28 November 2005

Northumbrian Water Group plc (NWG)

Adoption of International Financial Reporting Standards (IFRS)

NWG is required to report its consolidated financial results under IFRS from 1 April 2005. The first published financial results under IFRS will be the interim results for the six months ended 30 September 2005, which will be announced on 7 December 2005.

To assess the impact on the Group's financial results, this statement presents the unaudited reconciliations (from UK GAAP to IFRS) for the income statement for the year ended 31 March 2005 and the balance sheet at 31 March 2005. The unaudited reconciliations (from UK GAAP to IFRS) for the income statement for the six months ended 30 September 2004, the transitional balance sheet at 1 April 2004 and the balance sheet at 30 September 2004 under UK GAAP to IFRS, have also been presented.

The restated financial information for the year ended 31 March 2005 and the opening balance sheet at 1 April 2004 have been prepared in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

The Group's adopted policies under IFRS have also been included.

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RECONCILIATION OF UK GAAP TO IFRS
Consolidated Income Statement
Year ended 31 March 2005

	UK GAAP	Property, plant & equipment	Pensions	IAS 39	Deferred tax	Jointly controlled entities and associates	Other	Restated under IFRS
	£m	£m	£m	£m	£m	£m	£m	£m
Revenue	578.6	-	-	-	-	-	-	578.6
Operating costs	(373.9)	(4.1)	(2.7)	-	-	-	-	(380.7)
Group operating profit	204.7	(4.1)	(2.7)	-	-	-	-	197.9
Share of associates' operating profit	2.2	-	-	-	-	(2.2)	-	-
Share of jointly controlled entities' operating profit	1.0	-	-	-	-	(1.0)	-	-
Profit on ordinary activities before interest	207.9	(4.1)	(2.7)	-	-	(3.2)	-	197.9
Finance costs	(99.1)	-	-	(3.4)	-	2.9	-	(99.6)
Share of associates undertakings' and jointly controlled entities' profit	-	-	-	-	-	0.1	-	0.1
Profit on ordinary activities before taxation	108.8	(4.1)	(2.7)	(3.4)	-	(0.2)	-	98.4
Taxation on profit on ordinary activities								
- current taxation	(1.3)	-	-	-	-	-	-	(1.3)
- deferred taxation	(8.9)	1.2	0.8	(0.3)	(13.9)	-	0.1	(21.0)
- share of associates' and jointly controlled entities' tax	(0.2)	-	-	-	-	0.2	-	-
Profit on ordinary activities after taxation	98.4	(2.9)	(1.9)	(3.7)	(13.9)	-	0.1	76.1
Basic earnings per share	19.1p	(0.6p)	(0.4p)	(0.7p)	(2.7p)	-	-	14.7p
Adjusted earnings per share (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments)	18.1p	(0.8p)	(0.5p)	-	-	-	* (0.1p)	16.7p
Diluted earnings per share	19.1p	(0.6p)	(0.4p)	(0.7p)	(2.7p)	-	-	14.7p
Dividend per share	10.00p	-	-	-	-	-	-	10.00p

* Rounding

RECONCILIATION OF UK GAAP TO IFRS
Consolidated Balance Sheet
As at 31 March 2005

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

RECONCILIATION OF UK GAAP TO IFRS
Consolidated Income Statement
6 months ended 30 September 2004

	UK GAAP	Property, plant & equipment	Pensions	IAS 39	Deferred tax	Jointly controlled entities and associates	Restated under IFRS
	£m	£m	£m	£m	£m	£m	£m
Revenue	286.5	-	-	-	-	-	286.5
Operating costs	(185.2)	(2.0)	(1.4)	-	-	-	(188.6)
Group operating profit	101.3	(2.0)	(1.4)	-	-	-	97.9
Share of associates' operating profit	1.1	-	-	-	-	(1.1)	-
Share of jointly controlled entities' operating profit	0.5	-	-	-	-	(0.5)	-
Profit on ordinary activities before interest	102.9	(2.0)	(1.4)	-	-	(1.6)	97.9
Finance costs	(53.5)	-	-	(3.4)	-	1.4	(55.5)
Share of associates undertakings' and jointly controlled entities' profit	-	-	-	-	-	-	-
Profit on ordinary activities before taxation	49.4	(2.0)	(1.4)	(3.4)	-	(0.2)	42.4
Taxation on profit on ordinary activities							
- current taxation	(3.4)	-	-	-	-	-	(3.4)
- deferred taxation	(5.4)	0.5	0.4	0.3	(6.2)	-	(10.4)
- share of associates' and jointly controlled entities' tax	(0.2)	-	-	-	-	0.2	-
Profit on ordinary activities after taxation	40.4	(1.5)	(1.0)	(3.1)	(6.2)	-	28.6
Basic earnings per share	7.8p	(0.3p)	(0.2p)	(0.6p)	(1.2p)	-	5.5p
Adjusted earnings per share (excluding deferred tax, amortisation of debt fair value and IAS 39 adjustments) *	8.3p	(0.4p)	(0.3p)	-	-	-	7.6p
Diluted earnings per share	7.8p	(0.3p)	(0.2p)	(0.6p)	(1.2p)	-	5.5p
Dividend per share	2.87p	-	-	-	-	-	2.87p

