NORTHUMBRIAN WATER GROUP PLC

RESULTS FOR THE SIX MONTHS ENDED 30 SEPTEMBER 2009

TRANSCRIPT OF PRESENTATION – MONDAY 23 NOVEMBER 2009
ANDAZ HOTEL, LONDON

Main speakers:

John Cuthbert *Managing Director*
Chris Green *Finance Director*

Meeting begins 9:15am.

John Cuthbert: Welcome to the results announcement for the 6 months to the end of September. Chris will cover the financials, after which I'll go through some operational matters within the group leaving time for questions at the end.

Revenue increase has been in line with RPI but offset by some declines in the industrial and commercial, non-household revenue. Chris will explain that with the usual slides.

Funding is in place to cover all our business requirements for investment and operations for the next two years.

The investment programme is on track to deliver our regulatory outputs and we're enjoying high standards of customer satisfaction. I'll also talk about Abberton as we're beginning preparatory works.

Interim dividend of 4.39p per share, estimated on the usual basis of our calculation, assuming an average year-on-year RPI of 0% while maintaining the policy stated in June 2005. I don't need to say anything about the Determination due on Thursday.

Chris will now go through the financial review.

Chris Green: Good morning everyone. Overall summary results - revenue is 1% ahead. The tariff increase was in line with RPI of 3% but is affected by industrial revenues being lower - that's not a surprise given the economic conditions. Just to remind you what was said about revenues in the last IMS - we are looking, year-on-year, at revenues remaining broadly flat. If you're looking at revenues for the first and second halves, the forecast is split 50:50.

Profit before interest and tax is marginally up by 1%. It would have been more, but one very large industrial customer went into administration owing £1.7 million. If you look at PBIT then the first half will be marginally higher than the second half.

Interest is largely affected by the changes in RPI and the impact on index linked bonds. Most of the cash on deposit was earning much higher interest yields of 5.5-6%, but most of those ended in October and the market is not at that level now. Therefore PBT will not be an even split between first and second half. On the profit/loss for the period, we don't repeat the large tax charge in 2008 following the abolition of Industrial Buildings Allowances.

Looking at the business segments, Northumbrian Water Limited is slightly ahead by about 1%. Water & Waste Water Contracts is slightly behind, but not a concern. The gas index for one PFI was slightly lower this time around. In terms of Other, just over £1 million ahead at the smaller subsidiary in Belgium.

Segmental profit before interest: Water and Waste Water Contracts is marginally ahead, largely due to cost savings in Gibraltar. Group running costs remain stable.

Looking at the net interest payable line, that's pretty flat half year on half year. The big variance is on bond indexation. In July 2008 it was a very high RPI, some 5% compared to this July when it was -1.4%, resulting in a huge swing of £14.5 million. The cost of the pension scheme interest obligations net of expected return on assets has moved from a credit last year to a charge this year. We expect that to repeat itself in the second half.

The effective annual rate is calculated on net debt of £2.24 billion.

Taxation is slightly higher due to increased profitability and lower relief from the advanced pension contributions. Cash tax increased from 16% to 19%, still on target to move to the low 20%'s for the full year. The effective tax rate is reduced, largely to do with the charge on infrastructure, (IAS16 adjustment) with the balance due to settlement of prior periods.

Earnings per share: as stated in note 5, adjusted EPS now ignores the annual charge of £5 million for the amortisation of debt fair value. The impact is set out in the announcement. If you adjust for that this time, 12.85 would drop to 12.35p per share.

Summary results for Northumbrian Water Limited – capital maintenance costs are lower because of the IAS16 charge, otherwise the results are flat half year on half year.

Appointed and non-appointed business sections. Appointed business is up by 1%. Non-appointed activities are relatively flat at £17 million. In appointed, we are seeing some increase on renewables this half year, which has slightly compensated for other losses. Operating profits are relatively flat. Kielder revenues are at £6.7 million compared to £6.5 million in the same period last year.

Turnover movements - RPI at 3% added just over £9 million. The impact at Bran Sands, the large plant on Teesside, is the loss of industrial revenues totalling £4 million on the half year. Usage and meter optants account for a further £4.5m reduction in revenues while Other is £1.6 million ahead. This is made up by a number of miscellaneous items where some areas of the business are still relatively buoyant.

