

**NORTHUMBRIAN WATER LIMITED**

**FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 March 2011**

Registered no: 2366703

**Registered office**  
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# **FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 March 2011**

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**DIRECTORS' REPORT and OPERATING AND FINANCIAL REVIEW  
(OFR)  
for the year ended 31 March 2011**

The directors present their annual report and operating and financial review and the audited financial statements for the year ended 31 March 2011.

**Cautionary statement**

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

**Events since the balance sheet date**

On 1 July 2011 the Board of the Company's ultimate parent company, Northumbrian Water Group plc (NWG or the Group), announced that it had received a non-binding indicative proposal from Cheung Kong Infrastructure Holdings Limited (CKI) regarding a possible cash offer for the entire share capital of NWG. This was subsequently revised on 11 July 2011 when the Group announced it had received a further non-binding indicative proposal at 465p per ordinary share. The NWG Board has agreed to grant CKI a limited period to undertake confirmatory due diligence. There can be no certainty that an offer will be made. Further announcements will be made by the Group when appropriate.

**Principal activities**

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

**Directors**

The directors who served during the year were as follows:

Sir D Wanless	Non-Executive Chairman
H Mottram OBE	Chief Executive Officer
C M Green	Finance Director
G Neave	Operations Director
A C Jones	Regulation and Scientific Services Director
A G Balls	Independent Non-Executive Director (resigned 31/3/11)
M Fay CBE	Independent Non-Executive Director (appointed 1/6/10)
A M Frew	Independent Non-Executive Director (resigned 31/3/11)
A J Scott-Barrett	Independent Non-Executive Director
Dr S Lyster	Independent Non-Executive Director
Sir A P Brown	Non-Executive Director
C R Lamoureux	Non-Executive Director
M A B Nègre	Non-Executive Director
P Rew	Non-Executive Director (appointed 1/10/10)
J M Williams	Non-Executive Director (resigned 29/7/10)

## **DIRECTORS' REPORT and OFR (continued)**

### **BUSINESS OVERVIEW**

#### **Our market**

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

In the north east, the business comprises the supply of both potable and raw water and the collection, treatment and disposal of sewage and sewage sludge to 2.7m people. In this region, there has been a gradual fall in overall water demand in recent decades as a consequence of a reduction in industrial demand for water. This trend is expected to continue but the pace of decline has now stabilised after some industrial closures during the economic recession. The north east compares well to the rest of the country as far as water resources are concerned and our major regional rivers can all be supported by Kielder Water. This provides very high security of supply for our customers. We also provide the highest levels of compliance for waste water across this area ensuring that we can return the water and sewage sludge to the environment satisfactorily whilst meeting the demands of all customers. Bran Sands is particularly important in this respect as it supports the heavily industrialised area within Teesside by treating its waste. The advanced anaerobic digestion plant there is now operating effectively and helping us to build our use of renewable energy.

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

#### **Key facts**

47	impounding reservoirs
57	water treatment works
346	water pumping stations
338	water service reservoirs
25,624km	water mains
414	sewage treatment works
731	sewage pumping stations
16,181km	sewers

NWL is licensed to provide these services and currently supplies over 1,250 megalitres of water per day. This water is drawn from reservoirs, where it is collected and stored, rivers and groundwater sources. It is treated at our works before it is delivered by a network of pipes to homes and businesses.

In the north east of England, where we also provide sewerage services, waste water is then collected from these properties via the sewerage network and treated at our works before it is returned to the environment as either clean water or sludge which can be recycled as fertiliser or used to generate energy.

Our water and sewerage services in the north east cost an average householder 92 pence per day and in Essex and Suffolk area, 66 pence for a water only service.

## DIRECTORS' REPORT and OFR (continued)

### Key facts (continued)

The Water Services Regulation Authority (Ofwat), as the economic regulator, sets price limits for companies in England and Wales every five years. 2010/11 was the first year in the current five year investment plan. This regulation is performance based and companies are measured in terms of efficiencies related to operating costs, capital programmes and financing as well as their general operations. The regulated revenue of the Company is set by reference to the rate of inflation, measured by the Retail Price Index (RPI), as well as an adjustment factor referred to as 'k'. The profile of 'k' for the current five year period is shown below:

	2010/11	2011/12	2012/13	2013/14	2014/15
k(%)	5.0	3.8	0.9	0.0	(1.0)

We have a long term agreement with RWE npower for it to operate and sell the energy from NWL's hydroelectric power station at Kielder Water, which is the largest in England.