* The published adjusted EPS has been restated to exclude the amortisation of debt fair value.

RECONCILIATION OF UK GAAP TO IFRS
Consolidated Balance Sheet
As at 30 September 2004

	UK GAAP £m	Property, plant & equipment £m	Pensions £m	IAS 39 £m	Deferred tax £m	Dividends £m	Other £m	Restated under IFRS £m
ASSETS								
Non-current assets								
Goodwill	0.2	-	-	-	-	-	-	0.2
Other intangible assets	64.2	-	-	-	-	-	-	64.2
Property, plant and equipment	2,737.0	(4.5)	-	-	-	-	-	2,732.5
Investments in jointly controlled entities	3.5	-	-	-	-	-	-	3.5
Investments in associates	1.5	-	-	-	-	-	-	1.5
Other investments	0.4	-	-	-	-	-	-	0.4
Pension asset	13.8	-	(13.8)	-	-	-	-	-
	2,820.6	**(4.5)**	**(13.8)**	**-**	**-**	**-**	**-**	**2,802.3**
Current assets								
Inventories	6.8	-	-	-	-	-	-	6.8
Trade and other receivables	117.5	-	-	-	-	-	-	117.5
Cash and cash equivalents	95.6	-	-	-	-	-	-	95.6
	219.9	**-**	**-**	**-**	**-**	**-**	**-**	**219.9**
TOTAL ASSETS	**3,040.5**	**(4.5)**	**(13.8)**	**-**	**-**	**-**	**-**	**3,022.2**
EQUITY AND LIABILITIES								
Equity attributable to equity holders of the parent								
Issued capital	51.9	-	-	-	-	-	-	51.9
Share premium	446.3	-	-	-	-	-	-	446.3
Cash flow reserve	-	-	-	4.3	-	-	-	4.3
Treasury shares	(0.5)	-	-	-	-	-	-	(0.5)
Retained earnings	49.1	(3.8)	(61.7)	-	(304.3)	14.9	(0.6)	(306.4)
	546.8	(3.8)	(61.7)	4.3	(304.3)	14.9	(0.6)	195.6
Minority interest	1.6	-	-	-	-	-	-	1.6
TOTAL EQUITY	**548.4**	**(3.8)**	**(61.7)**	**4.3**	**(304.3)**	**14.9**	**(0.6)**	**197.2**
Non-current liabilities								
Interest bearing loans and borrowings	1,875.1	-	-	-	-	-	-	1,875.1
Provisions	6.6	-	-	-	-	-	-	6.6
Deferred income tax liabilities	164.2	(1.5)	(26.4)	-	304.3	-	(0.2)	440.4
Pension liability	-	-	74.3	-	-	-	-	74.3
Other payables	12.8	-	-	-	-	-	-	12.8
Interest rate swap	4.3	-	-	(4.3)	-	-	-	-
Grants	148.2	0.8	-	-	-	-	-	149.0
	2,211.2	**(0.7)**	**47.9**	**(4.3)**	**304.3**	**-**	**(0.2)**	**2,558.2**
Current liabilities								
Interest bearing loans and borrowings	90.4	-	-	-	-	-	-	90.4
Trade and other payables	184.9	-	-	-	-	(14.9)	0.8	170.8
Income tax payable	5.6	-	-	-	-	-	-	5.6
	280.9	**-**	**-**	**-**	**-**	**(14.9)**	**0.8**	**266.8**
TOTAL LIABILITIES	**2,492.1**	**(0.7)**	**47.9**	**(4.3)**	**304.3**	**(14.9)**	**0.6**	**2,825.0**
TOTAL EQUITY AND LIABILITIES	**3,040.5**	**(4.5)**	**(13.8)**	**-**	**-**	**-**	**-**	**3,022.2**

