage treatment works (%)	N	100	100	98.4	99.8
Bathing waters Mandatory Standard (%)	N	100	100	100	100
Pollution incidents	N	96	116	119	142

All 33 bathing waters in NWL's area passed the EU Mandatory Standard and, of these, 27 achieved the more demanding Guideline Standard, despite poor weather in the summer of 2007. We are working with the EA to identify the impact of other stakeholders including local authorities, highway authorities, farmers and land holders on the quality of bathing waters particularly with water running off the land.

We have only one non-compliant consented sewage treatment works out of a total of 158, based on Look-Up Table compliance for the year. This is a works that represents 1.6% of the population equivalent and is now compliant.

NWL has now installed nearly 500 real-time monitoring devices in the sewerage network to provide information on high or unusual flows. This information allows NWL to be proactive rather than reactive and to target action to prevent spillages and flooding. This investment, together with a more proactive maintenance programme, has improved performance and, whilst Category 1 and 2 pollution incidents (1 and 13 respectively) are broadly the same as the previous year, there has been a reduction of 20% in Category 3 incidents (105). This continues the

4. Operational performance continued

improvement trend that NWL has recorded for the last four years.

Intense rainfall during localised summer storms caused extensive flooding during the year with 813 properties flooded internally, well above the long term average and second only to 2005/06. Investment to reduce the risk of sewer flooding has been increased. During the year, 18 schemes were completed to alleviate flooding risk for 156 properties and we improved 86 combined sewer overflows. This will further improve local water courses, enhance their visual appearance and reduce pollution incidents.

Climate change

Over the last five years we have reduced the amount of energy we use by almost eight per cent. We have achieved this by improving our operations throughout the business, for example, by introducing anaerobic processes at Bran Sands, and by encouraging our customers to use water resources wisely, thereby reducing the associated energy consumption.

We have been working with independent experts and have carried out detailed assessments to identify and understand the impact climate change will have on our business. The UK Climate Impacts Programme will publish its climate change scenarios in November 2008 and we will be revisiting our assessment in the light of the new science that emerges. However, the water industry is one of the largest users of energy in the UK and we have been working hard to reduce our carbon footprint as part of our normal business.

Detailed below are some activities which reduce our impact on climate change:

- A new work management system which will not only improve customer service and introduce a more efficient way of working but will also reduce mileage significantly in our fleet of vehicles.
- By reducing tertiary UV disinfection outside of bathing water season at five major works, we will reduce energy consumption and carbon emissions with no detrimental effect on the marine environment.
- By developing and implementing a sludge strategy to introduce an anaerobic digestion process. This will help power the plant at three smaller sites initially, and two larger sites over the next seven years and will increase our total renewable energy to over 20%. The development of the plant at one of the larger sites at Bran Sands has begun and the work

NWL's Geoff Hartis and Claire Sharp explain the benefits of the Shiremoor flood relief scheme to John Harrison, Mayor of North Tyneside.

at Howdon is planned for the next five year investment period.

- We generate our own renewable energy with hydroelectric plants at Kielder, Derwent, Lartington and Wear Valley reservoirs and biogas combined heat and power at Stressholme, Hexham and Aycliffe. New opportunities are continually sought and reviewed.
- In our northern operating area, the North Pennines AONB has 27% of England's peat-forming blanket bog and wet peat locks in carbon, preventing it being released into the atmosphere. By funding grip blocking on blanket bog to enable it to work effectively (historically the grips were deliberately created to drain the land and have over time widened through erosion which is now damaging the natural environment) we can help to make a significant contribution to combating climate change. Wetter moorland also improves the habitat for wildlife and reduces soil erosion. Durham University is helping us to understand the hydrological carbon sequestration impacts of this.
- We are developing a marginal abatement cost curve which will identify those actions we can take which deliver the biggest emissions reductions for the investment made in preparation for the carbon reduction commitment legislation being introduced as a result of the Climate Change Bill.
- Our Water Resource Management Plan and our strategic direction statement 'Looking to the future' are now published and these include an assessment of climate change on water resource needs for the next 25 years.
- By 2013, we aim to have completed, with relevant agencies, a major study on Tyneside to explore sustainable drainage options that take into account regional development and the impact of climate change. This builds on the similar work carried out in Hartlepool as part of the Defra 'Making space for water' scheme.
- Our 'Water is precious' campaign encourages customers to use water wisely and to recognise that if they waste water, they also waste energy. A water carbon footprint calculator is now available for customers on our websites to encourage this link.
- We are also working with experts to understand the potential impact on our assets and have shared information with the North East Climate Change Adaptation Study and action plan published on 1 May 2008. We have also provided information to many of the plans being developed in our regions by other bodies e.g. local councils.

NWL's Dave Chapman and Minister for the Environment Phil Woolas, holding a question and answer session at the Science Learning Centre, Durham, about climate change.

Quality

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

The Company also achieved companywide accreditation to the international occupational health and safety management standard OHSAS 18001 in 2007 – the first water company to do so.

DIRECTORS' REPORT AND BUSINESS REVIEW

4. Operational performance continued

Employees

Throughout the Group we have 3,070 employees, as set out below:

Group business unit	Average number of employees	%
Northumbrian Water Limited	2,890	94
Water and waste water contracts	155	5
Other	25	1
Total employees	**3,070**	**100**

NWG's key asset is its employees and one of the strengths of NWL is employee loyalty; employee turnover is relatively low at 7.4%, well below the UK water industry average of 10.3%. NWG ensures that its terms and conditions are appropriate to attract and retain the best employees in the areas it serves. Employees also have access to a scheme which provides a range of benefits including childcare vouchers and discounted store vouchers. Currently 27% of employees participate in the scheme, up from 23% last year. NWG places an emphasis on health and safety and employees are actively involved in identifying and eliminating hazards in the workplace which has resulted in a significant reduction in accidents.

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Employees					
Employee turnover (rolling %)[1]	N/S	–	Industry average 10.3	7.4	8.2
Lost time reportable accidents (per 1,000 employees)	N/S	5	6	6	8
Sickness absence (%)	N/S	2.85	2.95	3.25	3.01

Notes:
1. No target set, data for information.

NWL continues to seek the views of employees. This year's survey was completed by 45% 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 75% of respondents stating they are proud to work for the company.

Training and development

NWL introduced an extensive People Plan in 2007 in which it sets out a five year programme to support and develop employees.

It is committed to the continuous development of occupational skills and has signed the Government's 'Skills Pledge' stating that we will ensure that 90% of employees will be qualified to the National Vocational Framework Level 2 by 2009 and 95% as soon as possible thereafter.

An ambitious National Vocational Qualification (NVQ) programme is being rolled out in our customer and operational areas. In line with the 'Competent Operator' framework, all of our production operators will have achieved NVQ Level 2 in 'Operating Process Plant' by the end of 2008. So far, 22 candidates have been successful in achieving this qualification, the first awarded in the country. Funding is being sourced, where possible, via the Learning and Skills Council's 'Train to Gain' fund and also through Business Link.

During the year, we have also introduced Union Learning Representatives who are trained with a key focus on supporting all employees in the area of basic skills development.

In September 2007, we re-introduced our apprenticeship scheme when 13 apprentices commenced employment in the maintenance area across the business. Candidates undertake a four year development programme and have excellent career prospects when they complete their apprenticeships. The apprentices are, for the first time, guaranteed employment at the end of successfully completing their training.

We are also recruiting for our Graduate Development Programme to provide potential leaders of the future.

One of the objectives of the People Plan is to develop leadership skills in current and potential managers. NWL continues to implement its Management Development Framework which is structured to cover training needs of those who show the potential for management right through to development at director level. As part of this framework we are working in partnership with the Newcastle Business School to provide qualifications from a diploma to an honours degree in leadership and management and ultimately, where appropriate, a Masters degree.

Employees' academic achievements were celebrated again this year at our second annual skills awards. Attended by senior managers from around the business, and with guest speaker

NWL's Management Development Framework model.

Kriss Akabusi, we experienced another motivational and memorable event.

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

The Group's medical advisor, Grosvenor Health, continues to provide occupational health services.

We continue to develop programmes to promote healthy eating, hydration and discourage smoking in our workforce and offer excellent health screening and medical insurance schemes. Around 1,700 employees have been through our health screening and fitness standards programmes, both of which now include lifestyle advice elements. We have introduced a new service in partnership with RehabWorks, who specialise in the prevention and management of muscular-skeletal injury. This service provides support for those employees who suffer from Muscular Skeletal Disorders (MSD) to help them return to fitness more quickly. RehabWorks will also provide our manual handling training to show people how they can avoid these sorts of injuries. We anticipate a reduction in MSD related absence as a result.

Our current level of sickness absence is just over our target of 3%, which is still well below the norm for the sector.

Research and development
We run a programme of research and development linked to UK business operations. This includes the provision of technical solutions for water and waste water management and developing partnerships with academic and research organisations. During the year, the Group invested £1.8 million (2007: £2.1 million) in research and development.

Water and waste water contracts
The Group is a member of two consortiums delivering private finance initiative contracts with Scottish Water for waste water treatment. At Levenmouth, the Group has a 75% shareholding in both project and operating companies. During the year, the operating company, CELTS, entered into a long term contract with Lafarge Cement for beneficial reuse of dried sludge as a replacement fuel in their cement kilns.

At Ayrshire, the Group has a 75% shareholding in the project company and a 100% shareholding in the operating company. The three effluent treatment plants that make up this contract continue to perform satisfactorily. The operating company, AESOps, has also entered into a long term contract with Lafarge Cement for beneficial reuse of dried sludge as a replacement fuel in their cement kilns.

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

AquaGib Limited, two thirds owned by the Group in a joint venture with the Government of Gibraltar, operates Gibraltar's dual drinking water and sea water distribution systems under its long term contract with the Government of Gibraltar. The company is currently undertaking a project to install two new reverse osmosis plants to replace ageing and relatively inefficient distillation plants. The project, involving capital expenditure of £3.4 million, is due for completion in July 2008.

Other
During the year, Agrer successfully completed a €5.2 million regional development project contract in Turkey and was awarded new contracts in the rural development sector in Algeria

DIRECTORS' REPORT AND BUSINESS REVIEW

4. Operational performance continued

(€6.3 million, a four year contract) and in the democratic Republic of Congo (€2.0 million, a five year contract).

Corporate responsibility

NWG helps the communities it serves in a number of different ways. As well as giving financial support, we encourage our employees to volunteer their time and expertise and we also provide facilities to help the communities in which we operate. These activities generally support projects that make the areas we serve better places in which to live, work or invest. The programme focuses on key themes throughout these communities but, increasingly, we are developing initiatives designed to tackle lasting and sustainable change in specific areas.

NWG continues to be a member of the FTSE4Good Index and 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, which assess how companies measure, manage and report responsible business practice. It was ranked as a 'Platinum' company, which is the top rank, as well as being rated as the leading company in the sector which covers 'Gas, water and multi-utilities.' NWG was also one of only eight companies that received the BITC 'Big Tick' for its impact on society. Last year, NWG was also named as the North East Representative Business of the Year by BITC. NWG uses these indices to measure, manage and report its responsible business practice underpinned by a rigorous external review process.

We have endeavoured for many years to donate at least 1% of our pre tax profits (through cash, employee time and expertise, or use of our facilities) to projects which benefit the communities we serve. We reported this publicly as part of BITC's Per Cent Club standard and, although this ended in October 2007, NWG has maintained this percentage. Some detail of our projects is provided below.

The Group made charitable donations totalling £134,702 during the year.

Community support

Employees and volunteering

Currently 23% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 5,431 hours to the community. The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments totalling £49,890 for our nominated charities: Great North Air Ambulance Service, Mencap's Dilston College, RNLI, St Teresa's Hospice and East Anglia's Children's Hospices.

Education

We have improved our educational support materials during the year and a wide range of additional educational materials are now available on our websites.

In July 2007, we launched the 'Northumbrian Water GLOBE programme' in a unique venture which saw us link up with the international GLOBE programme, an environmental education initiative set up by Al Gore in 1996. As part of this £100,000 project, we donated 85 fully automated weather stations and associated training to schools throughout the northern region, to collect weather data in areas where Meteorological Office coverage is poor. This data will help NWL and external scientists understand the impact of climate change, and will be a valuable curriculum tool.

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

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

Partnerships

Water for health

We are at the forefront in the water industry in communicating the health benefits of drinking tap water. To date, over £225,000 has been provided for water coolers in schools and over 500 have been supplied to date in over 300 schools. The trials and research into the effects of water coolers in a day centre, a care home for older people and two prisons have continued. We also continue to promote bottle-free water coolers as a sustainable alternative to bottle-fed coolers.

Arrangements were made with the North East Ambulance Trust to identify care homes in Newcastle where residents were particularly subject to falls. Coolers will be installed in these homes to monitor the impact of the availability and viability of drinking water. NWL also assisted Water UK and Unison in the regional launch of 'Water@work' in Essex, which encourages employers to ensure that employees have adequate access to drinking water.

Environmental

NWL has developed key partnerships to help the conservation of biodiversity on our sites. NWL's contribution to the partnerships includes funding project officers. Current partnerships include:

- Northumberland Wildlife Trust (Kielder and Bakethin);
- Durham Wildlife Trust;
- Essex Wildlife Trust (Hanningfield);

- Broads Authority (Lound and Trinity Broads); and
- Davy Down Trust.

Sustainable communities
NWG has a continuing commitment to support projects and organisations within the geographic areas in which we work and to contribute to the long term sustainability not only of our business, but also of the environment, society and communities we serve. Corporate responsibility is integral to how we do business and as part of this commitment we are looking at different ways to work within our communities to promote lasting change on key issues.

We are working with partners to create models of sustainable change and also methods of evaluating their success, which can be replicated in other communities. The focus has been on health, education, economy and affordable housing as well as creating new ways to support areas helped by our chosen charity WaterAid.

Health
Healthworks opened in November 2007 in Easington Colliery after NWL reached an agreement with County Durham Primary Care Trust (PCT) giving them a 99 year lease on a redundant building at our Easington waterworks and it was subsequently refurbished. We are working in partnership with the PCT, the District of Easington Council, the Neighbourhood Management Pathfinder and other stakeholders to develop services for the local community in an area where census records show one of the worst health records in the country.

However, our commitment has gone beyond providing the building. There is a natural synergy between our own 'Water for health' campaign and the 'Healthy Living' agenda, so we are devising new ways for NWL to work at a strategic level with the partners of the 'Healthy Living Centre'. We have already contributed research, marketing and communications support to create awareness of the Centre and understanding of local needs and have been involved in three events to promote healthy living, targeted at primary and secondary schools and day centres. This includes the creation of a graffiti garden as part of a community art programme at the Centre.

This activity is supported by sponsorship of 'Everyday Swim' an innovative swimming programme run by the Amateur Swimming Association to promote physical exercise and an arts programme run by Creative Partnerships to use arts-based activities to change children's attitudes to eating and drinking, supported by research by Durham University. Our contribution to the work of the Healthy Living Centre is a unique approach to tackling the poor long term health of the residents in Easington.

Education
Building began in March at the site of the Castle View Enterprise Academy (CVEA) where we are the lead sponsors for the development of the Academy. Sunderland City Council is pioneering its own model for academies as part of its wider Building Schools for the Future programme. The 'Sunderland model' has been designed to meet the needs of Sunderland pupils and has evolved through successful partnership working in the city. For each academy, a leading north east business is lead sponsor and the council is co-sponsor. A number of donors will also support each project. CVEA will specialise in business and enterprise. The funding from sponsors and donors will go into a trust fund for 'educational disadvantage' and will not be used for capital costs as is the normal practice for academies.

An Education Leadership Board, chaired by Baroness Estelle Morris, has also been set up to oversee the development of education in Sunderland and sponsors will be involved with this. We will be able to bring our expertise and network of contacts across the region to complement the curriculum and we will be able to guide, mentor and support staff and pupils to increase their understanding of business and enterprise. We can provide role models and an introduction to a wide range of employment opportunities because of the size and nature of our business; we can use our own employees and networks to provide help and support to meet the needs identified by staff or pupils. Our aim is to use our expertise to support academic and vocational attainment and help bring lasting improvement to this community. The Department for Education and Skills has approved the outline business case for the Academy. The consultation and design process to meet the vision of the new Academy is underway and is planned to be ready in autumn 2009.

Affordable housing
The nature of our business means that we own areas of land, often in rural areas with low commercial or development value. As part of our stewardship we are exploring ways it can be used for the benefit of rural communities. If we own land that can be developed, without affecting our core activity of maintaining and delivering a clean, safe, water supply, then we will give priority to providing affordable rural housing.

This will contribute to the sustainability and vitality of rural communities and reduce the need for people to move to towns and cities for both housing and employment. If jobs can be retained in rural communities, then there is the complementary environmental benefit of reducing the use of transport and the associated carbon emissions.