The current pressures within financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance. It is highly unlikely there will be a return to the exceptionally low cost of debt experienced from late 2005 to early 2007. Although market conditions have improved in recent months, some uncertainty remains. With the financing we have already put in place, we are sheltered from this uncertainty in the short term as we will not need to raise any new debt before March 2014.

### Regulatory and legislative framework

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

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

We aim to maintain good working relationships with our regulators and with regional organisations, such as local authorities, which have an interest in the services we provide and can influence our business. This is particularly important following Government reviews of the regulators, changes in regulatory reporting and proposals to legislate in the sector following the publication of a White Paper later in the year.

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

### 2010/11

The Company was successful in meeting many of the targets in its balanced scorecard during the year. Out of 26 targets we improved in 18, which is a very good start. Most notable were the improvements in sewer flooding and our Service Incentive Mechanism (SIM) score for customer service as well as the reduction in the number of interruptions to supply. We were also very proud to retain our industry-leading position in sewage treatment. Our independent customer satisfaction scores still show that customers are satisfied with the service we provide as well as value for money although we were disappointed that this was not reflected at the same level in the research undertaken by the Consumer Council for Water (CCWater) this year.

## **DIRECTORS' REPORT and OFR (continued)**

### **2010/11 (continued)**

This report will also focus on many highlights throughout the year but the development of our work to extend Abberton reservoir and commence our second advanced anaerobic digestion plant at Howdon, after the successful operation at Bran Sands, are particularly notable. The worst winter for over 100 years challenged our employees but they responded magnificently ensuring that no supplies were interrupted. This was a fantastic achievement and we were very proud and grateful for the commitment and hard work of so many of our employees in truly dreadful weather conditions.

We also continued to receive external recognition for our activity. This year, Ethisphere listed NWG in its top 110 most ethical companies in the world, one of only five companies chosen in the UK. This recognises the impact we have on underpinning the communities in which we operate and also recognises the longstanding relationships with key industrial and commercial customers.

We continue to be actively involved in the business community in all operating areas through direct membership and involvement in the councils/boards of the Confederation of British Industry (CBI), Chambers of Commerce and other similar organisations. Our Chief Executive Officer (CEO), Heidi Mottram, is involved in a number of organisations which we believe can influence the future of the Company and locally she is a member of the CBI Council and has been asked to join their national Infrastructure Group. Heidi has also joined the Government's Green Economy Council as the water industry representative and we hope that the Council can bring a real influence to the development of policy relating to a low carbon economy.

This year, industrial demand has stabilised and we were particularly pleased with the signing of the agreement by SSI from Thailand to secure the future of the Corus plant on Teesside. There is evidence of some industrial growth particularly with the confirmation that Hitachi will develop a site in Durham to assemble its high speed trains. Metering of our domestic customers continues to increase, although at a different pace in our various areas of supply, and domestic demand is also steady. The collection of income remains a key focus for us particularly in a difficult economic climate.

### ***Private drains and sewers***

One of the major challenges we face in 2011/12 is the transfer of private drains and sewers to the industry in October. This will almost double our sewerage network overnight and much work is already in hand to assess what is needed in terms of staffing, building effective data, information sharing and communications to customers. We don't fully know the impact of the transfer yet, but it will lead to higher costs, in the order of £20m a year initially, which we will need to recover in this five year investment period. The industry has worked well in partnership, via Water UK, to come up with the most practical cost effective way forward for customers.

### ***Legislative changes***

We look forward to publication of the Government's White Papers on Water and the Natural Environment later this year. The former should bring greater clarity in areas such as water resource planning, metering, social tariffs and broader market reform. We have worked with the industry, through Water UK, to set out a vision of how the Government can achieve many of its objectives without legislation or with only minor legislative changes. We have held frequent meetings with Defra and contributed ideas on water trading and abstraction reform including a joint project ('Trading theory for Practice') with Anglian Water, Cambridge Water and Veolia. We remain committed to any moves that can deliver clear and demonstrable improvements for customers, other stakeholders and the wider environment.

The Water White Paper will be an opportunity to end unhelpful speculation around the future regulatory regime and provide a clear vision for the future of the water industry that retains the confidence of customers and investors alike.

In addition, we await the publication for consultation of draft Regulations from Defra to introduce a duty on landlords to provide water companies with relevant details so that accurate bills can be issued to tenants. This should assist in collecting income from the private rented sector where bad debts have been relatively high.

## **DIRECTORS' REPORT and OFR (continued)**

### ***Regulatory reform***

We welcome the conclusions of the Defra review of Ofwat and CCWater conducted by David Gray. We also welcome the view that the overall regulatory framework, including the continued role for a separate customer body, is generally fit for purpose. We support the call for regulatory simplification and a reduced reporting burden which is already being championed enthusiastically by Ofwat. We also support further clarification of the respective roles of Government and regulators and a call for more transparency in consultation processes.