RECONCILIATION OF UK GAAP TO IFRS
Transitional Consolidated Balance Sheet
As at 1 April 2004

	UK GAAP	Property, plant & equipment	Pensions	IAS 39	Deferred tax	Dividends £m	Other	Restated under IFRS
	£m	£m	£m	£m	£m		£m	£m
ASSETS								
Non-current assets								
Goodwill	0.2	-	-	-	-	-	-	0.2
Other intangible assets	64.2	-	-	-	-	-	-	64.2
Property, plant and equipment	2,692.8	(2.8)	-	-	-	-	-	2,690.0
Investments in jointly controlled entities	3.4	-	-	-	-	-	-	3.4
Investments in associates	1.8	-	-	-	-	-	-	1.8
Other investments	0.4	-	-	-	-	-	-	0.4
Pension asset	14.3	-	(14.3)	-	-	-	-	-
	2,777.1	**(2.8)**	**(14.3)**	**-**	**-**	**-**	**-**	**2,760.0**
Current assets								
Inventories	4.8	-	-	-	-	-	-	4.8
Trade and other receivables	118.1	-	-	-	-	-	-	118.1
Interest rate swap	-	-	-	3.4	-	-	-	3.4
Cash and cash equivalents	44.8	-	-	-	-	-	-	44.8
	167.7	**-**	**-**	**3.4**	**-**	**-**	**-**	**171.1**
TOTAL ASSETS	**2,944.8**	**(2.8)**	**(14.3)**	**3.4**	**-**	**-**	**-**	**2,931.1**
EQUITY AND LIABILITIES								
Equity attributable to equity holders of the parent								
Issued capital	51.9	-	-	-	-	-	-	51.9
Share premium	446.3	-	-	-	-	-	-	446.3
Cash flow reserve	-	-	-	(2.9)	-	-	-	(2.9)
Treasury shares	(0.5)	-	-	-	-	-	-	(0.5)
Retained earnings	23.4	(2.3)	(75.5)	3.3	(298.1)	24.0	(0.6)	(325.8)
	521.1	(2.3)	(75.5)	0.4	(298.1)	24.0	(0.6)	169.0
Minority interest	1.9	-	-	-	-	-	-	1.9
TOTAL EQUITY	**523.0**	**(2.3)**	**(75.5)**	**0.4**	**(298.1)**	**24.0**	**(0.6)**	**170.9**
Non-current liabilities								
Interest bearing loans and borrowings	1,853.0	-	-	-	-	-	-	1,853.0
Provisions	6.3	-	-	-	-	-	-	6.3
Deferred income tax liabilities	158.8	(1.0)	(32.4)	0.1	298.1	-	(0.2)	423.4
Pension liability	-	-	93.6	-	-	-	-	93.6
Other payables	13.4	-	-	-	-	-	-	13.4
Interest rate swap	-	-	-	2.9	-	-	-	2.9
Grants	142.8	0.5	-	-	-	-	-	143.3
	2,174.3	**(0.5)**	**61.2**	**3.0**	**298.1**	**-**	**(0.2)**	**2,535.9**
Current liabilities								
Interest bearing loans and borrowings	48.0	-	-	-	-	-	-	48.0
Trade and other payables	194.2	-	-	-	-	(24.0)	0.8	171.0
Income tax payable	5.3	-	-	-	-	-	-	5.3
	247.5	**-**	**-**	**-**	**-**	**(24.0)**	**0.8**	**224.3**
TOTAL LIABILITIES	**2,421.8**	**(0.5)**	**61.2**	**3.0**	**298.1**	**(24.0)**	**0.6**	**2,760.2**
TOTAL EQUITY AND LIABILITIES	**2,944.8**	**(2.8)**	**(14.3)**	**3.4**	**-**	**-**	**-**	**2,931.1**

Northumbrian Water Group plc
International Financial Reporting Standards (IFRS)
Accounting policies

The restated financial information for the year ended 31 March 2005 and the opening balance sheet at 1 April 2004 have been prepared in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

The financial information has been prepared on the basis of IFRS expected to be in effect for the year ended 31 March 2006. The IFRS in effect at that date may differ owing to decisions taken by the EC on endorsement, interpretative guidance issued by the IASB or the International Financial Reporting Interpretations (IFRIC) and the requirements of company legislation. The Group has decided to adopt the amendments to IAS 19 "Employee Benefits" allowing actuarial gains and losses to be recognised in full through reserves. The Group has also adopted IAS 32 and 39 from 1 April 2004

The results of Northumbrian Water Group plc may change as a result of future changes to IFRS.