DIRECTORS' REPORT AND BUSINESS REVIEW

4. Operational performance continued

NWL has supported HRH The Prince of Wales' Affordable Rural Housing Initiative since it was launched in 2003. The initiative is a partnership between BITC and key strategic organisations. We are leading the industry in this initiative and, together with BITC, have supported a number of guides to affordable rural housing which have been endorsed by HRH The Prince of Wales.

As part of this commitment, we are now embarking on housing schemes at Hanningfield, in Essex, and Kielder, in Northumberland, and are identifying other opportunities for affordable rural housing in our supply areas. We believe that any programme of development should support issues of importance to us such as water and energy efficiency, sustainable communities, biodiversity, cultural opportunities and good design. We have produced briefs to ensure appropriate consideration of these issues and look for developers who share our ideals.

Economy

North East Enterprise Bond

Our investment in the bond is a five year interest free loan, which will help fund the purchase and running of a number of 'Launch Pads' – dynamic, state of the art mobile vehicles that will tour the region to help trigger and encourage enterprise start-ups to make real, long term change. The bond works in partnership with creative enterprise promoters such as Big Ideas, People into Enterprise and Newcastle Education Business Partnership which serve as a catalyst to help educate and inspire people to consider setting up their own business or social enterprise.

WaterAid

NWL continued to raise funds and awareness for the work of WaterAid which brings sustainable water and sanitation solutions as well as hygiene education to the poorest parts of Africa and Asia. The company's fundraising committee have raised £2.5 million, since 1997, with the help of the company and last year focused its fundraising support on specific projects in Malawi and India.

Community Foundations

Community Foundations covering our areas of supply hold endowment funds totalling nearly £1.0 million contributed by NWL over the last 16 years. These are long term investments with the income from the funds used to support community initiatives. Recipients are chosen by committees which include our own employees.

John Hall from NWL's southern area, tree coppicing at Ormesby Little Broad in Norfolk (part of the Trinity Broads).

NWL's Cara Hall on a recent trip to Burkina Faso organised by WaterAid.

NWL performance against non-financial KPIs summary (unaudited)

	North (N) South (S)	Target 2008/09	Target 2007/08	Performance Current year	Performance Previous year
Customer satisfaction					
Overall service (%)	N/S	90	Maintain	89	92
Value for money (%)	N/S	85	Maintain	83	87
Customer – levels of service					
Properties at risk of low pressure	N	274	274	181	298
	S	126	126	60	130
Properties subject to unplanned interruption of 6 hours or more	N	3,000	3,000	3,318	20,389[1]
	S	2,000	2,000	3,405	3,967
Properties subject to hosepipe bans at any time during the year	N/S	0	0	0	0
Properties subject to sewer flooding incidents (other causes)	N	150	150	290	183
Properties at risk of sewer flooding incidents (once in ten years)	N	183	78	125	116
Properties at risk of sewer flooding incidents (twice in ten years)	N	331	51	329	229
Billing contacts responded to (within five working days) (%)	N	99.2	99.0	99.3	99.3
	S	99.2	99.0	99.6	99.2
Written complaints responded to (within ten working days) (%)	N	99.8	99.8	99.9	99.9
	S	99.8	99.8	99.7	99.9
Bills based on meter readings (%)	N	99.95	99.95	99.80	99.84
	S	99.95	99.95	99.96	99.94
All telephone lines busy (%)	N	0.25	0.25	0.03	0.20
	S	0.25	0.25	0	0
Abandoned telephone calls (%)	N	2.5	2.5	2.8	3.2
	S	2.5	2.5	3.3	2.3
Water					
Water quality (%)	N/S	>99.9	Maintain >99.9	99.9	99.9
Leakage (Ml/d)	N	≤153.0	≤154.5	135.93	145.94
	S	≤67.3	≤67.9	68.26	67.99
Environment					
Sewage treatment works (%)	N	100	100	98.4	99.8
Bathing waters Mandatory Standard (%)	N	100	100	100	100
Pollution incidents	N	96	116	119	142
Employees					
Employee turnover (rolling %)[2]	N/S	–	Industry average 10.3	7.4	8.2
Lost time reportable accidents (per 1,000 employees)	N/S	5	6	6	8
Sickness absence (%)	N/S	2.85	2.95	3.25	3.01

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.

DIRECTORS' REPORT AND BUSINESS REVIEW

5. Risks and resources

Upgrading mains serving Newcastle upon Tyne.

All subsidiaries within the Group identify and assess the impact of risks to their business. For each risk, the likelihood and consequences are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed.

For NWL, the management team reviews the approach to risk management in detail every year. The Audit Committee considers the outcome of this review. The NWL management team reviews the significant risks every month and summary reports on these reviews are submitted to the NWL board.

Apart from NWL, none of the subsidiaries has risks considered to be significant to the Group's short and long term value. The NWG Board considers environmental, social and governance risks as outlined in the corporate governance report on page 44. Details of the Group's treasury risks are contained in note 20 to the financial statements.

Regulatory risk

In February 2008, the Government announced a study (the 'Cave review') into the scope for innovation and competition in water services and, in May, Ofwat published the second part of its own competition review. The latter is intended to inform the Cave review and effectively forms Ofwat's view of the legislative action which may be required to introduce competition to the sector. Government is proposing to introduce a Water Bill in the next parliamentary session which will propose various measures to tidy up water related legislation but may also include reference to introducing measures in response to the Cave review. This may result in enabling legislation that provides Ministers with powers to pass secondary legislation to enact recommendations from the review. However, a Water Act is unlikely to materialise for at least two years.

Environmental, social and governance risks

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

The first relates to the use of sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, the sector would need to find or develop alternative ways to re-use or dispose of its sewage sludge. This could mean higher capital and revenue costs to provide additional sludge processing facilities. The development of the 'Safe Sludge Matrix' and the proposed revision of the Sludge (Use in Agriculture) Regulations have reduced the immediate risk in this area. NWL is introducing advanced digestion to both reduce sludge volumes and the carbon impact of its activities. NWL will retain a facility to dry sludge and produce pellets as a fuel replacement, as a viable alternative way of using sludge in the medium term.

The second is the potential for sewer flooding. As rainfall patterns become more variable and intense storms more frequent, localised heavy rainfall can result in sewers becoming overloaded. We welcome the focus on integrated flood management in Defra's strategic document 'Future Water' and in the 'Pitt Review' on recent flooding.

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

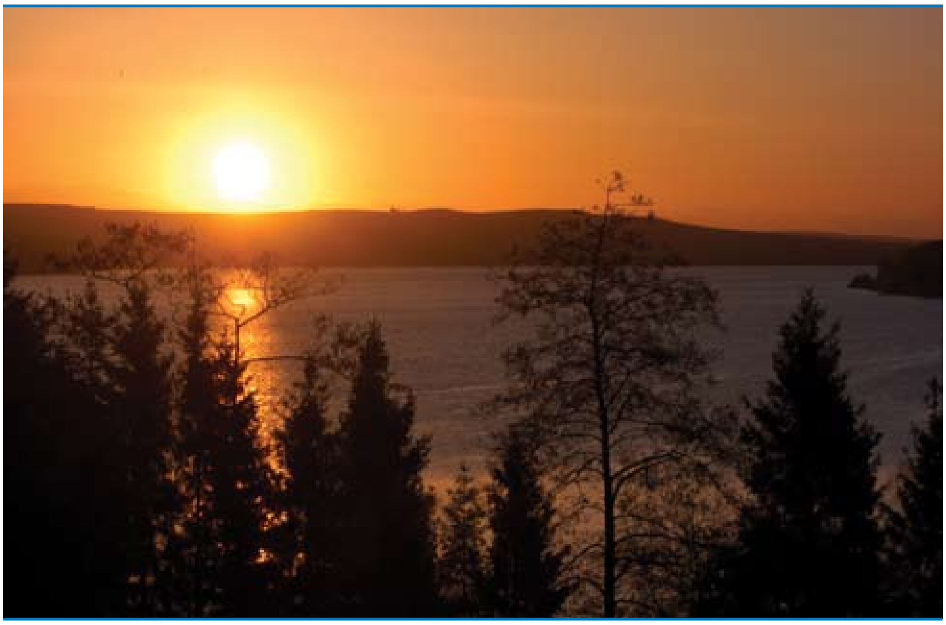
- the Traffic Management Act, which was implemented in April 2008; and
- the transfer of private drains and sewers, which will increase the network owned and maintained
- by NWL by about 60%.

Affordability and customer debt

Although our average household bills are relatively low, affordability is an issue for us with income deprivation levels in our northern area the highest of all water and sewerage companies and in our southern area, close to the national average.

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

Customers who deliberately avoid paying charges are actively pursued and we continue to work with Ofwat and Defra to seek changes to legislation to assist the industry to impose and collect charges.



Sunrise at Kielder Water in Northumberland.

5. Risks and resources continued

Water resources

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

In our Essex and Suffolk area, however, water resource availability is a key issue. Although we did not have to impose a hosepipe ban during the drought of 2006, we need to continue to invest to achieve our aim of ensuring our customers have access to the water they need. In spring 2008, we published our draft 'Water Resources Management Plan' and this is now out for consultation.

In December, we submitted our applications for planning permission for the Abberton scheme which will increase the capacity of the Abberton reservoir, near Colchester in Essex, by around 60%. Once this is in operation in 2014, we predict we will not need to develop major resources, such as reservoirs, in the next 25 years.

We will continue to lead the industry on water efficiency measures and to encourage customers to use water wisely. We will work with other stakeholders to develop a co-ordinated strategy for reducing water use to sustainable levels.

In areas where water is scarce, water meters have a key role to play in reducing demand. We aim to achieve as near to universal metering as possible in Essex by 2020 and Suffolk by around 2023. On current policies it will take considerably longer to achieve full metering in the north east and there is no economic, environmental or social driver to move more quickly.

Changing weather patterns

The water cycle and the changing British weather has a direct influence on the provision of water and waste water services. NWL's employees are experienced in managing the effects of too much or too little rainfall, but changing weather patterns will remain a challenge for the business.

The water industry is a major user of energy in its processes. We have carried out research into the impact of climate

Abberton reservoir in Essex.

change on all our assets and water resources and this has been incorporated in our 'Climate Change Policy' as part of our corporate responsibility work. We will continue to explain to customers that energy is also being wasted when water is being wasted.

Employees

People are our key asset and if we are to continue to meet the needs of our customers, and to achieve our regulatory obligations, we need to continue to recruit and retain talented and skilled people as a leading employer in our regions. We will continue to offer all our employees terms and conditions at least commensurate with other major employers as well as appropriate training and development to support their career development. This will include comprehensive management, graduate and apprentice programmes, as well as initiatives such as our NVQ programmes which reach many employees.

Directors' remuneration and interests

Information about directors' remuneration and their interests in the shares of the Company is contained in the directors' remuneration report on pages 46 to 55.

Indemnification of directors

The Company has in place directors' and officers' insurance and, on 28 November 2005, entered into a deed of indemnity to grant the directors further protection against liability to third parties, subject to the conditions set out in the Companies Acts. Such qualifying third party indemnity provision remains in force as at the date of approving the directors' report and business review. The deed, together with directors' service contracts, will be available for inspection by shareholders at the AGM, or from the Company Secretary.

Annual General Meeting

The notice convening the AGM, to be held on 31 July 2008, was sent to shareholders with this report, together with an explanation of the business to be conducted at the meeting, and a form of proxy.

NWL's apprentices visiting Birtley sewage treatment works near Gateshead.

Auditors

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

Financial statements preparation and going concern

The directors consider that it is appropriate to prepare the financial statements for the financial year on a going concern basis. The directors have arrived at their decision based on consideration of the Company's detailed budget for 2008/09 and the business plan for the period to 31 March 2010. Their analysis included a review of the capital expenditure and investment plans, the anticipated funding requirements and facilities available, and the reasonableness of the underlying assumptions of both the budget and business plan.

Directors' declaration

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

By order of the Board

Martin Parker
Company Secretary
3 June 2008

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

Appendix to the directors' report and business review

Group financial KPIs

Gearing to RCV

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

Purpose: The RCV generates most of the revenue stream of the Group and regulatory gearing is an important factor in credit ratings.

Source of underlying data: NWL's RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Group net debt is disclosed in the audited financial statements.

Cash interest cover

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

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

Source of underlying data: Audited financial statements.

Cash flow to net debt

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

Purpose: Indicates the Group's ability to reduce debt in the absence of need for additional investment, without resorting to asset disposal.

Source of underlying data: Audited financial statements.

NWL financial KPIs

Regulatory gearing

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

Purpose: The RCV generates most of the revenue stream of the Group and regulatory gearing is an important factor in credit ratings.

Source of underlying data: NWL's RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. NWL's net debt can be found in the audited regulatory accounts and Ofwat annual reports on financial performance.

NWL non-financial KPIs
Water

Drinking water quality

Definition and calculation: Compliance with drinking water regulations as monitored by the Drinking Water Inspectorate (DWI).

Purpose: To monitor drinking water quality.

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

Leakage

Definition and calculation: Total leakage from the water network (including customer pipes).

Purpose: To monitor compliance with Ofwat leakage targets.

Source of underlying data: Information recorded by NWL and audited by Ofwat.

NWL non-financial KPIs 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 Environment Agency (EA) and reported on by the latter.

Bathing waters Mandatory Standard

Definition and calculation: Percentage of bathing waters complying with Mandatory Standards.

Purpose: To monitor the impact of NWL's coastal treatment works on the environment.

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

Pollution incidents

Definition and calculation: Number of category 1, 2 and 3 pollution incidents in the calendar year as defined by the EA.

Purpose: To monitor the performance of NWL's sewerage system and its impact on the environment.

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

NWL non-financial KPIs Customer

Customer – levels of service

Definition and calculation: Customer service standards are established by Ofwat, the economic regulator, and calculated using source data in the company.

Purpose: To monitor performance of NWL.

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

Customer satisfaction

Definition and calculation: Domestic customers' satisfaction with overall service and overall value for money, expressed as satisfaction averaged over the surveys carried out during the year.

Purpose: To enable tracking of perception of reputation, service and value for money over time.

Source of underlying data: Independent surveys of 500 customers (300 north, 200 south) chosen at random, but representative of the customer base, carried out each quarter – a total of 2,000 customers.

NWL non-financial KPIs Employee

Lost time reportable accidents

Definition and calculation: Injury accidents that are reported to the Health & Safety Executive as required by the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 1995. Calculated as number of accidents reported in financial year per 1,000 employees.

Purpose: To monitor the safety performance of NWL over time.

Source of underlying data: Completed NWL Accident/Incident report forms. Employee numbers provided by the human resources department.

Sickness absence

Definition and calculation: Sickness absence days as a percentage of total working days multiplied by the end of month headcount.

Purpose: To track and trend sickness absence levels across the organisation.

Source of underlying data: Sicknotes, return to work interviews and weekly returns by managers.

Employee turnover

Definition and calculation: Number of leavers within the year as a percentage of average headcount.

Purpose: To track the employee turnover within the business to ensure that it is within benchmark data.

Source of underlying data: Current employees' details are held within the human resources management system – reports show leavers against headcount.

Board directors' biographies

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

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

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

4. Sir Patrick Brown
Senior Independent Non-executive Director

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

5. Claude Lamoureux
Non-executive Director

Claude Lamoureux was appointed to the boards of NWG and NWL on 1 December 2006. Claude was until 1 December 2007, President and CEO of the Ontario Teachers' Pension Plan Board (OTPP). Previously, he spent 25 years as a financial executive with Metropolitan Life in Canada and the US. He is also a director of Xstrata plc, Maple Leaf Foods Inc, Atrium Innovations Inc, the Canadian Institute for Advanced Research, The Learning Partnership and the York University Foundation. OTPP holds 26% of the issued share capital of Northumbrian Water Group plc and Claude is, therefore, not regarded as an independent director.

6. Martin Nègre
Independent Non-executive Director

Martin Nègre was appointed to the Board in May 2003 and to the board of NWL in January 2006. He was, between April 2000 and April 2001, the CEO of the former Northumbrian Water Group plc and the chief corporate representative of its parent company, Suez, in the UK. He is currently the Chairman of Ecofin Global Utilities Hedge Fund Limited, an Irish Stock Exchange listed fund, Chairman of Ecofin Special Situations Utilities Fund and of Ecofin North American Hedge Fund, a director of Ecofin Water & Power Opportunities plc, a London listed investment trust of which he was Chairman for three years, as well as a director of Bolux Utilities (Sicav Luxembourg) and of Mercurius Utilities (Lichtenstein). All the above funds are focused on utilities. In 2005, he was appointed a director of Promethean plc, an AIM-listed investment company. Martin chairs the Remuneration Committee and is a member of the Nomination Committee.

7. Alex Scott-Barrett
Independent Non-executive Director

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

8. Jenny Williams
Independent Non-executive Director

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

9. Martin Parker
Company Secretary

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

Corporate governance report

Introduction and general compliance statement

The Board believes best practice in corporate governance is an important tool in helping it carry out its responsibilities. The Board considers that, during the year and up to the date of this report, it has complied with the main and supporting principles and the provisions of the Combined Code 2006. This report, the directors' report and business review and the directors' remuneration report describe how the Company has applied the principles of the Combined Code during the year.