Operating costs. Stripping out one-off costs between the first and second halves, RPI, with deflation this year, would have reduced costs by £1.8 million. The reality is that cost increases on things like chemicals and manpower have added some £4 million to the cost base. Power costs this half are actually up by £2.5 million. That reflects the purchasing policy where advance purchases of energy in 2008 were at much higher prices. As stated in the announcement, those markets have softened and in the second half there is actually a reduction in energy costs.

Bran Sands incurred a specific bad debt charge of £1.7 million. Otherwise bad debts have not changed and we've not seen an impact on the domestic customer base.

Capital maintenance - you've asked us to provide the links between the regulated accounts and IFRS. This slide shows that for the first time, but will perhaps be more effective when you see the full year's figures. NWL's UK Gaap charge is set out here. The movement for the IFRS charge shows the IAS16 adjustment for depreciation and expense items. The main change is the amount of infrastructure that goes through IFRS as an expense, an £11 million adjustment last time, but only a £4.2 million adjustment this half year.

In terms of the group's depreciation charge, NWL was shown on the previous slide and other companies are flat at £2.8 million. The group depreciation charge is as shown in the cash flow adjustment.

Energy costs for the full year: While the first half had a £2.5 million increase, the full year is showing a reduction to £36.1 million. We continue to purchase in advance and have locked 2010/2011 power costs, with costs reducing to £30 million. In addition, you'll recall the Anaerobic Digestion plant at Bran Sands that will come into full operation next year and will lower the import of power at that site, generating something like 4-4.5MW to reduce our exposure to volatility on power costs. A similar plant at Howdon on Tyneside is planned for 2013 to meet the high renewables target in future years.

The cost and usage chart shows the full benefit for this year and next.

Returning to the Group, gearing is stable at all levels. NWG is stable at 67%, NWL including Kielder is stable at 62% and appointed is flat at 60%. The group movement in net debt is dominated by the increase in capital expenditure and the bond indexation mentioned previously.

Funding facilities - no change as we continue to utilise the cash raised in the corporate bond markets in 2006. Resources are adequate for the next two years.

The group net debt - no change. The index linked Euro bonds have changed slightly relative to RPI. No change in terms of the facilities we've put in place and no change in the mix between floating and index linked. For the regulated business, index linked debt is some 24%.

Gross debt maturity profile: no change and no refinancing plans for the next 5 years in the core business.

Back to John.

John Cuthbert: Thanks, Chris. The operational highlights will concentrate on Northumbrian Water Limited but just a few words on the other water and waste water contracts. Chris has referred to the improving performance, particularly from Gibraltar where we commissioned a new reverse osmosis plant. The key message is that those Water & Waste Water contracts are all meeting or exceeding their contractual obligations.

NWL continues to deliver high standards of drinking water quality - around 99.9% in the north and 99.8% in the south. We are also meeting leakage targets in both the north and south.

Abberton is a major project for NWL. We have begun the preparatory works and we are evaluating tenders for the main civils contract and hope to make a start in early 2010.

We have brought back the resources graph. For those who haven't seen this, the upper and lower bands are the historic maximum and minimum. The dotted line is the historic mean. The blue line is the performance during the course of the current year. We were pretty much at the historic mean up until August and through the high demand season. But this was followed by a dry period and the graph shows the impact. You'll see that it's kicked up towards the end and we expect this to continue. It shows that, even in what is not a high-demand period, water resources do come under pressure, which is why Abberton is so important – it gives that guarantee of supply for customers in Essex.

Environmental slide - all 34 bathing waters in England met the standards required. We are continuing to address sewer flooding. You've seen over recent days some of the horrific impacts that can be caused by high amounts of rainfall.

Bran Sands - this advanced digestion plant is nearing completion. We expect to be in full gas production and power generation by the end of the year. When that plant is up and running, it will move us halfway towards our renewable energy target of 20% by 2015.

On the customer side, high standards of customer service are being held. 'Right First Time Every Time' has been emphasised across the business. Complaint numbers are starting to fall away. We continue to do regular quarterly research with customers and you'll see both high levels of satisfaction and value for money. The final statistic on the slide shows that the levels of metering are starting to climb in the north.

On the investment programme, £109 million was invested in regulatory assets including significant investment in sewer flooding and a mains cleaning programme in the North East to address the issue that some customers are having with discoloured water. That large programme is progressing well.

People are what deliver value from the business. We're continuing to invest in developing our people at all levels. We've launched a Leadership executive programme, MA and BA programmes, NVQ Level 2 at a lower level of the business. We've highlighted that the new plant at Bran Sands requires less manning, so we are going through the process of manpower reduction, specifically at Bran Sands, but we are looking to do this across other parts of the organisation. Estimated manpower reduction is about 60.