The consolidated financial statements have been prepared on a historical cost basis except for derivative financial instruments that have been measured at fair value. The date of transition from accounting under UK GAAP to accounting under IFRS is 1 April 2004. The directors consider the following accounting policies to be relevant in relation to the Group's financial statements.

First time adoption

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

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

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

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

Infrastructure assets have been measured at a date prior to transition to IFRSs (23 May 2003) at their fair value which has been adopted as deemed historic cost. The fair value, established at 23 May 2003, meets the criteria of paragraph 19 of IFRS 1 as all assets and liabilities were measured at fair value at that date, the event being the acquisition of AWL (Atlantic Water Limited) and subsequent IPO of NWG.

The Group has elected to take the exemption available under IFRS 1 from restating business combinations before 1 April 2004 on an IFRS basis.

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

Basis of consolidation

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

(a) Associates and jointly controlled entities

Investments in associates and jointly controlled entities in the group accounts are accounted for using the equity method of accounting where the group exercises significant influence over the associate. Significant influence is generally presumed to exist where the group's effective ownership is 20% or more. The Group's share of the post tax profits less losses of associates and jointly controlled entities is included in the consolidated income statement and the Group's share of their net assets/liabilities is included in the consolidated balance sheet. Goodwill arising on the acquisition of associates and jointly controlled entities is accounted for in accordance with the accounting policy set out below.

(b) Goodwill

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

(c) 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'

Research and development expenditure is charged to the income statement in the period in which it is incurred.

(d) Property, plant and equipment

Tangible fixed assets and depreciation

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

Tangible assets are included at cost less accumulated depreciation and any provision for impairment.

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives, which are principally as follows: freehold buildings, 30-60 years; short leasehold land and buildings, 25 years or lease term if shorter; operational structures, plant and machinery, 4-92 years; infrastructure assets 13-200 years (see below), fixtures, fittings, tools and equipment, 4-10 years.

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

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

Infrastructure assets

In the regulated water services business, infrastructure assets comprise a network of systems being mains and sewers, reservoirs, dams and sea outfalls. Prior to 1 April 2004, expenditure on infrastructure assets relating to increases in capacity or enhancements to the network and on maintaining the operating capability of the network, in accordance with defined standards of service, was treated as additions to fixed assets. This treatment is not permitted under IAS 16. The opening balance for infrastructure assets was determined as described under 'First time adoption' above.

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

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

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

(e) Foreign currencies

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

(f) Inventories

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

(g) Revenues

Provision of services

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

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

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

Interest

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

Dividends

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

(h) Government grants and contributions

Government 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.

(i) Leases

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

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

(j) Pensions and other post-employment benefits

Defined benefit scheme

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

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

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

Defined contribution scheme

The Group operates a defined contribution scheme for those members of staff who are not members of its defined benefit scheme. Obligations for contributions to the scheme are recognised as an expense in the income statement in the period in which they arise.

(k) 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 fily 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.

(l) Taxes

Current tax

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

Deferred tax

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

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

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

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

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

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

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

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

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

Value added tax

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

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

- receivables and payables that are stated with the amount of value added tax included.

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

(m) Derivative financial instruments

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

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

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

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

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

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

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

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

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

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

(n) 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.

(o) Cash and cash equivalents

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

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

(p) Trade and other receivables

Trade receivables are recognised and carried at original invoice amount less an allowance for any uncollectible 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.

(q) Investments
Investments are initially recorded at cost, being the fair value of the consideration given and including the acquisition charges associated with the investment.

After initial recognition, investments, which are classified as held for trading and available-for-sale are measured at fair value. Gains or losses on investments held for trading are recognised in income. Gains or losses on available-for-sale investments are recognised as a separate component of equity until the investment is sold, collected or otherwise disposed of, or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is included in income.

(r) 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.