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

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

The Board

The Board sets and implements the Company's strategy and ensures compliance with Group policies and legal and regulatory obligations. The Group's mission and strategy is set out in the directors' report and business review on pages 6 and 7.

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

The Company has adopted terms of reference which set out the matters reserved to the Board for approval and matters which are, or can be, delegated to the committees and management. The Company has also adopted financial approval rules that set out the authorisation processes and financial limits to be applied to financial transactions within the Company. NWL has adopted its own versions of these guidelines. Standing or Executive Committees can take decisions not delegated to specific committees between Board meetings. All directors receive notice of Standing Committee meetings and may participate if they wish. Decisions taken by the Standing or Executive Committees are reported at the next Board meeting.

The following table sets out the attendance of directors at Board and committee meetings during 2007/08:

Name	Board	Nomination	Remuneration	Audit
Number of meetings	6	3	4	3
Sir Derek Wanless*	6	2	4	3†
Sir Patrick Brown	6	3	4	3
John Cuthbert	6	3	4†	3†
Chris Green	6	–	–	3†
Claude Lamoureux	3	–	1†	–
Martin Nègre	6	3	4	–
Alex Scott-Barrett	6	3	4	3
Jenny Williams	5	3	1†	3

* Sir Derek Wanless absented himself from one Nomination Committee convened for the purpose of considering an extension to his appointment.
† Not a member, but attended at the invitation of the Committee Chairman.

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

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

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

Board balance and independence

There are currently eight directors – the Chairman, two executive directors, the senior independent non-executive director and four other non-executive directors. Sir Derek Wanless is the non-executive Chairman. The executive directors are John Cuthbert (Managing Director) and Chris Green (Finance Director). Sir Patrick Brown is the senior independent non-executive director and the other independent non-executive directors are Martin Nègre, Alex Scott-Barrett and Jenny Williams. Claude Lamoureux is also a non-executive director but is not independent as he was, until 1 December 2007, President and CEO of OTPP, which holds 26% of the issued share capital of the Company.

The Company complies with the Combined Code's requirement that half of the directors, excluding the Chairman, are independent non-executive directors. The Chairman was independent on appointment. Biographical details of the directors appear on pages 38 and 39 and details of their service contracts are in the directors' remuneration report on page 49.

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

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

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

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

Information and professional development

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

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

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

Performance evaluation

A full evaluation of the performance of the Board, its committees and of individual directors was conducted in October 2007. Each director completed a detailed questionnaire prior to a personal appraisal with the Chairman. The questionnaire was prepared by the Chairman and Company Secretary and was designed to address strategic issues as well as the approach of the Board to operational and financial matters, the role of the non-executive directors and the quality of information received by the Board. The results of the evaluation were considered by the Board at its meeting in November and were generally very positive but the Chairman will, following the evaluation, increase the Board's focus on operational efficiency, review the programme in place for collecting and considering the views of analysts, regulators and customers and give more structured updates to non-executive directors on regulatory, legal and financial developments. The performance of NWL's board, committees and individual directors was evaluated at the same time. The Chairman's comments on the evaluation of the directors seeking re-appointment at the AGM are provided in the Notice of Meeting.

External appointments

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

Board committees

The Board has Audit, Nomination and Remuneration Committees to assist it in the performance of its duties. The Board sets the terms of reference of the Committees and receives regular reports from their chairmen at board meetings. The terms of reference of committees are available on the Company's website or from the Company Secretary.

Corporate governance report continued

Remuneration Committee

The work of the Remuneration Committee and details of the directors' remuneration are set out in the directors' remuneration report on pages 46 to 55.

Nomination Committee

The members of the Nomination Committee are Sir Derek Wanless (Chairman), Sir Patrick Brown, John Cuthbert, Martin Nègre, Alex Scott-Barrett and Jenny Williams, and the membership is compliant with the Combined Code.

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The Committee also reviews succession planning for the Board, NWL board and senior appointments and will make recommendations to the Board when appropriate. The Committee's general policy is to use external recruitment consultants or to advertise in order to identify suitable candidates. All non-executive directors are appointed for a term of one year. In accordance with the Articles, all directors are subject to re-election at the AGM at least every three years.

During the year, the Committee considered extensions to the appointments of non-executive directors on the NWG and NWL boards whose contracts for services expired during the year.

Accountability and audit

Audit Committee

The Audit Committee members are Sir Patrick Brown (Chairman), Alex Scott-Barrett and Jenny Williams. Alex Scott-Barrett is a chartered accountant. The Board is satisfied that he has recent and relevant financial experience.

The Committee's membership complies with the Combined Code. The Chairman, Managing Director and Finance Director are invited to Audit Committee meetings with the permission of its Chairman but have no right of attendance. Managers from within the Group are invited to Audit Committee meetings to discuss issues relating to their areas of the business. During the year, Sir Patrick has discussed audit business with both the Internal Audit Manager and the external auditors, without the executive directors being present.

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

The purpose of the Audit Committee is to assist both executive and non-executive directors of NWG to discharge their individual and collective responsibilities in relation to:
- ensuring the financial and accounting systems of NWG and its subsidiaries are providing accurate and up to date information on their current position;
- ensuring NWG's published financial statements represent a true and fair reflection of this position; and
- assessing the scope and effectiveness of the Group's risk management systems and the integrity of its internal financial controls.

During the year its work included:
- monitoring the integrity of the financial statements of the Company;
- reviewing the Company's internal financial controls by considering reports of both the internal and external auditors, directing questions to management and reviewing the financial risks and controls information provided to them on an annual basis;
- monitoring and reviewing the effectiveness of the internal audit function by reviewing the scope of the annual audit plan, the results of those audits and monitoring the completion of actions identified during the audit;
- monitoring and reviewing the performance and effectiveness of the external auditors, in particular, by reviewing the scope and costs of the audit process;
- reviewing the external auditors' independence by monitoring the extent of the provision of non-audit services and receiving reports from the external auditors;
- monitoring the potential impact and management of significant risks to the business using a risk methodology (meeting the recommendations of the 2005 Turnbull Review Group guidance) which sets out and rates all identified risks, including operational, external, financial, environmental, social and governance risks;
- reviewing the Committee's terms of reference;
- reviewing the Group's accounting, treasury and whistleblowing policies; and
- reviewing the Company's interim management statements, half-yearly and preliminary results' announcements and final published annual report and financial statements.

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

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

External auditors
Ernst & Young LLP have been the Group's auditors since 2003. The key audit partner is subject to change every five years and the last change took place during the year.

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

On 28 May 2008, Ernst & Young confirmed to the Audit Committee, in accordance with ISA 260 (Communication of audit matters to those charged with governance), that they have considered their relationship with the Company and that, in their professional judgement, the objectivity of the audit engagement partner and audit staff is not impaired.

Review of internal control
The Board has overall responsibility for maintaining a sound system of internal control and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the 2005 Turnbull Review Group guidance. The actions necessary to address weaknesses and otherwise improve the system of internal control are communicated to management. Internal Audit monitors implementation of these actions and report back to the Audit Committee. This process has been in place throughout the year and up to the date of approval of the 2007/08 annual report and financial statements. There are inherent limitations in any system of internal control and even the most effective system can only provide a reasonable, and not absolute, assurance against material misstatement or loss.

The Board has reviewed the effectiveness of the Group's system of internal control, outlined below, as follows during the year. The Internal Audit team manages a process whereby all of the financial controls within the Group are identified and certified by the relevant manager as having operated for the full year. As part of a programme of work (which is agreed with the Audit Committee), these controls are tested throughout the year. A report detailing any areas of concern is produced after each audit. As part of the same process all of the key business risks are identified. Each risk is assessed on an unmanaged basis, the controls in place to mitigate the risks are detailed and the risk is then re-assessed after these controls.

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

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

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

Corporate governance report continued

The Board is able to monitor the impact of environmental, social and governance matters on the Group's business, to assess the impact of significant risks on the business and to evaluate methods of managing these risks through reports it receives from the Subsidiary Boards and the Audit Committee. The environmental risks considered to be significant by the Board are described on page 33, together with a summary of how NWL is managing these risks.

For a number of years, the Subsidiary Boards have performed a full annual business risk analysis to meet the recommendations of the 2005 Turnbull Review Group guidance. This methodology is described above in relation to the work of the Audit Committee. The results of the risk reviews are reported in detail to the Audit Committee and a summary is reported to the Company's directors. Accompanying the risk model is a detailed review of each company's internal financial controls along with either confirmation that the controls have operated throughout the year or details of any exceptions. Action points arising from these reviews are followed up as part of the internal audit process.

Some subsidiaries, such as NWL, consider risks more frequently. The NWL management team considers significant risks in a structured way every two months, assessing the likelihood and potential impact of the relevant risks both before and after risk management measures have been put in place. Further details about how risks and uncertainties facing the Group are assessed and managed are included in the directors' report and business review on pages 32 to 35.

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

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

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

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

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

The work of NWL's Corporate Responsibility Committee is described on page 13 and on the corporate responsibility section of the Company's website.

Investor relations

The Company welcomes constructive communication with all its shareholders. Details of the Company's investor relations activities during the year are described in the directors' report and business review on page 12. Investor feedback reports from investor meetings, prepared by the Company's advisers, are considered at Board meetings, and analysts' notes on the Company are made available to all directors on the Board's intranet Team Room. The Board believes that these methods of investor feedback provide the senior independent non-executive director and the other non-executive directors with a balanced understanding of the issues and concerns of major shareholders. The senior independent director is available to shareholders who wish to raise any matters of concern and the Chairman welcomes contact with any shareholders who have matters they wish to discuss. The Company has not received any requests from institutional shareholders to meet with non-executive directors.

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

AGM

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

Martin Parker
Company Secretary
3 June 2008

Directors' remuneration report

Information not requiring audit

The Remuneration Committee

The Remuneration Committee of the Board (the Committee) determines the remuneration and terms of employment of the Chairman of the Company, executive directors of NWG and NWL and a further seven senior managers, in accordance with a remuneration policy approved by the Board. The Committee pays particular attention to the remuneration of senior executives who are not board members. The terms of reference for the Committee are published on NWG's website (in the 'about us: corporate governance' section) or a copy can be requested from the Company Secretary.

The Committee members are Martin Nègre (Chairman), Sir Patrick Brown, Alex Scott-Barrett, who are all considered by the Company to be independent, and Sir Derek Wanless. The membership of the Committee was therefore, compliant with the Combined Code throughout the year.

The Committee met three times during the year with 100% attendance by all members. As the Committee works closely with NWL's Remuneration Committee, Committee papers and minutes are circulated to all NWL and NWG non-executive directors, who can give their views direct to the Committee Chairman and can attend meetings if they wish.

The Committee again received advice during the year from Hewitt New Bridge Street (HNBS) and also from the Managing Director (although never about his own remuneration). HNBS continues to assist the Committee in maintaining best practice in relation to remuneration. HNBS does not provide any other service to the Company.

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

During the year the Committee:
- agreed bonuses for 2006/07;
- agreed salaries for 2008/09;
- decided the vesting percentage to be applied to the LTIP awards made on 22 December 2004, which vested on 22 December 2007;
- granted LTIP awards on 13 December 2007 (to vest in December 2010); and
- set performance targets for executive directors and senior managers.

Remuneration policy

The Committee considers the principles and provisions of the Combined Code when setting its policy and believes it is fully compliant. The policy of the Company, which applied throughout 2007/08 and applies for 2008/09 and subsequent financial years, is to provide remuneration that is sufficient to attract, retain and motivate directors of the quality required to run the Company successfully, whilst paying fairly. Although HNBS provides the Committee with detailed comparative data on other companies in the sector, the Committee is aware of, and avoids the risk of, remuneration being ratcheted up as a result of benchmarking exercises. For example, when reviewing the pay practices of water companies this year, it noted that the market level of annual bonus had increased, but it has not followed suit and increased annual bonus potential at NWG.

Consistent with its fair pay policy, when considering the remuneration packages of senior executives and directors, the Committee takes into account pay awards to other employees in the Group. The Committee also considers environmental, social and governance issues when setting remuneration terms.

The remuneration policy of the Committee is:
- that the setting of base salaries is largely influenced by individual contributions and internal relativities rather than external comparators;
- the annual bonus plan recognises the interests of all of the Company's stakeholders (shareholders, customers and employees) rather than being focused solely on profit; and
- management shares in the longer term value created for the Company's investors, but equity incentive schemes should only reward if there is clear outperformance of the market and other relevant companies.

Elements of remuneration

The remuneration of the executive directors comprises basic salary and benefits, including pension and participation in the Company's SIP, all of which are fixed pay, and a performance related annual bonus and LTIP awards. The relative importance of the fixed and variable performance related elements is monitored and, while the Committee recognises the importance of the performance related elements, it has not created a scenario where high levels of incentive pay promote risk taking in order to secure personal reward. For executive directors in 2008/09, on-target annual bonus is 35% of salary and the expected value of longer term incentives is 55% of salary. This is not a small sum, but it is less than the executive directors' total fixed pay.

Basic salary and benefits

The basic salaries paid to each director during the year are set out in Table 1 on page 51. Data received from HNBS over the years has consistently indicated that the Managing Director's basic salary is significantly less than the market rate paid to his counterparts at other quoted water companies. When defining the market rate, the Committee has regard to the comparator group's market capitalisation, turnover and complexity and adjustments are made to ensure that an appropriate comparison is made. However, John Cuthbert declined the Committee's proposed salary increase in 2006 and 2007. This year he has accepted an increase and, as from 1 April 2008, his annual basic salary is £295,000 (previously £270,000). Chris Green's salary, from 1 April, was increased to £225,000 (from £210,000) and, again, it was noted by the Committee that this is still below the market rate.

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

Pensions

The main features of the Northumbrian Water Pension Scheme are set out in note 25 to the financial statements. Basic salary is the only pensionable element of the executive directors' remuneration packages.

The executive directors' pensions were modified with effect from 1 January 2008, in line with the changes proposed for the pension scheme as a whole, and the executive pension arrangements were closed to new entrants on that date.

The accrued defined benefit pensions and corresponding transfer values for the executive directors are set out in Table 6 on page 54.

Annual bonus

Since 2005/06, the annual bonus plan reflects the interests of all of the Company's stakeholders. Maximum annual bonus potential for the executive directors for 2008/09 continues to be 70% of salary, which is apportioned as follows:

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

The PBT bonus is based on actual PBT performance compared to the budget PBT set by the Board at the beginning of the year. PBT has been chosen because it is a primary financial measure for the Company, for which the executive directors are accountable. In 2007/08, PBT of £170.3 million was higher than the budget and, consequently, 29% out of the maximum 40% allocated to PBT is payable.

NWL's estimated OPA score for 2007/08 is 345, against a range for bonus purposes of 342 to 413, being the published range of performance across the ten water and sewerage companies in 2006/07. NWL's score was adversely affected by sewer flooding caused by severe weather conditions and, as a consequence, no bonus is payable in respect of the OPA rating.

The year end percentage of time lost through sickness was 3.25%, against a target of 2.95%. No bonus was therefore payable in respect of this metric.

Directors' remuneration report continued

In 2007/08, John Cuthbert's personal targets related principally to maintaining key financial ratios and measures, ensuring that good relationships are maintained with major investors, ensuring proper implementation of reporting under the Transparency Directive, implementing pension scheme changes and succession planning. Chris Green's personal targets were focused mainly on the maintenance of key financial ratios and measures, relationships with major investors and analysts, disposal of surplus properties and upgrading financial systems.

Taking account of performance against personal targets and the OPA, PBT and lost time performance, bonuses equal to 47% of basic salary were approved for payment to John Cuthbert and Chris Green. Bonus payments are included in Table 1 on page 51.

The Committee is aware of Guideline 3.2 of the ABI Guidelines on Responsible Investment Disclosure and is satisfied that neither the executive directors' annual bonus targets nor the LTIP performance conditions are likely, inadvertently, to motivate irresponsible behaviour.

LTIP

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company. All awards have three year pre-vesting performance conditions. These are described in detail below but, in summary, the current policy is for half of an award to be subject to relative total shareholder return performance against the FTSE 250 (excluding investment trusts) and the other half to be subject to a relative return on capital target as monitored by Ofwat.

At last year's AGM, shareholders approved an increase in the maximum individual award that can be made under the LTIP. It is now an award over shares worth 100% of annual salary at grant, but only the executive directors participate at this level. Full details of the levels of award and performance conditions are shown in Table 2 on page 52.

The Remuneration Committee, with advice from HNBS, has reviewed the LTIP and is still of the view that it remains the most appropriate equity incentive plan, particularly in the light of the Company's dividend policy.

Total shareholder return (TSR) remains an appropriate performance measure because it ensures that executives are rewarded fairly for value created for the Company's investors. Relative return on capital employed was chosen as a complementary measure because:

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

For the awards granted on 13 December 2007, the three years to be reviewed are 2007/08, 2008/09 and 2009/10. Over the three year performance period, the return on capital employed will be calculated on a compounded annualised return basis.