Draft determination - this slide reminds you about what came out at the end of July. You'll see that we were actually fairly close to where the regulator came out. The cost of capital wasn't too far away. Everyone is waiting for Thursday when we get the final determination.

Economic climate is still a concern. We're not seeing significant declines in industrial and commercial, but we do have large customers and, as reported, one of them has actually gone under. We've got a draft Floods and Water bill. We're waiting to see the detail on that so that we can assess the impacts. There is also what will come through Anna Walker's review, which is due to report shortly.

In summary, against the current economic background, we have delivered good operational and financial performance and continue to focus on our core water and waste water activities.

We will be very happy to take any questions?

Robert Miller-Bakewell, Bank of America Merrill Lynch: In terms of the restructuring, I haven't seen numbers for what you expect the restructuring to cost. Secondly, if you've lost a key customer at Bran Sands, then surely the facility is not fully loaded. Given the flooding we've had, have you had any sewer incidents?

John Cuthbert: There are no numbers for the reorganisation. We're looking at the detailed numbers, but we think around 60 people will be affected. An estimate of costs would be something circa £3 million. Where we are now in terms of planning, we expect that to come through in the second half of the year. In Bran Sands, clearly losing major customers is a challenge but Bran Sands is not just there for industrial customers. It also handles municipal waste, so we have substantial volumes to treat. We work with the RDA to support local business and make sure that our facilities on Teesside are helped through this difficult period. We want to become more efficient, which is why we have the manpower reduction. On the sewer flooding side, we've not been affected over recent days by anything like the scale you've seen in the North West of the country. We've had elements of sewer flooding, but no more than in recent years. It has been high in recent years though, which is why we need an increase in the future allowance. If they carry through on Thursday what came out of the draft determination, we will be fine for the next 5 years.

Nigel Hawkins, Libertas Partners: You are expected to have the biggest OPA revenue adjustment? Secondly, if the opinion polls are correct and we have a Conservative Government next year, have there been any discussions about mergers?

Chris Green: OPA adjustment - largely reflects sewer flooding. It's arguable that some double counting in the draft determination has happened with regards to this. We've made our representations on the OPA adjustment and that needs to be considered. If there's going to be an adjustment through the OPA, that's one thing, but you can't then incur a further penalty in other areas of the price determination. Ofwat set out very clearly that they would not double count things.

John Cuthbert: It's worth saying that the OPA methodology has been subject to a degree of questioning. Ofwat is changing the basis on which customer service will be measured. We will have a new mechanism in place for next year to replace OPA. We don't think the OPA properly reflects performance as a business. Last year, we reported that in the CC Water Survey, we came out top in terms of customer satisfaction. The new mechanism recognises the weakness in the current approach.

On the question of discussions with the Conservative party around the water sector, clearly there are discussions and they're forming their views at the moment. I think we've probably been saying for a while that the case against mergers is weakening all the time. Consolidation of water only companies and water and sewerage companies in the same area are, perhaps, difficult to argue against. There is a slightly bigger question around water and waste water businesses. From our point of view, unless you change the regulatory time period or introduce a mechanism that allows people to hold on to merger benefits for longer, it's difficult to do a water and waste water merger and get benefits quickly before the next regulatory review period. We don't think that there is time to get the benefits in a 5 year period. You look at the implementation costs and 5 years is too short to generate the benefits. It may be that the system changes as part of the review. There are no clear signals of the Conservative Party policies.

Lakis Athansiou, Evolution Securities: Can you say something about pension contributions? In the chart, you showed the £30 million in electricity for 2010/2011. If I read it correctly, the other half is reduced requirement? Also in non-appointed Kielder, can you please say how that has been moving? Just finally, what benefits can be taken from a merger other than overhead savings?

Chris Green: They are very small pensions contributions. Our major contributions were put in place over 2006/2007. All contributions were made in advance, some £60 million paid for the period up to 31 December 2010. There were no contributions on an ongoing basis, other than some very minor changes. You won't see any change in that until we get to January 2011.

Electricity benefit is a mixture of price (softening prices) and the effect of Bran Sands coming through with a lower power import requirement.

Non-appointed excluding Kielder, there is very small movement. We're seeing some small improvements in fishing and recreation. The housing market is starting to recover. It's a mixture of items, none of them material.