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

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

The LTIP award, granted on 22 December 2004, became available to vest on 22 December 2007. The Committee instructed PricewaterhouseCoopers (PwC) to assess the level of vesting of this award. PwC reported that 73% of the award was available to vest (being 100% of the award relating to the Company's TSR performance against the FTSE 250 Index and 60% of the award relating to the Company's TSR performance against the other listed water companies). Prior to vesting, the Committee satisfied itself that the recorded TSR performance was a genuine reflection of the Company's underlying performance. Details of the number of awards which lapsed and those which were exercised by the directors of the Company are shown in Table 3 on page 53.

Non-executive directors' fees
The Company's remuneration policy is that the Chairman and the non-executive directors should receive a fixed fee for their normal duties. Reflecting the added responsibilities and time commitment, chairing the Remuneration and Audit Committees attracts an additional fee over the non-executive directors' standard base fee.

Fees payable during 2007/08 and the Company's policy from 1 April 2008 are:

	2007/08 fee (£)	Policy for 2008/09 (£)
Chairman	150,000	157,500
Non-executive director base fee	35,000	36,750
Audit Committee chairing fee	10,000	10,500
Remuneration Committee chairing fee	5,000	5,250

The Chairman and the non-executive directors do not receive benefits in kind and do not participate in bonus, pension or share schemes operated by the Company. Details of non-executive directors' remuneration are set out in Table 1 on page 51.

Directors' interests in LTIP awards
The directors' conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP as at 31 March 2008, are set out in Table 3 on page 53.

Ordinary 10 pence shares required to fulfil LTIP awards which have vested may be provided by the Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited. The Trustees are Sir Patrick Brown, Martin Nègre and Anita Frew (a non-executive director of NWL). At 31 March 2008, the Trust held a total of 443,507 ordinary 10 pence shares. This represents 0.08% of the Company's total issued share capital, so is materially less than the 5% restriction on shares that can be held in trust. In line with the ABI Guidelines, dividends are waived on these shares and the voting rights attached to these shares will not be exercised at the AGM.

Share dilution
The Company's share plans contain dilution limits that comply with the ABI Guidelines. Shares for both the LTIP and SIP schemes are provided by purchase on the market. There has, therefore, been no dilution to date and there is no commitment to issue new shares in relation to either scheme.

Performance graph
The TSR performance graph is shown at Table 4 on page 53.

Service contracts
All non-executive directors are appointed for a term of 12 months with a six month notice period for the Company and the director. The executive directors have service contracts with 12 months' notice periods and which expire when the directors reach normal retirement age. Details of the contracts of the executive and non-executive directors who served during the year are shown in Table 5 on page 54.

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

External appointments of executive directors
The Board's position on external appointments is described in the corporate governance report on page 41. To date, no fees for external appointments have been retained by executive directors.

Directors' interests in shares
The directors' beneficial interests in the ordinary 10 pence shares of the Company, as at 31 March 2008, are set out in Table 7 on page 55.

Directors’ remuneration report continued

Directors’ interests in shares under the SIP

The Company SIP is open to UK employees with more than three months’ service. Further details of the SIP are set out in the directors’ report and business review on page 13. During the year, the executive directors had the opportunity to participate in the SIP and their interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP, are set out in Table 8 on page 55.

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

Martin Parker
Company Secretary
3 June 2008

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

Table 1
Directors' emoluments (audited)

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

	Fees £000	Basic salary £000	Benefits[1] £000	Bonus[2] £000	**Total for the year ended 31 March 2008 £000**	Total for the year ended 31 March 2007 £000
Executive Directors						
John Cuthbert	–	270	6	127	**403**	443
Chris Green	–	210	8	99	**317**	338
Non-executive Directors						
Sir Derek Wanless	150	–	–	–	**150**	93
Sir Patrick Brown[3]	45	–	–	–	**45**	38
Claude Lamoureux[4]	35	–	–	–	**35**	10
Martin Nègre[5]	40	–	–	–	**40**	35
Alex Scott-Barrett	35	–	–	–	**35**	15
Jenny Williams	35	–	–	–	**35**	30
Ron Lepin[6,7]	–	–	–	–	**–**	20
Sir Fred Holliday[8]	–	–	–	–	**–**	50
Total remuneration	340	480	14	226	**1,060**	1,072

Notes:
1. The remuneration of each executive director includes non-cash benefits comprising the provision of car allowances and healthcare.
2. The annual bonus is payable in June 2008, for performance during the year ended 31 March 2008.
3. Includes additional fee paid as Chairman of Audit Committee.
4. Up until 15 February 2008, fee was payable to OTPP.
5. Includes additional fee paid as Chairman of the Remuneration Committee.
6. Fee payable to OTPP.
7. Resigned on 1 December 2006.
8. Retired as Chairman on 27 July 2006.

Directors' remuneration report continued

Table 2
Summary of LTIP award and performance conditions (unaudited)

LTIP award made 22 December 2004	
Maximum award	75% of salary permitted. Actual grants to executive directors related to shares worth 40% of salary.
Performance conditions	Comparison of TSR with two comparator groups over three years: (1) 70% of award depends on the Company's TSR performance against other listed water companies: AWG plc, Bristol Water Group plc, East Surrey Holdings plc, Kelda Group plc, Pennon Group plc, Severn Trent plc and United Utilities plc; and (2) 30% of award depends on the Company's TSR performance against the FTSE 250 Index, excluding investment trusts. East Surrey Holdings plc de-listed on 28 October 2005 and Bristol Water Group plc de-listed on 18 May 2006. AWG plc de-listed on 21 December 2006. These companies have been left in the comparator group for the purpose of the awards and their performance was frozen on the date each company de-listed. This means that a constant TSR has been applied at each date after the de-listing.
Vesting schedules	(1) 30% vests at median performance with sliding scale based on ranking to 100% if the Company tops the group. Where the Company's TSR performance is below the median performance of the comparator group, none of that element of the award will vest. (2) 30% vests if the Company's TSR equals the FTSE 250 Index, increasing to 100% if the Company's TSR outperforms the Index by at least 6%. Where the Company's TSR performance is less than that of the Index, none of that element of the award will vest.

LTIP award made 9 December 2005	
Maximum award	75% of salary permitted. Actual grants to executive directors related to shares worth 70% of salary.
Performance conditions	As above, except that Kelda Group plc de-listed on 12 February 2008. This also remained in the comparator group as described above.
Vesting schedules	(1) as above but, between median and upper quartile, the vesting will be calculated on a straight line basis comparing the Company's TSR to that of the median and upper quartile positions, rather than ranking. (2) 30% vests at median performance with straight line pro-rating of TSR performance against the members of the FTSE 250 Index, excluding investment trusts, to 100% for upper quartile performance. Where the Company's TSR performance is below the median, none of that element of the award will vest.

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

LTIP award made 13 December 2007 and future awards	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth 100% of salary.
Performance conditions and vesting schedules	As per LTIP award made 21 December 2006.

Table 3
Directors' interests in LTIP awards (audited)

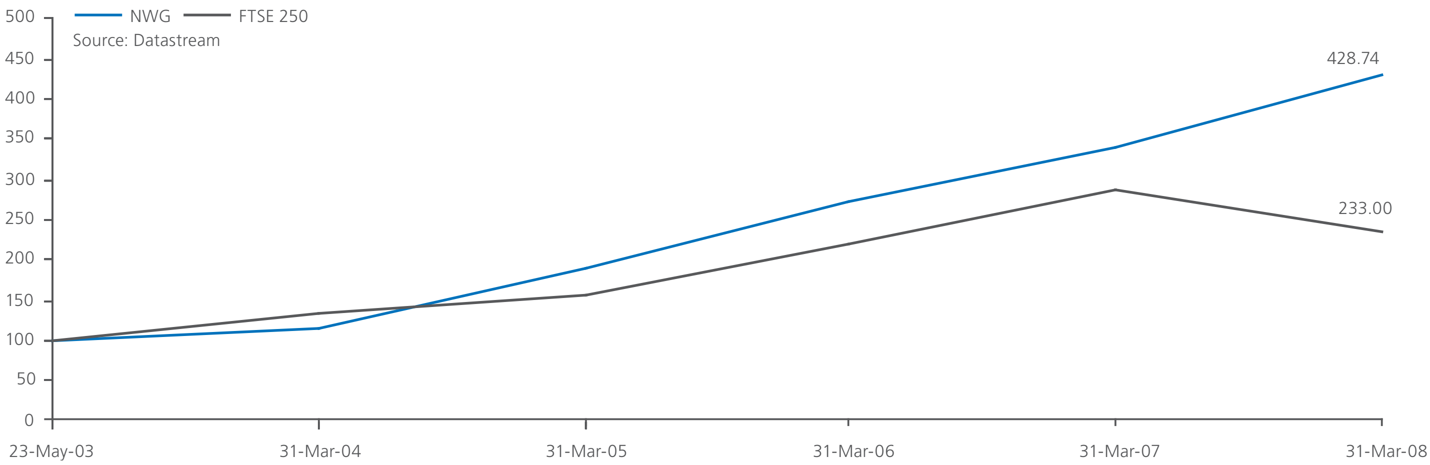
As at 31 March 2008, the directors had the following conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP:

	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2008[1]
John Cuthbert	22.12.04[2]	67,001	–	18,649	48,352[3]	**–**
	9.12.05[4]	75,903	–	–	–	**75,903**
	21.12.06[5]	66,721	–	–	–	**66,721**
	13.12.07[6]	–	79,230	–	–	**79,230**
Totals		209,625	79,230	18,649	48,352	**221,854**
Chris Green	22.12.04[2]	44,221	–	12,308	31,913[3]	**–**
	9.12.05[4]	50,602	–	–	–	**50,602**
	21.12.06[5]	49,423	–	–	–	**49,423**
	13.12.07[6]	–	61,620	–	–	**61,620**
Totals		144,246	61,620	12,308	31,913	**161,645**

Notes:
1. There have been no changes to any of the above interests in awards under the LTIP from the end of the year to 3 June 2008.
2. The market value of the shares on the date of the award was 174.50 pence per share. The three year performance period ran from 1 October 2004 to 30 September 2007.
3. Shares vested on 27 December 2007 and the closing price on that date was 345.75 pence per share.
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. The market value of the shares on the date of the award was 334.00 pence per share. The three year performance period runs from 1 October 2007 to 30 September 2010.
7. 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, £0.5 million was charged to the income statement (2007: £0.4 million).
8. Details of the performance conditions are shown at Table 2 on page 52.
9. The market price of the shares on 31 March 2008 was 349.25 pence per share. During the year, the highest market price was 376.00 pence per share and the lowest market price was 288.25 pence per share.
10. Aggregate gross gains made by directors on exercise of awards at date of vesting was £277,516 (2007: £302,069).

Table 4
TSR graph (unaudited)

The graph below shows a comparison between the TSR for the Company's shares for the period 23 May 2003 (the date the Company's shares were listed on AIM) to 31 March 2008, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as the Company is a constituent of the FTSE 250.



Note:
This graph shows the value, by 31 March 2008, of £100 invested in Northumbrian Water Group plc on 23 May 2003 (the date the Company's shares were listed on AIM) compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

Table 5
Directors' service contracts (unaudited)

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

	Initial appointment	Current contract start date	Unexpired term[1]	Notice period by either party	Current contract end date
Executive Directors[2]					
John Cuthbert	23 May 2003	23 May 2003	Not fixed term	12 months	Normal retirement age (65)
Chris Green	23 May 2003	23 May 2003	Not fixed term	12 months	Normal retirement age (65)
Non-executive Directors[3]					
Sir Derek Wanless	1 December 2003	1 December 2007	6 months	6 months	30 November 2008
Sir Patrick Brown	12 May 2003	12 May 2008	11 months	6 months	11 May 2009
Martin Nègre	12 May 2003	12 May 2008	11 months	6 months	11 May 2009
Alex Scott-Barrett	26 September 2006	26 September 2007	4 months	6 months	25 September 2008
Claude Lamoureux	1 December 2006	1 December 2007	6 months	6 months	30 November 2008
Jenny Williams	27 May 2004	27 May 2008	12 months	6 months	26 May 2009

Notes:
1. Calculated as at 3 June 2008 and rounded to nearest whole month.
2. The service contracts of the executive directors do not contain provisions relating to compensation for termination. In the event of termination by the Company, the Remuneration Committee would make recommendations to the Board on what payments, if any, should be made to the director, depending on the circumstances of the termination, and taking into account the provisions of the Combined Code discouraging payment for failure. The Company would also expect directors to seek to mitigate their loss.
3. Contracts do not provide for compensation for loss of office in excess of fees accrued.

Table 6
Directors' pensions and pension benefits (audited)

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

	Accrued pension at 31 March 2007 £000	**Accrued pension at 31 March 2008 £000**	Increase in accrued pension £000	Increase in accrued pension net of inflation £000	Transfer value of net increase in accrued pension less directors' contributions £000	Transfer value of accrued pension at 1 April 2007 £000	**Transfer value of accrued pension at 31 March 2008 £000**	Total change in transfer value less directors' contributions £000
John Cuthbert	133.8	**141.7**	7.9	2.8	131.5	2,301.0	**2,503.1**	202.1
Chris Green	83.3	**88.0**	4.7	1.5	74.4	1,373.6	**1,492.1**	118.5

Notes:
1. Accrued pensions shown are the amounts that would be paid annually on retirement based on service to the end of the year.
2. Voluntary contributions paid by the directors and resulting benefits are not shown.
3. The change in transfer value reflects fluctuations in the transfer value due to factors beyond the control of the Company and directors, such as changes in stock market conditions.
4. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11.
5. The directors participate in a salary sacrifice arrangement and, therefore, paid no contributions to the scheme during the year.

Table 7
Directors' interests in shares (audited)

The directors had the following beneficial or family interests in the ordinary 10 pence shares of the Company as at 31 March 2008:

	Number of shares held at the start of the year	**Number of shares held as at 31 March 2008**	Number of shares held as at 3 June 2008
Sir Patrick Brown	43,000	**43,000**	43,000
John Cuthbert	126,350[1]	**163,892[2]**	162,892[3]
Chris Green[4]	89,042	**107,865**	107,865
Claude Lamoureux	–	**–**	–
Martin Nègre	170,000	**70,000**	70,000
Alex Scott-Barrett[5]	–	**10,000**	10,000
Sir Derek Wanless	30,000	**30,000**	30,000
Jenny Williams	6,000	**6,000**	6,000

Notes:
1. At 1 April 2007, 26,350 of these shares were beneficially owned by Mrs Lynn Cuthbert.
2. At 31 March 2008, 46,892 of these shares were beneficially owned by Mrs Lynn Cuthbert, 8,000 were beneficially owned by Mr I M Cuthbert and 9,000 were beneficially owned by Miss S L Cuthbert.
3. At 3 June 2008, 46,892 of these shares are beneficially owned by Mrs Lynn Cuthbert, 7,000 are beneficially owned by Mr I M Cuthbert and 9,000 are beneficially owned by Miss S L Cuthbert.
4. These shares are beneficially owned by Mrs Geraldine Green.
5. These shares are beneficially owned by Cazenove Capital Management.

Table 8
Directors' interests in shares under the SIP (audited)

The directors who held office as at 31 March 2008 had the following interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP:

	Number of SIP shares held at the start of the year[1]	**Number of SIP shares held as at 31 March 2008[1]**	Number of SIP shares held as at 3 June 2008[1]
John Cuthbert	3,565	**4,176**	4,785
Chris Green	3,565	**4,176**	4,785

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

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

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

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

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

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

Responsibility statements

We confirm that to the best of our knowledge:

a) the financial statements, prepared in accordance with IFRS as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Company and the undertakings included in the consolidation taken as a whole; and

b) the directors' report and business review includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Sir Derek Wanless
Chairman

John Cuthbert
Managing Director

Report of the Auditors on the Group financial statements

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

We have audited the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2008 which comprise the Consolidated income statement, the Consolidated statement of recognised income and expense, the Consolidated balance sheet, the Consolidated cash flow statement, and the related notes 1 to 29. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2008 and on the information in the Directors' remuneration report that is described as having been audited.

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

Respective responsibilities of directors and auditors

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

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

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

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

We review whether the Corporate governance statement reflects the Company's compliance with the ten provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited Group financial statements. The other information comprises only Highlights, NWG at a glance, the Chairman's statement, the Directors' report and business review, Appendix to the directors' report and business review, Board directors' biographies, the unaudited part of the Directors' remuneration report and Shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Report of the Auditors on the Group financial statements continued

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 March 2008 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Directors' report is consistent with the Group financial statements.

Ernst & Young LLP
Registered Auditor
Newcastle upon Tyne
3 June 2008

Consolidated income statement

For the year ended 31 March 2008

	Notes	Year to 31.3.2008 £m	Year to 31.3.2007 (restated) £m
Continuing operations			
Revenue	2	**670.4**	633.5
Operating costs	3	**(392.6)**	(385.8)
Profit on ordinary activities before interest	2	**277.8**	247.7
Finance costs payable	6	**(173.5)**	(159.4)
Finance income receivable	6	**65.5**	58.7
Share of profit after tax of associates and jointly controlled entities		**0.5**	0.8
Profit on ordinary activities before taxation	2	**170.3**	147.8
– current taxation	7	**(25.4)**	(8.6)
– deferred taxation	7	**13.6**	(28.0)
– overseas tax	7	**(0.2)**	–
Profit for the year		**158.3**	111.2
Attributable to:			
Equity shareholders of the parent Company		**158.1**	110.9
Minority interests		**0.2**	0.3
		158.3	111.2
Basic earnings per share for profit attributable to ordinary equity holders of the parent Company	8	**30.52p**	21.42p
Diluted earnings per share for profit attributable to ordinary equity holders of the parent Company	8	**30.48p**	21.38p
Adjusted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent Company (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments)	8	**26.72p**	24.95p
Ordinary final dividend proposed per share	9	**8.07p**	7.52p
Dividend paid per share	9	**11.52p**	10.79p

Consolidated statement of recognised income and expense

For the year ended 31 March 2008

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Actuarial gains	**27.3**	25.0
Gains on cash flow hedges	**–**	2.4
Tax on items charged or credited to equity	**(7.8)**	(7.5)
Translation differences	**0.3**	(0.2)
Total income and expense recognised in equity	**19.8**	19.7
Transferred to the income statement on cash flow hedges	**–**	(2.9)
Profit for the year	**158.3**	111.2
Total recognised income and expense	**178.1**	128.0
Attributable to:		
Equity shareholders of the parent Company	**177.9**	127.7
Minority interests	**0.2**	0.3
	178.1	128.0

Consolidated balance sheet

As at 31 March 2008

	Notes	31.3.2008 £m	31.3.2007 £m
Non-current assets			
Goodwill	10	**3.6**	3.6
Other intangible assets	10	**64.2**	64.2
Property, plant and equipment	11	**3,256.3**	3,119.9
Investments in jointly controlled entities	12	**3.8**	3.6
Financial assets		**16.4**	18.0
Pension asset	25	**90.5**	42.7
Other investments	12	**–**	0.2
		3,434.8	3,252.2
Current assets			
Inventories	13	**3.4**	3.7
Trade and other receivables	14	**125.1**	124.5
Cash and cash equivalents	15	**294.2**	316.9
		422.7	445.1
Total assets		**3,857.5**	3,697.3
Non-current liabilities			
Interest bearing loans and borrowings	17	**2,326.4**	2,382.1
Provisions	19	**2.8**	2.9
Deferred income tax liabilities	7	**525.4**	531.2
Other payables		**9.0**	10.0
Grants		**209.0**	193.3
		3,072.6	3,119.5
Current liabilities			
Interest bearing loans and borrowings	17	**136.3**	34.5
Provisions	19	**0.2**	0.2
Trade and other payables	16	**152.9**	165.6
Income tax payable		**3.7**	4.4
		293.1	204.7
Total liabilities		**3,365.7**	3,324.2
Net assets		**491.8**	373.1
Capital and reserves			
Issued capital	21/22	**51.9**	51.9
Share premium reserve	22	**446.5**	446.5
Cash flow hedge reserve	22	**1.0**	1.0
Treasury shares	22	**(0.8)**	(1.3)
Currency translation	22	**0.1**	(0.2)
Retained earnings	22	**(8.6)**	(126.5)
Equity shareholders' funds		**490.1**	371.4
Minority interests	22	**1.7**	1.7
Total capital and reserves		**491.8**	373.1

Approved by the Board on 3 June 2008 and signed on its behalf by:

Sir Derek Wanless
Chairman

John Cuthbert
Managing Director

Consolidated cash flow statement

For the year ended 31 March 2008

	Notes	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Operating activities			
Reconciliation of profit before interest to net cash flows from operating activities			
Profit on ordinary activities before interest		**277.8**	247.7
Depreciation and other similar non-cash charges		**98.3**	92.9
Other non-cash credits		**(5.0)**	(6.2)
Net credit for provisions, less payments		**(0.1)**	(0.3)
Difference between pension contributions paid and amounts recognised in the income statement		**15.3**	14.9
Decrease/(increase) in inventories		**0.3**	(0.4)
Increase in trade and other receivables		**(1.0)**	(13.6)
(Decrease)/increase in trade and other payables		**(3.8)**	0.9
Cash generated from operations		**381.8**	335.9
Advanced contributions in respect of retirement benefits		**(22.6)**	(25.8)
Interest paid		**(131.3)**	(124.7)
Income taxes paid		**(26.3)**	(14.6)
Net cash flows from operating activities		**201.6**	170.8
Investing activities			
Interest received		**18.2**	12.5
Capital grants received		**20.5**	18.8
Proceeds on disposal of property, plant and equipment		**1.8**	2.2
Dividends received from jointly controlled entities		**0.5**	0.9
Purchase of property, plant and equipment		**(236.8)**	(211.4)
Net cash flows from investing activities		**(195.8)**	(177.0)
Financing activities			
New borrowings		**31.4**	425.0
Maturity of investments		**1.8**	2.1
Settled hedge instruments		**–**	3.4
Issue costs of new borrowings		**–**	(0.4)
Own shares purchased		**–**	(0.2)
Dividends paid to minority interests		**(0.2)**	(0.1)
Dividends paid to equity shareholders		**(59.7)**	(55.8)
Repayment of borrowings		**(22.1)**	(201.1)
Payment of principal under hire purchase contracts and finance leases		**(6.4)**	(4.8)
Net cash flows from financing activities		**(55.2)**	168.1
(Decrease)/increase in cash and cash equivalents		**(49.4)**	161.9
Cash and cash equivalents at start of year	15	**315.8**	153.9
Cash and cash equivalents at end of year	15	**266.4**	315.8

Notes to the consolidated financial statements

1. Accounting policies

(a) Statement of compliance

The consolidated financial statements have been prepared in accordance with IFRS as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2008 and in accordance with the Companies Act 1985. The consolidated financial statements are also consistent with IFRS as issued by the IASB.

The Group has changed its presentation in respect of its defined benefit pension cost. The service cost is disclosed in employment costs and the expected interest income and interest cost on obligations have been disclosed within finance costs payable/(income receivable) as the directors believe this is more comparable to other companies in the industry. Operating costs, finance costs payable and finance income receivable have been restated for the year ended 31 March 2007 by £10.5 million, £32.4 million and £42.9 million, respectively. There is no effect on profit on ordinary activities before tax or profit for the year.

The Group has adopted the following new and amended IFRS and IFRIC interpretations during the year. Adoption of these revised standards and interpretations did not have any effect on the financial performance or position of the Group. However, they did give rise to additional disclosures including, in some cases, revisions to accounting policies.

IFRS 7 Financial Instruments: Disclosures

This standard requires disclosures that enable users of the financial statements to evaluate the significance of the Group's financial instruments and the nature and extent of risks arising from those financial instruments. The new disclosures are included throughout the financial statements. While there has been no effect on the financial position or results, comparative information has been revised where needed.

IAS 1 Presentation of Financial Statements

This amendment requires the Group to make new disclosures to enable users of the financial statements to evaluate the Group's objectives, policies and processes for managing capital. These new disclosures are shown on pages 17 to 19 of the Directors' report and business review.

IFRIC 8 Scope of IFRS 2, IFRIC 9 Reassessment of Embedded Derivatives, IFRIC 10 Interim Financial Reporting and Impairment and IFRIC 11 Group and Treasury Share transactions

These interpretations had no impact on the financial position or performance of the Group.

The directors consider the following accounting policies to be relevant in relation to the Group's financial statements. The financial statements of the Group for the year ended 31 March 2008 were authorised for issue by the Board of directors on 3 June 2008 and the balance sheet was signed on the Board's behalf by Sir Derek Wanless (Chairman) and John Cuthbert (Managing Director).

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

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

(b) Basis of consolidation

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

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

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

(c) Associates and jointly controlled entities

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

(d) Goodwill

Goodwill arising on the acquisition of subsidiary undertakings and businesses represents the excess of the fair value of the consideration given over the fair value of the identifiable assets and liabilities acquired. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Prior to 1 April 2004, goodwill was amortised over its estimated useful life; such amortisation ceased on 31 March 2004. Goodwill relating to acquisitions since 1 April 2004 is not amortised. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired. For the purposes of impairment testing, goodwill is allocated to the related cash-generating units monitored by management at statutory company level. Where the recoverable amount of the cash-generating unit is less than its carrying amount, including goodwill, an impairment loss is recognised in the income statement. The carrying amount of goodwill allocated to a cash-generating unit is taken into account when determining the gain or loss on disposal of the unit, or of an operation within it.

(e) Intangible assets other than goodwill

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

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

(f) Property, plant and equipment

Property, plant and equipment and depreciation

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

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

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

1. Accounting policies continued

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

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

Infrastructure assets

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

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

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

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

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

(g) Financial assets

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

(h) Foreign currencies and foreign currency transactions

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

Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities, where material, and includes the differences, if any, had those cash flows been reported at end of period exchange rates.

(i) Inventories

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

(j) Revenues

Provision of services

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

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

Interest

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

Dividends

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

(k) Grants and contributions

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

(l) Leases

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

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

(m) Pensions and other post-employment benefits

Defined benefit scheme

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

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

Actuarial gains and losses on experience adjustments and changes in actuarial assumptions are recognised in full in the period in which they occur in the consolidated statement of recognised income and expense.

Defined contribution scheme

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

1. Accounting policies continued

(n) Share-based payments

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

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

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

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

(o) Taxes

Current tax

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

Deferred tax

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

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

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

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

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

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

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

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

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

Value added tax

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

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

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

(p) Derivative financial instruments

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

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

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

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

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

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

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

1. Accounting policies continued

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

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

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

(q) Interest bearing loans and borrowings

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

Borrowing costs are recognised as an expense when incurred.

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

(r) Loans and receivables

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

(s) Cash and cash equivalents

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

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

(t) Trade and other receivables

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

(u) Investments

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

(v) Provisions

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

(w) Impairment of assets

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any such indication exists, or when annual impairment testing for an asset is required, the Group makes an estimate of the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use and is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Impairment losses on continuing operations are recognised in the income statement in those expense categories consistent with the function of the impaired asset.

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

(x) De-recognition of financial assets and liabilities

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

(y) Accounting Standards

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

International Accounting Standards (IAS/IFRS)	Effective date
IFRS 2: Share-based Payments – Vesting Conditions and Cancellations	1 January 2009
IFRS 3: Business Combinations (Revised)	1 July 2009
IFRS 8: Operating Segments	1 January 2009
IAS 1: Presentation of Financial Statements (Revised)	1 January 2009
IAS 23: Borrowing Costs (Revised)	1 January 2009
IAS 27: Consolidated and Separate Financial Statements (Revised)	1 July 2009

International Financial Reporting Interpretation Committee (IFRIC)	Effective date
IFRIC 12: Service Concession Arrangements	1 January 2008
IFRIC 13: Customer Loyalty Programmes	1 July 2008
IFRIC 14: The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	1 January 2008

With the exception of IAS 23: Borrowing Costs (Revised), the directors do not anticipate that the adoption of these standards and interpretations will have a material impact on the Group's financial statements in the period of initial application. The directors continue to assess the impact of IAS 23: Borrowing Costs (Revised) on the Group's financial statements.

(z) Key assumptions

The directors consider that the key assumptions applied at the balance sheet date, which may have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are:

- those assumptions used in arriving at the pension asset/liability under IAS 19. These key assumptions and their possible impact are disclosed in note 26, 'Pensions and other post-retirement benefits';

- the bad debt provision which 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; and
- the asset lives assigned to Property, plant and equipment, details of which can be found in note 1(f).

2. Segmental analysis

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

The Group has changed its presentation in respect of its defined benefit pension cost. The service cost is disclosed in employment costs and the expected interest income and interest cost on obligations have been disclosed within finance costs payable/(income receivable) as the directors believe this is more comparable to other companies in the industry. Operating costs, finance costs payable and finance income receivable have been restated for the year ended 31 March 2007 by £10.5 million, £32.4 million and £42.9 million, respectively. There is no effect on profit on ordinary activities before tax or profit for the year. The impact at the NWL segment is a reduction on profit on ordinary activities before interest for the year ended 31 March 2007 of £4.3 million.

The 'Other' segment (formerly disclosed as 'Related services') previously included AES. On 31 March 2007, the business of AES merged with NWL and operates as a trading division of NWL. Accordingly, the comparatives for the 'Other' and 'Northumbrian Water Limited' segments, for the year ended 31 March 2007, have been restated by £5.3 million and £0.4 million in respect of external revenue and profit on ordinary activities before interest, respectively. Segment assets and liabilities have also been restated by £1.9 million and £1.4 million, respectively.

Northumbrian Water Limited

NWL is one of the ten regulated water and sewerage businesses in England and Wales. NWL operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water. NWL also has non-regulated activities closely related to its principal regulated activity.

Water and waste water contracts

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

Other

Central unallocated costs and provisions reported previously in profit on ordinary activities before interest for the year ended 31 March 2007, of £2.8 million, have also been restated to be included within the 'Other' segment.

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

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

Revenue

	Northumbrian Water Limited £m	Water and waste water contracts £m	Other £m	Total £m
Year ended 31 March 2008				
Segment revenue	**628.0**	**35.5**	**12.6**	**676.1**
Inter segment revenue	**–**	**–**	**(5.7)**	**(5.7)**
Revenue to external customers	**628.0**	**35.5**	**6.9**	**670.4**
Year ended 31 March 2007 (restated)				
Segment revenue	591.8	37.0	11.2	640.0
Inter segment revenue	–	–	(6.5)	(6.5)
Revenue to external customers	591.8	37.0	4.7	633.5

All revenue above represents services provided.

Notes to the consolidated financial statements continued

2. Segmental analysis continued

Profit on ordinary activities before interest

	Northumbrian Water Limited £m	Water and waste water contracts £m	Other £m	Total £m
Year ended 31 March 2008				
Segment profit on ordinary activities before interest	**272.0**	**8.4**	**(2.6)**	**277.8**
Net finance costs				**(108.0)**
Share of profit from associates and jointly controlled entities				**0.5**
Profit on ordinary activities before taxation				**170.3**
Taxation				**(12.0)**
Profit for the year from continuing operations				**158.3**
Year ended 31 March 2007 (restated)				
Segment profit on ordinary activities before interest	238.7	11.9	(2.9)	247.7
Net finance costs				(100.7)
Share of profit from associates and jointly controlled entities				0.8
Profit on ordinary activities before taxation				147.8
Taxation				(36.6)
Profit for the year from continuing operations				111.2

Assets and liabilities

	Northumbrian Water Limited		Water and waste water contracts		Other		Total	
	31.3.2008 £m	31.3.2007 £m	**31.3.2008 £m**	31.3.2007 £m	**31.3.2008 £m**	31.3.2007 £m	**31.3.2008 £m**	31.3.2007 £m
Segment assets	**3,398.9**	3,161.7	**133.1**	137.5	**325.5**	398.1	**3,857.5**	3,697.3
Segment liabilities	**303.8**	303.1	**23.0**	20.7	**3,038.9**	3,000.4	**3,365.7**	3,324.2

Other comprises taxation, interest and net debt.

	Northumbrian Water Limited		Water and waste water contracts		Total	
	31.3.2008 £m	31.3.2007 £m	**31.3.2008 £m**	31.3.2007 £m	**31.3.2008 £m**	31.3.2007 £m
Other segment information:						
Property, plant and equipment additions	**233.8**	226.2	**1.5**	1.0	**235.3**	227.2
Depreciation	**93.0**	87.4	**5.3**	5.4	**98.3**	92.8
Impairment of intangible	**–**	0.1	**–**	–	**–**	0.1

3. Operating costs

	Year to 31.3.2008 £m	Year to 31.3.2007 (restated) £m
Materials and consumables	**22.3**	20.4
Manpower costs (see note 5)	**106.9**	103.2
Own work capitalised	**(26.2)**	(24.4)
Depreciation of property, plant and equipment	**98.3**	92.8
Profit on disposal of property, plant and equipment	**(1.2)**	(2.1)
Impairment of goodwill	**–**	0.1
Amortisation of capital grants	**(4.8)**	(4.5)
Costs of research and development	**1.8**	2.1
Operating lease payments	**1.1**	1.2
Bad debt charge	**13.7**	13.3
Other operating costs	**180.7**	183.7
Operating costs	**392.6**	385.8

4. Auditors' remuneration

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Audit of the financial statements*	**0.3**	0.3
Other fees to auditors:		
Taxation services	**0.1**	–
Regulatory services	**–**	0.1

* £90,000 of this relates to the Company (2007: £84,000).