Coming back to merger benefits - if you were to move to a regime where you saw a 10 year period for those benefits to be captured it would help. You've got to allow a process of integration which can be between 1 and 2 years.

Lakis Athansiou, Evolution Securities: Are there really any benefits in mergers other than overhead savings?

Chris Green: You need men, depots and vans criss-crossing each other's areas to generate large savings. You could see some benefits across boundaries but, certainly in the North East and in the North West, you've got moorland, no major conurbations and hence little opportunity where you can make savings.

John Cuthbert: When we did the acquisition of the old Northumbrian in 1995, there were operational savings. When we did the ESW merger in 2000, it was IT systems and executive management. Implementation was quick because we were on the same IT platform.

Verity Mitchell, HSBC: How much do you think OFWAT has really taken account of the reduction in revenues? Do you think they understand the revenue reductions?

John Cuthbert: In terms of industrial and commercial? We included this in the final business plan, but there has been movement since then. We have submitted papers to OFWAT, which have been reviewed and audited by the reporter. This looked at revenue and cost implications. That has gone to OFWAT. We wait for Thursday, but - at the end of the day - we've put in actual events, not forecast events. We're talking about closures that have been announced and are clear, therefore our expectation is that OFWAT will take them into account. Had that been the position when we did our final business plan, it would have been included. We think that the case has been made very clearly. We also picked it up in our meeting with OFWAT.

Chris Green: The other point linked to that, is that this was exactly one of the problems coming through the 1999 review. There were major closures in 1999/2000 that were missed as part of the review which led to the substantial effects claim in 2003. We didn't want a repeat of that position this time around.

Sarah Laitung (JP Morgan): There are reports of companies going to the Competition Commission. Is that something you will need to do?

John Cuthbert: Again, we shouldn't answer that until we see the final determination. It's all about the detail, so we just have to wait until we get that on Thursday, spend some time going through the details and then we'll take a view and make a decision.

Chris Green: When you make that decision, you need to do it for the right reason. What you're effectively saying is that you cannot finance your functions; that is the overarching purpose of going to the Competition Commission. You're looking at the FD result and saying "you cannot finance your functions going forward for the next 5 years".

Richard Stuber, Cazenove: Apart from major bad debts, are you finding it hard with household bills?

John Cuthbert: Experience is broadly unchanged. We were fearful that we would see pressure in collections, but to date that hasn't really come about. We're maintaining our performance on the domestic side. Interestingly, there is a greater realisation of the scale of the challenge. This sector has seen debts increasing for some time. Whilst it's too early to say what might come from this, we take comfort that it is being recognised as an issue that requires some intervention to move some of the pressure. We're not seeing deterioration currently, we're keeping an eye on it and we hope that the Government will put provisions in place to make it easier for companies to collect debt. One of the things being looked at is landlords and how the situation works with tenants, who are liable.

Nigel Hawkins, Libertas Partners: Can I pick up a point on the Competition Commission? You said that you only go to them if you cannot finance your functions, so being bankrupt? It's not quite as clear cut as that, is it?

John Cuthbert: The regulator, in carrying out a price determination, is setting the price limits which allow a company to finance its functions. That's the purpose of the review. What Chris was saying is that if you go to the Competition Commission, then your view is that the regulator has failed to allow you to finance your functions.

Chris Green: There is probably a middle ground. If, when looking at the 5 year period, you consider the investment quality and financial ratios and if they appear to be slipping down the credit curve, you would not wait until you're in administration. Financing functions is about the next 5 years and also where you will want to be beyond that.

Pinaki Das, Bank of America Merrill Lynch: On RPI, you mentioned -1.4% RPI. Can you comment on this change?

Chris Green: OFWAT make an estimate as to what they think this November's RPI will be, and, inevitably, it will probably be different from that. They will estimate something when they make the determination.

John Cuthbert: There is a concern with smoothing 'K' that customers end up paying more at the end than they would have done with unsmoothed price limits. Therefore, smoothing, which many of us would say makes sense for customers, has a counter argument that says they would end up paying more. OFWAT didn't do a huge amount with the draft, and it remains to be seen how much they have taken the representations into account from both companies and CC Water when they publish on Thursday. Will they have been influenced by their expectations of RPI? Possibly, but it's difficult to ascertain.

Any other questions? If not, thank you all again for coming. No doubt, we'll speak some time after Thursday. Thank you.