5. Employee information

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

	Year to 31.3.2008 £m	Year to 31.3.2007 (restated) £m
Wages and salaries	**82.8**	79.6
Social security costs	**7.0**	6.8
Defined benefit pension service cost (see note 25)	**15.7**	16.0
Other pension costs	**1.4**	0.8
Total employment costs	**106.9**	103.2
Total employment costs were charged as follows:		
Capital schemes and infrastructure renewals	**25.9**	24.2
Manpower costs	**81.0**	79.0
	106.9	103.2

Included in wages and salaries is a total expense of shared-based payments of £0.8 million (2007: £0.7 million) which arises from transactions accounted for as equity-settled share-based payment transactions.

Notes to the consolidated financial statements continued

5. Employee information continued

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

	Year to 31.3.2008 Number	Year to 31.3.2007 (restated) Number
Northumbrian Water Limited	**2,890**	2,862
Water and waste water contracts	**155**	153
Other	**25**	25
	3,070	3,040

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

The 'Other' segment (formerly disclosed as 'Related services') previously included AES. On 31 March 2007, the business of AES merged with NWL and operates as a trading division of NWL. Accordingly, the comparatives for the 'Other' and 'Northumbrian Water Limited' segments, for the year ended 31 March 2007 have been restated by 308.

6. Finance costs payable/(income receivable)

	Year to 31.3.2008 £m	Year to 31.3.2007 (restated) £m
Finance costs payable on debentures, bank and other loans and overdrafts	**141.5**	128.4
Amortisation of discount, fees, loan issue costs and other financing items	**(5.6)**	(7.1)
Settled hedge instruments	**–**	2.9
Interest cost on pension plan obligations	**35.2**	32.4
Finance costs payable on hire purchase contracts and finance leases	**2.4**	2.8
Total finance costs payable	**173.5**	159.4
Expected return on pension plan assets	**(48.4)**	(42.9)
Finance income receivable	**(17.1)**	(15.8)
Net finance costs payable	**108.0**	100.7

7. Taxation

(a) Tax on profit on ordinary activities

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Current tax:		
Current income tax charge at 30% (2007: 30%)	**28.1**	21.0
Income tax reported in equity on cash flow hedges	**–**	0.1
Adjustment in respect of prior periods	**(2.7)**	(12.5)
UK corporation tax	**25.4**	8.6
Overseas tax	**0.2**	–
Total current tax	**25.6**	8.6
Deferred tax:		
Impact of opening rate reduction	**(35.4)**	–
Origination and reversal of temporary differences in the year at 28% (2007: 30%)	**15.1**	21.0
Income tax reported in equity on cash flow hedges	**–**	(0.1)
Adjustment in respect of prior periods	**6.7**	7.1
Total deferred tax	**(13.6)**	28.0
Tax charge in the income statement	**12.0**	36.6

7. Taxation continued

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

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Current tax:		
Current tax recycled to income statement on cash flow hedges	–	(0.1)
Deferred tax:		
Actuarial gains and losses on pension schemes	7.6	7.5
Deferred tax recycled to income statement on cash flow hedges	–	0.1
Tax on share-based payment	0.2	–
Tax charge in the statement of recognised income and expense	7.8	7.5

(c) Reconciliation of the total tax charge

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Accounting profit before tax	170.3	147.8
Accounting profit multiplied by standard rate of corporation tax (30%) (2007: 30%)	51.1	44.3
Effects of:		
Expenses not deductible for tax purposes	3.0	0.7
Depreciation in respect of non-qualifying items	0.8	0.7
Non-taxable income and enhanced tax reliefs	(0.6)	(0.8)
Non-taxable amortisation of financing items	(1.8)	(2.3)
Refinancing of infrastructure assets	(7.7)	–
Adjustment to tax charge in respect of prior periods	4.0	(5.4)
Other	(0.3)	(0.6)
	48.5	36.6
Impact of rate reduction on deferred tax:		
Restatement of opening balance	(35.4)	–
Movement in the year	(1.1)	–
Total tax expense reported in the income statement	12.0	36.6

The effective tax rate for the current year was 7.0% (2007: 24.8%). The reduction of 17.8% is mainly due to the impact of the reduction in the rate of corporation tax used to calculate deferred tax offset by a reduction in the level of adjustments in respect of prior years.

(d) Unrecognised tax losses

The Group has tax losses of £8.7 million (2007: £9.1 million) which have arisen in its Gibraltar subsidiary for which a deferred tax asset has not been recognised as they may not be used to offset taxable profits elsewhere in the Group and it is not expected that the subsidiary will utilise significant amounts in the foreseeable future. The losses are, however, available for offset against future taxable profits without time limit.

(e) Temporary differences associated with Group investments

At 31 March 2008, there was no recognised deferred tax liability (2007: £nil) for taxes that would be payable on the unremitted earnings of the Group's subsidiaries as the Group has determined that undistributed profits of its subsidiaries will not be distributed in the foreseeable future. The temporary difference associated with investments in subsidiaries for which a deferred tax liability has not been recognised aggregate to £8.5 million (2007: £7.2 million).

Notes to the consolidated financial statements continued

7. Taxation continued

(f) Deferred tax

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

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Accelerated capital allowances	**(18.0)**	22.3
Intangible asset	**(1.3)**	–
Shared-based payments	**(0.1)**	–
Provisions	**0.5**	1.3
Deferred grant income	**(0.5)**	(5.3)
Retirement benefits	**6.1**	5.4
Losses carried forward	**0.8**	(0.3)
Finance costs payable	**–**	5.5
Fair value adjustment on previous business combinations	**(1.1)**	(0.4)
Other	**–**	(0.5)
	(13.6)	28.0

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

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Deferred tax assets:		
Provisions	**1.2**	1.7
Deferred income	**57.2**	56.7
Losses available for offset against future taxable income	**4.8**	5.6
Share-based payments	**0.2**	0.3
Cash flow hedges	**1.1**	1.2
Other	**0.2**	0.3
Deferred tax asset	**64.7**	65.8
Deferred tax liabilities:		
Accelerated capital allowances	**537.1**	555.1
Intangible asset	**18.0**	19.3
Fair value adjustment on previous business combinations	**11.5**	12.6
Retirement benefits	**23.5**	9.9
Other	**–**	0.1
Deferred tax liability	**590.1**	597.0
Net deferred tax liability	**525.4**	531.2

(g) Factors that may affect future tax charges

The Group expects to continue to incur high levels of capital expenditure and be able to claim tax relief in excess of depreciation for the remainder of NWL's current regulatory period. The annual excess has been falling mainly because, since 1 April 2005, tax deductions for deferred revenue expenditure are claimed on a depreciation basis (as originally set out in HM Revenue and Customs' Tax Bulletin 53).

7. Taxation continued

Future capital allowances claims are subject to proposals announced by the UK Government on 21 March 2007 to revise the rates of allowances with effect from 1 April 2008. The proposed changes are expected to become law when the Finance Act 2008 is enacted and include a reduction in the rate of allowance for items of general plant and machinery from 25% to 20% per annum; an increase in the rate for long life assets from 6% to 10% per annum; the phased abolition of industrial building allowances by 31 March 2011; and the introduction of a new rate of 10% per annum for fixtures that are integral to buildings and structures. The Finance Act 2007 has already removed any potential balancing adjustments in respect of assets on which industrial building allowances are being claimed.

In the directors' view, if all the changes to industrial buildings allowances had been enacted or substantively enacted by the date of these financial statements, the Group's deferred tax liability at 31 March 2008 would have been increased by approximately £117.0 million.

8. Earnings per share

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

	Earnings 31.3.2008 £m	Weighted average number of shares 31.3.2008 million	Earnings per share 31.3.2008 pence	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence
Basic EPS	**158.1**	**518.0**	**30.52**	110.9	517.7	21.42

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

	Earnings 31.3.2008 £m	Weighted average number of shares 31.3.2008 million	Earnings per share 31.3.2008 pence	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence
Diluted EPS	**158.1**	**518.6**	**30.48**	110.9	518.6	21.38

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

	Earnings 31.3.2008 £m	Weighted average number of shares 31.3.2008 million	Earnings per share 31.3.2008 pence	Earnings 31.3.2007 £m	Weighted average number of shares 31.3.2007 million	Earnings per share 31.3.2007 pence
Basic EPS	**158.1**	**518.0**	**30.52**	110.9	517.7	21.42
Deferred tax	**(13.6)**		**(2.62)**	28.0		5.41
Amortisation of debt fair value	**(6.1)**		**(1.18)**	(7.7)		(1.49)
Derivatives	**–**		**–**	(2.0)		(0.39)
Adjusted EPS	**138.4**	**518.0**	**26.72**	129.2	517.7	24.95

Notes to the consolidated financial statements continued

9. Dividends paid and proposed

	Year to 31.3.2008 £m	Year to 31.3.2007 £m
Declared and paid during the year:		
Equity dividends on ordinary shares:		
Final dividend for 2006/07: 7.52p (2005/06: 7.04p)	**39.0**	36.4
Interim dividend for 2007/08: 4.00p (2006/07: 3.75p)	**20.7**	19.4
Dividends paid	**59.7**	55.8
Proposed for approval by shareholders at the AGM:		
Final dividend for 2007/08: 8.07p (2006/07: 7.52p)	**41.8**	39.0

10. Intangible assets

	Goodwill £m	Other £m	Total £m
Cost:			
At 1 April 2006, 1 April 2007 and 31 March 2008	**3.8**	**64.2**	**68.0**
Impairment:			
At 1 April 2006	(0.1)	–	(0.1)
Impairment	(0.1)	–	(0.1)
At 1 April 2007 and 31 March 2008	**(0.2)**	**–**	**(0.2)**
Net book value at 31 March 2008	**3.6**	**64.2**	**67.8**
Net book value at 31 March 2007	3.6	64.2	67.8
Net book value at 1 April 2006	3.7	64.2	67.9

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

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

The other intangible asset represents the right in perpetuity to receive income under the operating agreement with the Environment Agency in respect of the Kielder Water transfer scheme and, therefore, the directors consider the asset has an indefinite life. Accordingly, future cash flows, which increase in line with inflation, have been discounted at a rate of 6.21% in perpetuity. This represents a long term nominal gilt yield and an assumed credit spread. This calculation satisfied the Group that the carrying value at 31 March 2008 had not been impaired. Furthermore, it is improbable that the discount rate would increase to such a level that the carrying value would be impaired.

11. Property, plant and equipment

	Freehold land and buildings £m	Infrastructure assets £m	Operational structures, plant and machinery £m	Fixtures, fittings, tools and equipment £m	Assets in the course of construction £m	Total £m
Cost:						
At 1 April 2006	86.4	1,443.5	1,847.7	161.4	80.3	3,619.3
Additions	–	0.2	0.3	1.7	225.0	227.2
Schemes commissioned	6.2	100.1	94.6	4.4	(205.3)	–
Reclassifications	–	0.6	(0.6)	–	–	–
Disposals	(0.2)	(9.9)	–	(0.2)	–	(10.3)
At 1 April 2007	92.4	1,534.5	1,942.0	167.3	100.0	3,836.2
Additions	–	0.1	1.4	–	233.8	235.3
Schemes commissioned	0.4	82.2	96.8	7.9	(187.3)	–
Reclassifications	0.9	(0.1)	(0.8)	–	–	–
Disposals	(0.4)	(7.5)	(2.5)	–	–	(10.4)
At 31 March 2008	**93.3**	**1,609.2**	**2,036.9**	**175.2**	**146.5**	**4,061.1**
Depreciation:						
At 1 April 2006	28.0	45.8	460.7	99.2	–	633.7
Charge for the year	2.2	20.4	60.4	9.8	–	92.8
Disposals	(0.1)	(9.9)	–	(0.2)	–	(10.2)
At 1 April 2007	30.1	56.3	521.1	108.8	–	716.3
Charge for the year	2.0	21.2	65.3	9.8	–	98.3
Disposals	–	(7.5)	(2.3)	–	–	(9.8)
At 31 March 2008	**32.1**	**70.0**	**584.1**	**118.6**	**–**	**804.8**
Net book value at 31 March 2008	**61.2**	**1,539.2**	**1,452.8**	**56.6**	**146.5**	**3,256.3**
Net book value at 31 March 2007	62.3	1,478.2	1,420.9	58.5	100.0	3,119.9
Net book value at 1 April 2006	58.4	1,397.7	1,387.0	62.2	80.3	2,985.6

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

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

	31.3.2008 £m	31.3.2007 £m
Infrastructure assets	**28.9**	–
Operational structures, plant and machinery	**23.7**	23.2
	52.6	23.2

Notes to the consolidated financial statements continued

12. Investments

	31.3.2008 £m	31.3.2007 £m
Investments in jointly controlled entities	**3.8**	3.6
Other investments	**–**	0.2
	3.8	3.8

(a) Investments in jointly controlled entities

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

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

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

	VLS 31.3.2008 £m	Agreco 31.3.2008 £m	VLS 31.3.2007 £m	Agreco 31.3.2007 £m
Revenue	**5.8**	**1.7**	5.8	1.3
Operating costs	**(5.1)**	**(1.5)**	(4.9)	(1.1)
Profit on ordinary activities before interest	**0.7**	**0.2**	0.9	0.2
Finance costs payable	**(0.4)**	**–**	(0.3)	–
Finance income receivable	**0.1**	**–**	0.1	–
Profit on ordinary activities before taxation	**0.4**	**0.2**	0.7	0.2
– current taxation	**(0.1)**	**–**	(0.1)	–
Profit for the year	**0.3**	**0.2**	0.6	0.2
Share of the jointly controlled entities' balance sheet:				
Non-current assets	**5.7**	**–**	5.6	–
Current assets	**6.0**	**3.5**	5.1	1.5
Share of gross assets	**11.7**	**3.5**	10.7	1.5
Current liabilities	**(3.6)**	**(3.1)**	(3.5)	(1.3)
Non-current liabilities	**(4.7)**	**–**	(3.8)	–
Share of gross liabilities	**(8.3)**	**(3.1)**	(7.3)	(1.3)
Share of net assets	**3.4**	**0.4**	3.4	0.2

12. Investments continued

(b) The Group's interests in principal subsidiaries at 31 March 2007 and 31 March 2008 were as follows:

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

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

13. Inventories

	31.3.2008 £m	31.3.2007 £m
Stores	**3.4**	3.7

Notes to the consolidated financial statements continued

14. Trade and other receivables

	31.3.2008 £m	31.3.2007 £m
Trade receivables	**66.5**	61.7
Amounts owed by jointly controlled entities	**0.7**	0.7
Prepayments and accrued income	**48.9**	45.6
Financial assets	**1.7**	2.1
Other receivables	**7.3**	14.4
	125.1	124.5

As at 31 March 2008, trade receivables at nominal value of £93.8 million (2007: £86.4 million) were impaired. Movements in the provision for impairment of trade receivables were as follows:

	£m
At 1 April 2006	23.7
Charge for the year	13.3
Utilised	(12.3)
At 1 April 2007	24.7
Charge for the year	13.7
Utilised	(11.1)
At 31 March 2008	**27.3**

At 31 March, the ageing analysis of trade receivables overdue but not impaired is as follows:

	0–3 months £m	>3 months £m	Total £m
2008	**17.8**	**0.1**	**17.9**
2007	13.1	0.1	13.2

15. Cash and cash equivalents

	31.3.2008 £m	31.3.2007 £m
Cash at bank and in hand	**92.3**	53.3
Short term deposits	**201.9**	263.6
	294.2	316.9

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

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

	31.3.2008 £m	31.3.2007 £m
Cash at bank and in hand	**92.3**	53.3
Short term deposits	**201.9**	263.6
Bank overdrafts	**(27.8)**	(1.1)
	266.4	315.8

16. Trade and other payables

	31.3.2008 £m	31.3.2007 £m
Trade payables	**9.7**	8.7
Other payables	**16.7**	17.2
Interest payable	**38.7**	43.5
Accruals and deferred income	**87.8**	96.2
	152.9	165.6

17. Interest bearing loans and borrowings

	31.3.2008 £m	31.3.2007 £m
Current:		
Bank overdrafts	**27.8**	1.1
Current instalments due on borrowings (principal £96.8 million, 2007: £22.5 million)	**102.4**	28.6
Current obligations under finance leases and hire purchase contracts (see note 18)	**6.1**	4.8
	136.3	34.5
Non-current:		
Non-current obligations under finance leases and hire purchase contracts (principal £83.6 million, 2007: £56.4 million) (see note 18)	**83.7**	56.5
Non-current instalments on borrowings (principal £2,204.1 million, 2007: £2,281.6 million)	**2,242.7**	2,325.6
	2,326.4	2,382.1
Borrowings comprise the following:		
Loans (principal £550.0 million, 2007: £569.9 million)	**556.9**	579.0
Eurobonds – due 11 October 2017 bearing interest rate of 6.0% (principal £300.0 million, 2007: £300.0 million)	**311.0**	312.1
Eurobonds – due 6 February 2023 bearing interest rate of 6.875% (principal £350.0 million, 2007: £350.0 million)	**392.7**	395.5
Eurobonds – due 29 April 2033 bearing interest rate of 5.625% (principal £350.0 million, 2007: £350.0 million)	**345.6**	345.6
Eurobonds – due 23 January 2034 bearing interest rate of 5.87526% (principal £248.0 million, 2007: £248.0 million)	**240.4**	240.1
Eurobonds – due 31 March 2037 bearing interest rate of 6.627% (principal £61.6 million, 2007: £61.6 million)	**58.8**	58.6
Index linked Eurobonds – due 15 July 2036 bearing interest rate of 2.033% (principal £163.7 million, 2007: £157.6 million)	**162.6**	156.5
Index linked Eurobonds – due 30 January 2041 bearing interest rate of 1.6274% (principal £64.4 million, 2007: £61.6 million)	**64.3**	61.8
Index linked Eurobonds – due 16 July 2049 bearing interest rate of 1.7118% (principal £106.6 million, 2007: £102.7 million)	**106.4**	102.5
Index linked Eurobonds – due 16 July 2053 bearing interest rate of 1.7484% (principal £106.6 million, 2007: £102.7 million)	**106.4**	102.5
	2,345.1	2,354.2
Less current instalments due on bank loans (principal £96.8 million, 2007: £22.5 million)	**(102.4)**	(28.6)
	2,242.7	2,325.6

Notes to the consolidated financial statements continued

17. Interest bearing loans and borrowings continued

The difference between the principal value of £2,204.1 million (2007: £2,281.6 million) and the carrying value of £2,242.7 million (2007: £2,325.6 million) are unamortised issue costs of £15.9 million (2007: £16.1 million) and a credit of £54.5 million (2007: £60.1 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

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

18. Obligations under hire purchase contracts and finance leases

	31.3.2008 £m	31.3.2007 £m
Amounts due:		
Not later than one year	**6.1**	4.8
After one year but not more than five years	**19.2**	21.3
Later than five years	**123.8**	53.5
	149.1	79.6
Less finance charges allocated to future periods	**(59.3)**	(18.3)
Present value of minimum lease payments	**89.8**	61.3
Disclosed as due:		
Not later than one year	**6.1**	4.8
After more than one year	**83.7**	56.5
	89.8	61.3

Lease commitments

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

	31.3.2008 £m	31.3.2007 £m
Not later than one year	**0.7**	0.6
After one year but not more than five years	**2.6**	2.8
After five years	**25.7**	25.9
	29.0	29.3

19. Provisions

	£m
At 1 April 2007	
Current	0.2
Non-current	2.9
At 1 April 2007	3.1
Arising during the year	0.1
Utilised	(0.2)
At 31 March 2008	**3.0**
Analysed as:	
Current	0.2
Non-current	2.8
	3.0

The provision represents outstanding discretionary pension liabilities. The discretionary pension liabilities have been calculated by an independent actuary and are expected to be paid over the remaining lives, which is approximately 12 years.

20. Financial instruments

(a) Group strategy

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

(b) Treasury operations

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

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

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

(d) Liquidity risk

As regards day to day liquidity, the Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0 million and with a bank agreement availability period of no less than three months. At 31 March 2008, the Group had £75.0 million available in standby committed bank facilities (2007: £75.0 million).

Notes to the consolidated financial statements continued

20. Financial instruments continued

(e) Interest rate risk

The Group finances its operations through a mixture of retained profits and bank borrowings. It borrows at both fixed and floating rates of interest and, accordingly, uses interest rate swaps to generate the desired interest profile and to manage the Group's exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2008, 63% (2007: 65%) of the Group's borrowings were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

The current pressures within the financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance (such as index linked bonds) and a significant increase in the cost of corporate debt. It is not clear how long current difficult market conditions will persist. However, as the Group has sufficient funding in place to 2011, the effects on the Group are minimal.

(f) Foreign currency risk

The Group's policy is that any foreign currency exposure in excess of £100,000 sterling equivalent of a transactional nature, or £3.0 million sterling equivalent of a translation nature, should be covered immediately on identification.

(g) Market price risk

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

(h) Credit risk

There are no significant concentrations of credit risk within the Group. Management's assessment of the maximum credit risk exposure relating to financial assets is represented by carrying value as at the balance sheet date. A significant proportion of the trade debtor balances are with domestic customers who are unlikely to have a published credit rating.

(i) Interest rate risk table

In relation to financial liabilities, the following table shows the impact on profit and equity of an increase in the variable cost of borrowing. The range applied is considered a reasonable basis and highlights this is not material to the Group:

	Effect on profit/equity	
Increase in basis points	**31.3.2008 £m**	31.3.2007 £m
+35	**0.5**	0.3
+25	**0.4**	0.2
+10	**0.2**	0.1

(j) Contractual maturity of financial liabilities

The table below summarises the maturity profile of the Group's financial liabilities at 31 March based on contractual undiscounted payments:

Year ended 31 March 2008

	On demand £m	Less than 3 months £m	3–12 months £m	1–5 years £m	More than 5 years £m	Total £m
Interest bearing loans and borrowings	27.8	42.7	208.0	797.2	4,531.3	5,607.0
Trade and other payables	0.3	100.4	52.1	0.1	–	152.9
	28.1	**143.1**	**260.1**	**797.3**	**4,531.3**	**5,759.9**

20. Financial instruments continued

Year ended 31 March 2007

	On demand £m	Less than 3 months £m	3–12 months £m	1–5 years £m	More than 5 years £m	Total £m
Interest bearing loans and borrowings	1.1	42.7	132.8	951.3	4,535.1	5,663.0
Trade and other payables	1.8	102.9	60.8	0.1	-	165.6
	2.9	145.6	193.6	951.4	4,535.1	5,828.6

(k) Currency exposures

At 31 March 2008, after taking into account the effects of forward foreign exchange contracts, the Group had no currency exposures (2007: £nil).

(l) Borrowing facilities

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

	31.3.2008 £m	31.3.2007 £m
Expiring in more than two years but not more than four years	**75.0**	–
Expiring in more than two years but not more than five years	**–**	75.0
	75.0	75.0

(m) Fair values of financial assets and financial liabilities

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

	Book value		Fair value	
	31.3.2008 £m	31.3.2007 £m	31.3.2008 £m	31.3.2007 £m
Financial assets:				
Cash and cash equivalents	**294.2**	316.9	**294.2**	316.9
Financial investments	**17.1**	18.9	**17.1**	18.9
Sterling loans receivable	**1.0**	1.2	**1.0**	1.2
Financial liabilities:				
Overdraft	**(27.8)**	(1.1)	**(27.8)**	(1.1)
Bank loans (principal of £541.3 million, 2007: £563.6 million)	**(548.2)**	(572.7)	**(545.6)**	(566.3)
Subordinated loan stock	**(6.4)**	(6.3)	**(6.4)**	(6.3)
Other loans	**(2.3)**	–	**(2.3)**	–
Eurobonds (principal of £1,750.9 million, 2007: £1,734.2 million)	**(1,788.2)**	(1,775.2)	**(1,819.6)**	(1,837.8)
Obligations under finance leases and hire purchase contracts (principal of £89.7 million, 2007: £61.2 million)	**(89.8)**	(61.3)	**(89.8)**	(61.3)
	(2,150.4)	(2,079.6)	**(2,179.2)**	(2,135.8)

The fair values of the interest rate swaps, forward foreign currency contracts and sterling denominated long term fixed rate debt with a book value of £1,788.2 million (2007: £1,775.2 million), have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

The difference between the principal value of £2,381.9 million (2007: £2,359.0 million) and the carrying value of £2,426.2 million (2007: £2,409.2 million) are unamortised issue costs of £15.9 million (2007: £16.1 million) and a credit of £60.2 million (2007: £66.3 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

Notes to the consolidated financial statements continued

20. Financial instruments continued

(n) Hedges

Cash flow hedges – currency forward contracts

At 31 March 2008, the Group held the following forward exchange contracts, designated as hedges of expected future purchases for which the Group has firm commitments. The forward currency contracts are being used to hedge the foreign currency risk of the firm commitments. The terms of these contracts are as follows:

Currency bought	Maturity	Exchange rate
Eur 473,100	**30.4.2008**	**1.2669**
USD 150,000	**19.5.2008**	**2.0216**
USD 150,000	**18.6.2008**	**2.0163**

These hedges were designated as highly effective. At 31 March 2008, no change occurred in the fair value and, therefore, no gain or loss has been included in equity.

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

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

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

Cash flow hedges – interest rate swap

At 31 March 2008, the Group held one interest rate swap, designated as a hedge of future interest cash flows, for which the Group has firm commitments. The swap is used to convert cash deposit interest receipts to a fixed rate basis. The terms of this swap are as follows:

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

This hedge was designated as highly effective.

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

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

This hedge was designated as highly effective.

During the year to 31 March 2007, the Group entered into a hedging instrument in order to protect the Group against movement in real interest rates prior to the launch of the two £100 million index linked bonds issued in June 2006. The bonds were priced on 24 May 2006 and the hedging instrument was liquidated on the same day resulting in a gain of £0.5 million. This gain was transferred to equity.

21. Authorised and issued share capital

	31.3.2008 £m	31.3.2007 £m
Authorised:		
700 million ordinary shares of 10 pence each	**70.0**	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence each	**51.9**	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 443,507 (2007: 716,917) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the Directors' remuneration report on pages 48 to 52. As at 31 March 2008, the share price of the ordinary 10 pence shares in the Company was 349.25 pence (2007: 310.00 pence).

22. Reconciliation of movements in equity

	Equity share capital £m	Share premium reserve £m	Cash flow hedge reserve £m	Treasury shares £m	Currency translation £m	Retained earnings £m	Total equity £m	Minority interests £m	Total £m
At 1 April 2006	51.9	446.5	1.5	(1.7)	–	(198.9)	299.3	1.5	300.8
Shares purchased	–	–	–	(0.2)	–	–	(0.2)	–	(0.2)
Total recognised income and expense for the year	–	–	(0.5)	–	(0.2)	128.4	127.7	0.3	128.0
Share-based payment	–	–	–	–	–	0.4	0.4	–	0.4
Exercise of LTIP awards	–	–	–	0.6	–	(0.6)	–	–	–
Equity dividends paid	–	–	–	–	–	(55.8)	(55.8)	(0.1)	(55.9)
At 1 April 2007	51.9	446.5	1.0	(1.3)	(0.2)	(126.5)	371.4	1.7	373.1
Total recognised income and expense for the year	–	–	–	–	0.3	177.6	177.9	0.2	178.1
Share-based payment	–	–	–	–	–	0.5	0.5	–	0.5
Exercise of LTIP awards	–	–	–	0.5	–	(0.5)	–	–	–
Equity dividends paid	–	–	–	–	–	(59.7)	(59.7)	(0.2)	(59.9)
At 31 March 2008	**51.9**	**446.5**	**1.0**	**(0.8)**	**0.1**	**(8.6)**	**490.1**	**1.7**	**491.8**

Nature and purpose of other reserves

Cash flow hedge reserve

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

Treasury shares

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

Notes to the consolidated financial statements continued

23. Additional cash flow information

Analysis of net debt as at 31 March 2008

	As at 1.4.2007 £m	Cash flow £m	Other non-cash movements £m	As at 31.3.2008 £m
Cash and cash equivalents	315.8	(49.4)	–	**266.4**
Loans (principal of £2,282.8 million, 2007: £2,284.0 million)	(2,334.1)	18.0	(10.9)	**(2,327.0)**
Finance leases (principal of £89.7 million, 2007: £61.2 million)	(61.3)	(22.7)	(5.8)	**(89.8)**
	(2,079.6)	(54.1)	(16.7)	**(2,150.4)**

The difference between the principal value of £2,372.5 million (2007: £2,345.2 million) and the carrying value of £2,416.8 million (2007: £2,395.4 million) are unamortised issue costs of £15.9 million (2007: £16.1 million) and a credit of £60.2 million (2007: £66.3 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

Analysis of net debt as at 31 March 2007

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

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

24. Financial commitments

Capital expenditure

	31.3.2008 £m	31.3.2007 £m
Expenditure contracted for	**166.8**	109.0

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

25. Pensions and other post-retirement benefits

The Group operates a defined benefit pension scheme providing benefits based on final pensionable remuneration to 2,391 active members at 31 March 2008 (2007: 2,310). The Northumbrian Water Pension Scheme (NWPS) comprises four unitised sub-funds – WPS, Northumbrian Water (North), Northumbrian Water (South) and MIS.

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

The most recent actuarial valuation of the NWPS was at 31 December 2004. At that date the market value of assets amounted to £520.0 million. The valuation also took account of debt on the employer payments in respect of the withdrawal of two participating employers and added £10.0 million to the asset value. The 2004 valuation disclosed that the combined value of the assets represented 97.6% of the value of the accrued liabilities.

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

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

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

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

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

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

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

The employers' proposals were accepted by the NWPS Trustee.

The Group made changes to the NWPS during the year after consultation with employees and trade unions, and discussions with the NWPS Trustee. The main changes (effective 1 January 2008 unless stated otherwise) were:

- defined benefit scheme closed to new entrants on 31 December 2007;
- member contributions increased with effect from 1 April 2008;
- normal retirement date set as the day before age 65 for future service;
- rule of 85 removed for future service; and
- the introduction of a defined contribution section of NWPS for new entrants.

Notes to the consolidated financial statements continued

25. Pensions and other post-retirement benefits continued

The Group contributed to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP), until 31 December 2007. Members and employers contributed 3% and 6% of salary respectively. The NWGPPP was provided by an insurance company and members had their own individual policy. The contributions paid to the NWGPPP in the year by the Group totalled £0.2 million (2007: £0.3 million).

The defined contribution section of NWPS commenced on 1 January 2008 and had 219 active members at 31 March 2008. Members can choose to contribute either 3%, 4% or 5% of salary, with employers contributing at either 6%, 7% or 8% depending on the member contribution rate. The contributions paid to the defined contribution section of NWPS in the year by the Group totalled £0.1 million (2007: £nil).

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

A qualified actuary, using revised assumptions that are consistent with the requirements of IAS 19, has updated the actuarial valuation described above as at 31 March 2008. Investments have been valued, for this purpose, at fair value.

IAS 19 actuarial assumptions:

	31.3.2008	31.3.2007
Pay increases[1]	**4.5%**	4.1%
Pension increases	**3.5%**	3.1%
Price inflation	**3.5%**	3.1%
Discount rate	**6.8%**	5.3%
Mortality assumptions[2,3]	**PMA/PFA00**	PMA/PFA92
– Life expectancy for a member aged 60 – female (years)	**28.0**	27.6
– Life expectancy for a member aged 60 – male (years)	**25.2**	24.6

1. Including promotional salary scale.
2. 115% of PMA/PFA00.
3. PMA/PFA92 (year of birth), PMA/PFA00 (year of birth with medium cohort improvements).

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

	Long term expected rate of return 31.3.2008 %	31.3.2008 £m	Long term expected rate of return 31.3.2007 %	31.3.2007 £m
Equities	**7.5**	**457.1**	7.5	498.5
Corporate bonds	**6.8**	**51.6**	5.3	50.3
Government bonds	**4.5**	**66.1**	4.5	65.9
Property	**6.0**	**76.3**	6.0	86.7
Cash	**5.3**	**15.6**	5.3	9.4
Total fair value of assets		**666.7**		710.8
Present value of liabilities		**(576.2)**		(668.1)
Surplus		**90.5**		42.7

25. Pensions and other post-retirement benefits continued

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

	31.3.2008 £m	31.3.2007 (restated) £m
Recognised in the income statement:		
Current service cost	**15.3**	15.6
Past service cost	**0.4**	0.4
Recognised in operating costs in arriving at profit on ordinary activities before interest	**15.7**	16.0
Interest cost on plan obligations	**35.2**	32.4
Expected return on plan assets	**(48.4)**	(42.9)
Recognised in finance costs payable/(income receivable)	**(13.2)**	(10.5)
Recognised in the statement of recognised income and expense:		
Net actuarial gains	**27.3**	25.0
Cumulative amounts recognised since adopting the standard	**126.2**	98.9

History of experience gains and losses:

	31.3.2008 £m	31.3.2007 £m	31.3.2006 £m	31.3.2005 £m	31.3.2004 £m
Fair value of assets	**666.7**	710.8	659.8	523.8	472.1
Present value of defined benefit obligation	**(576.2)**	(668.1)	(663.5)	(600.2)	(565.7)
Surplus/(deficit)	**90.5**	42.7	(3.7)	(76.4)	(93.6)
Experience adjustments arising on plan assets	**(93.4)**	0.6	87.1	25.6	28.5
Experience adjustments arising on plan liabilities	**0.6**	1.7	34.0	(4.4)	8.0

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

	31.3.2008 £m	31.3.2007 £m
At 1 April	**668.1**	663.5
Current service cost	**15.3**	15.6
Past service cost	**0.4**	0.4
Interest cost on plan obligations	**35.2**	32.4
Contributions by plan participants	**0.1**	0.3
Actuarial gains on obligations	**(120.7)**	(24.4)
Benefits paid	**(22.2)**	(19.7)
At 31 March	**576.2**	668.1
Present value of funded defined benefit obligations	**576.2**	668.1

Notes to the consolidated financial statements continued

25. Pensions and other post-retirement benefits continued

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

	31.3.2008 £m	31.3.2007 £m
At 1 April	**710.8**	659.8
Expected return on plan assets	**48.4**	42.9
Actuarial (losses)/gains on plan assets	**(93.4)**	0.6
Contributions by employer	**23.0**	26.9
Contributions by plan participants	**0.1**	0.3
Benefits paid	**(22.2)**	(19.7)
At 31 March	**666.7**	710.8

The Group through its subsidiary, AquaGib, also operates a non-contributory defined benefit scheme. The surplus at 31 March 2008, under local GAAP, was £0.2 million (2007: deficit of £0.7 million). The Group made contributions amounting to £0.6 million (2007: £0.5 million) to the defined benefit pension scheme.

Sensitivity to key assumptions

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

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

A reduction in the net discount rate will increase the assessed value of liabilities, as a higher value is placed on benefits paid in the future. A rise in the net discount rate will have an opposite effect of similar magnitude. The overall effect of a change in the net discount rate of 0.1% would change the liabilities by around £11.0 million.

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

The disclosures have been prepared using the proposed mortality assumptions basis for the 2007 formal valuation – namely the PA00 tables, applying a medium cohort adjustment with a 115% loading to mortality rates based on the year of birth of the membership. These assumptions imply an assumed life expectancy for a member aged 60 at 31 March 2008 of 25.2 years (2007: 24.6 years) for males and 28.0 years (2007: 27.6 years) for females.

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

26.Share incentive plans

Long Term Incentive Plan (LTIP)

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company. Further details of the LTIP can be found in the Directors' remuneration report on page 48.

26. Share incentive plans continued

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

	31.3.2008 Number	31.3.2007 Number
Outstanding at 1 April	**1,114,715**	1,216,320
Granted during the year	**364,370**	360,022
Forfeited/lapsed during the year	**(102,606)**	(131,876)
Exercised	**(273,410)**	(329,751)
Outstanding at 31 March	**1,103,069**	1,114,715
Exercisable at 31 March	**4,062**	11,418

The weighted average exercise price throughout the year was £nil (2007: £nil). The fair value of conditional share awards granted during the year was £0.1 million (2007: £0.1 million).

The weighted average share price at the date of exercise for the conditional share awards is 343.34 pence (2007: 296.92 pence).

For the conditional awards outstanding as at 31 March 2008, the weighted average remaining contractual life is 1.7 years (2007: 1.7 years).

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

	31.3.2008	31.3.2007
Dividend yield	**3.5%**	4.0%
Expected share price volatility	**24%**	22%
Share price at award	**334.00p**	302.75p
Expected FTSE 250 index volatility	**13%**	12%
Risk free interest rate	**4.6%**	5.01%
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.

Share Incentive Plan (SIP)

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

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

	31.3.2008 Number	31.3.2007 Number
Outstanding at 1 April	**115,219**	136,168
Granted during the year	**100,721**	118,625
Forfeited during the year	**(3,647)**	(3,358)
Exercised	**(114,417)**	(136,216)
Outstanding at 31 March	**97,876**	115,219

Notes to the consolidated financial statements continued

27. Special purpose entities

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

Bakethin Finance plc was established for the purpose of issuing guaranteed secured Eurobonds. On 12 May 2004, Bakethin Finance plc issued £248.0 million of guaranteed secured bonds maturing January 2034. Bakethin Finance plc used the proceeds of the bond issue to make a loan to Reiver Finance Limited to fund the consideration given by that company to Northumbrian Water Limited for the securitisation of the cash flows receivable from the Environment Agency under the Water Resources Operating Agreement relating to Kielder Reservoir. The assignment is for a period of 30 years.

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

	31.3.2008 £m	31.3.2007 £m
Income statement:		
Finance costs receivable	**15.0**	15.0
Finance costs payable	**(15.0)**	(14.9)
Profit for the year	**–**	0.1
Balance sheet:		
Investments	**240.4**	240.1
Current assets	**4.6**	4.5
Non-current liabilities	**(242.2)**	(241.8)
Current liabilities	**(2.7)**	(2.7)
Net assets	**0.1**	0.1

28. Related parties

During the year, the Group entered into transactions, in the ordinary course of business, with other related parties. Those transactions with directors of the Company are disclosed in the Directors' remuneration report on pages 46 to 55. In accordance with IAS 24, the directors consider that there are no further disclosures in respect of key management. Transactions entered into, and trading balances outstanding at 31 March with other related parties, are as follows:

	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m
Related party:				
Jointly controlled entities				
2008	**0.1**	**7.4**	**0.7**	**7.3**
2007	–	5.2	0.7	6.2

Purchases from jointly controlled entities include £3.8 million (2007: £2.5 million) in respect of capital purchases under finance leases, £3.3 million (2007: £2.2 million) in respect of operating leases and £0.3 million (2007: £0.5 million) in respect of finance costs payable under finance leases.

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

29. Contingent liability

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

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

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

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

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

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

Report of the Auditors on the Company financial statements

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

We have audited the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2008 which comprise the balance sheet and the related notes 1 to 10. These parent Company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' remuneration report that is described as having been audited.

We have reported separately on the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2008.

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

Respective responsibilities of directors and auditors

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

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

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

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

We read other information contained in the Annual Report and consider whether it is consistent with the audited parent Company financial statements. The other information comprises only Highlights, NWG at a glance, the Chairman's statement, the Directors' report and business review, Appendix to the Directors' report and business review, Board Directors' biographies, Corporate governance report , the unaudited part of the Directors' remuneration report and Shareholder information. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent Company financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- the parent Company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 March 2008;
- the parent Company financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' report and business review is consistent with the parent Company financial statements.

Ernst & Young LLP
Registered auditor
Newcastle upon Tyne
3 June 2008

Company balance sheet

As at 31 March 2008

	Notes	31.3.2008 £m	31.3.2007 £m
Fixed assets			
Investments in subsidiary undertakings	4	**1,022.6**	1,022.6
		1,022.6	1,022.6
Current assets			
Debtors: receivable within one year	5	**10.2**	6.9
Cash at bank		**16.7**	15.6
		26.9	22.5
Creditors: amounts falling due within one year	6	**(15.7)**	(10.9)
Net current assets		**11.2**	11.6
Total assets less current liabilities		**1,033.8**	1,034.2
Creditors: amounts falling due after more than one year	7	**(490.0)**	(490.0)
Net assets		**543.8**	544.2
Capital and reserves			
Called up share capital	8	**51.9**	51.9
Share premium account	9	**446.5**	446.5
Treasury shares	9	**(0.8)**	(1.3)
Profit and loss account	9	**46.2**	47.1
Equity shareholders' funds		**543.8**	544.2

Approved by the Board on 3 June 2008 and signed on its behalf by:

Sir Derek Wanless
Chairman

John Cuthbert
Managing Director

Notes to the Company financial statements

1. Accounting policies

(a) Basis of accounting

The financial statements have been prepared in accordance with applicable United Kingdom law and accounting standards. The accounting policies have been reviewed in accordance with the requirements of FRS 18. The directors consider the following accounting policies to be relevant in relation to the Company's financial statements. The Company's financial statements are included in the consolidated financial statements of Northumbrian Water Group plc. Accordingly, the Company has taken advantage of the exemption from publishing a profit and loss account and cash flow statement and from disclosing related party transactions with its subsidiaries. The Company is also exempt from disclosing the information otherwise required by FRS 29 Financial Instruments: Disclosures and Presentation, as the Consolidated financial statements, in which the Company is included, provide equivalent disclosures for the Group under IFRS 7 Financial Instruments: Disclosures.

(b) Fixed asset investments

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

(c) Taxation

Corporation tax is based on the profit for the year as adjusted for taxation purposes using the rates of tax enacted at the balance sheet date. Provision is made for deferred tax in respect of all timing differences that have originated but not reversed at the balance sheet date that will result in an obligation to pay more, or a right to pay less, tax in future periods. Deferred tax is calculated at the tax rates that are expected to apply in the periods in which timing differences are expected to reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date. Deferred tax assets are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

(d) Interest bearing loans and borrowings

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

2. Auditors' remuneration

Auditors' remuneration for the year ended 31 March 2008 was £90,000 (2007: £84,000).

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

3. Profit attributable to members of the parent Company

The profit dealt with in the financial statements of the parent Company is £59.2 million (2007: £56.9 million).

Notes to the Company financial statements continued

4. Investments in subsidiary undertakings

	£m
At 1 April 2007 and 31 March 2008	**1,022.6**

The Company's interests in principal subsidiaries at 31 March 2007 and 31 March 2008 were as follows:

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

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

5. Debtors

	31.3.2008 £m	31.3.2007 £m
Amounts owed by subsidiary undertakings	**9.7**	6.5
Prepayments and accrued income	**0.2**	0.2
Other	**0.3**	0.2
	10.2	6.9

Amounts owed by subsidiary undertakings include amounts receivable for the provisional surrender of tax losses amounting to £5.5 million (2007: £4.7 million).

6. Creditors: amounts falling due within one year

	31.3.2008 £m	31.3.2007 £m
Amounts owed to subsidiary undertakings	**15.3**	10.6
Accruals and deferred income	**0.4**	0.3
	15.7	10.9

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

	31.3.2008 £m	31.3.2007 £m
Amounts owed to subsidiary undertakings	**490.0**	490.0

	31.3.2008 £m	31.3.2007 £m
Loans are repayable as follows:		
Not wholly repayable within five years	**490.0**	490.0

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

8. Authorised and issued share capital

	31.3.2008 £m	31.3.2007 £m
Authorised:		
700 million ordinary shares of 10 pence each	**70.0**	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence each	**51.9**	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 443,507 (2007: 716,917) ordinary 10 pence shares in the Company for use under the Company's Long Term Incentive Plan (LTIP). All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the Directors' remuneration report on pages 48 to 52. As at 31 March 2008, the share price of the ordinary 10 pence shares in the Company was 349.25 pence (2007: 310.00 pence).

Notes to the Company financial statements continued

9. Reserves

	Treasury shares £m	Share premium account £m	Profit and loss account £m
At 1 April 2006	(1.7)	446.5	46.5
Profit for the year	–	–	56.9
Purchase of own shares for the LTIP	(0.2)	–	–
Share-based payment	–	–	0.1
Exercise of LTIP awards	0.6	–	(0.6)
Dividends	–	–	(55.8)
At 31 March 2007	(1.3)	446.5	47.1
Profit for the year	–	–	59.2
Share-based payment	–	–	0.1
Exercise of LTIP awards	0.5	–	(0.5)
Dividends paid	–	–	(59.7)
At 31 March 2008	**(0.8)**	**446.5**	**46.2**

10. Commitments

The Company has issued letters of continuing support to subsidiary companies with net liabilities amounting to £5.6 million (2007: £4.2 million) and net current liabilities of £nil (2007: £nil). These subsidiary companies are expected to meet their working capital requirements from operating cash flows.

The Company is guarantor to the EIB in respect of borrowings to Northumbrian Water Limited. The loan principal outstanding at 31 March 2008 amounted to £356.0 million (2007: £376.0 million).

The Company is party to a cross guarantee arrangement with other group companies in respect of bank facilities. Overdrafts outstanding at 31 March 2008 in respect of the arrangement amounted to £26.4 million (2007: £1.1 million). The directors do not expect any loss to arise as a result of this arrangement.

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

Shareholder information

Share Portal (www.capitashareportal.com)
You can manage your shareholding online, through the website of our registrar, Capita Registrars, by registering for the Share Portal. This provides free, secure, online access to your shareholding. Facilities include:

Electronic communications
This allows you to register your email address to enable you to receive shareholder communications such as annual reports via the internet rather than by post.

Account enquiry
You can access your personal shareholding, including share transaction history, dividend payment history and to obtain an up-to-date shareholding valuation.

Amendment of standing data
This allows you to change your registered postal address and add, change or delete dividend mandate instructions.

You can also download from this site forms such as change of address, stock transfer and dividend mandates and buy and sell shares in the company.

To use any of these facilities, please log on to the Capita Registrars website at www.capitashareportal.com

If you have any queries about the above facilities, please contact the Capita Share Portal helpline on 0871 664 0391 (calls cost 10 pence plus network extras) overseas +44 20 8639 3367, or by email at shareportal@capita.co.uk

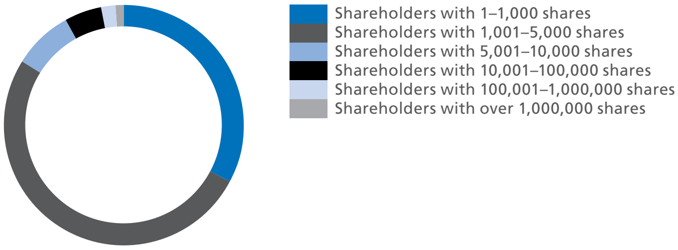
Capita share dealing services
Capita Registrars provides a low cost share dealing service. Further information is available at www.capitadeal.com or by telephoning 0871 664 0454 (calls cost 10 pence per minute plus network extras). This enables you to deal in the shares of the Company and other companies for which Capita acts as registrar, provided you are already a shareholder in the relevant company, and it offers the share deal facility to its shareholders.

ShareGift
You may donate your shares to charity free of charge through ShareGift. Further details are available at www.sharegift.org.uk or by telephoning 020 7930 3737.

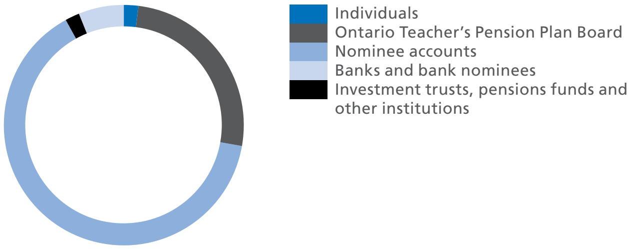
Dividend re-investment plan
The Company receives occasional requests from shareholders wishing to receive their dividends in the form of shares instead of cash. There are costs involved in providing this service and at present it would not be cost effective. This issue is kept under regular review.

Beneficial owners of shares with 'information rights'
Please note that beneficial owners of shares who have been nominated by the registered holder of those shares to receive information rights under Section 146 of the Companies Act 2006 are required to direct all communications to the registered holder of their shares rather than to the Company's registrar, Capita Registrars, or the Company.

Shareholder analysis
Number of shareholders by size of holding as at 31 March 2008



Breakdown of shareholdings by type as at 31 March 2008



Shareholder information continued

Disability Discrimination Act
If you wish to receive a copy of our report on audio tape, in braille or in a large text version, please telephone us on 0191 301 6701, or email us at shareholders@nwl.co.uk

For queries about your shares, please contact Capita Registrars:
PO Box 1269
Huddersfield
HD1 9UT
Tel: 0871 664 0300 (Calls cost 10 pence per minute plus network extras)
From overseas: +44 20 8639 3399
Fax: +44 (0) 1484 600 911
Email: ssd@capitaregistrars.com
Web: www.capitaregistrars.com

For general shareholder queries please contact Secretariat:
Tel: 0191 301 6701
Fax: 0191 301 6705
Email: shareholders@nwl.co.uk

To request financial statements and other Company literature please contact Communications:
Tel: 0191 301 6734
Email: shareholders@nwl.co.uk

Annual General Meeting
The Notice of Meeting, information about the AGM to be held on 31 July 2008 and the proxy voting card are enclosed with these financial statements. Shareholder questions and special needs requests should be addressed to Secretariat at our registered office address, raised by telephone on 0191 301 6701, or sent by email to shareholders@nwl.co.uk

Company secretary and registered office
Martin Parker
Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham DH1 5FJ
Tel: 0870 608 4820

Financial calendar

2008	
31 July	AGM
31 July	Interim Management Statement
13 August	Ex-dividend date
15 August	Record date
12 September	Final dividend payment
27 November	Half-yearly announcement
17 December	Ex-dividend date
19 December	Record date

2009	
30 January	Interim dividend payment

Group websites
www.nwg.co.uk
www.nwl.co.uk
www.eswater.co.uk
www.aes-services.co.uk
www.agrer.com

Northumbrian Water main switchboard
Tel: 0870 608 4820

Northumbrian Water customer queries
Customer services: 0845 717 1100
Customer accounts: 0845 733 5566

Essex & Suffolk Water customer queries
Customer services: 0845 782 0999
Customer accounts: 0845 782 0111

Notes

This annual report has been printed using vegetable based inks on Symbol Freelife Satin and Evolution Bright paper stock. Symbol Freelife Satin is an environmentally-friendly ECF (elemental chlorine free) woodfree paper and board with a high content of selected pre-consumer recycled material. This product is completely bio-degradable and recyclable. Evolution Bright is manufactured with 50% pulp and 50% virgin pulp, with FSC and ISO14001 certification.

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Telephone **020 7729 9090 www.emperordesign.co.uk**

Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham DH1 5FJ

Tel: 0870 608 4820
Fax: 0191 301 6202
Registered in England & Wales
Registered number 4760441

www.nwg.co.uk