We strongly support the move by Ofwat to significantly reduce the burden of regulatory reporting and move towards risk-based regulation. A useful start was made in the simplified 2011 June Return reporting requirements but we support the proposal for more radical change in 2012. We have been working in partnership with Ofwat to pilot a set of high level KPIs to be reported by companies in place of the current detailed and prescriptive reporting requirements.

Ofwat has published a series of consultation and discussion papers on the subject of 'Future price limits'. We have responded to these papers and also engaged in a range of workshops, meetings and informal discussions with Ofwat. We believe the more focused approach to regulation should be reflected in the approach to future price reviews as well as the annual reporting cycle. We welcome Ofwat's intention to adopt a more outcome-focused approach to price setting and have made suggestions as to how the price setting methodology could be simplified and made more transparent. We look forward to responding to Ofwat's formal consultation paper outlining its proposals for future price reviews later in the year.

The Office of Fair Trading has announced a market study looking at whether the market for treatment of organic waste is working effectively to deliver the best outcomes for customers. We were an early investor in advanced anaerobic digestion technology and we welcome this review as it should provide the clarity required to inform investment decisions.

## **BUSINESS STRATEGY AND OBJECTIVES**

### **Our vision**

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

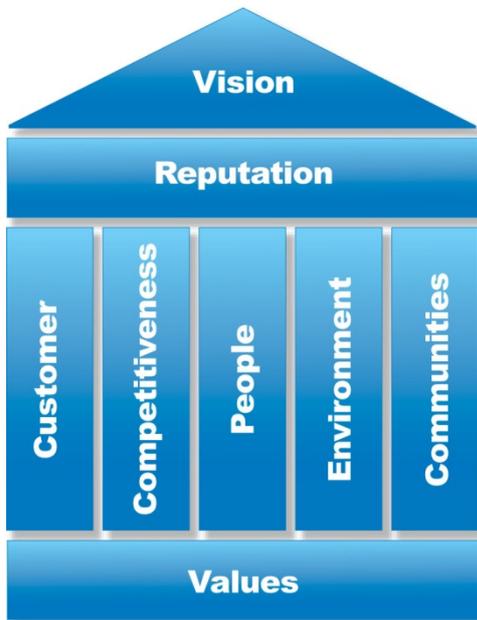
### **Strategic direction**

We want to continue to deliver value to customers and other stakeholders by focusing on our core competencies of water and waste water management. We underpin our drive to be the best with five strategic themes containing goals and targets that, when reached, will see our vision and our values delivered. In the autumn, 'Our Vision Our Values Our Way' was introduced to all our employees during a series of interactive roadshows and, as a result, there is clarity and energy throughout the company which is driving the business forward.

The five themes described below are mutually supportive and achieving the right balance between them is essential to our success and reputation.

## DIRECTORS' REPORT and OFR (continued)

### Strategic direction (continued)



**Customer** focuses on delivering industry-leading customer service. Our relationship with customers is core to the success of our business and it is essential that they trust our service. Customer service is at the heart of the company and all employees have a clear focus on getting things 'right first time every time'. Although we are required to meet regulated standards for customer service, this should not define our aspiration as the quality of our service must go beyond that.

**Competitiveness** will drive us to greater efficiency and, indeed, to be the most efficient water company. It is not just about driving cost down but using innovation to support our activity.

**People** are our greatest asset and we want to be recognised as a great company to work for with high levels of satisfaction from our employees. We will provide support and training and promote excellent employee relations.

**Environment** is critical to us and our stakeholders and we acknowledge our responsibilities to protect and enhance the natural environment. Our carbon management plan will help reduce our carbon footprint and we will adopt good environmental practice in all aspects of our activity.

**Communities** are important to us and we want to build strong relationships with the communities we serve. We will ensure that corporate responsibility is embedded in performance management and that we benchmark ourselves against the best companies.

We have agreed specific goals to help us achieve our vision against these themes, and have clear accountability for their achievement throughout the company. These are measured in a balanced scorecard which assesses our performance against key performance indicators (KPIs). This is reviewed by the Board, management team and all employees on a monthly basis.

We believe that clear direction and goals are key to success, but just as important is a clear sense of values, and how we do things 'around here'. So at the same time as reviewing our vision, we have made a clear commitment to five core values.

**One team** – we work together consistently, promoting co-operation, to achieve our corporate objectives.

**Customer focused** – we aim to exceed the expectations of our external and internal customers.

**Results driven** – we take personal responsibility for achieving excellent business results.

**Creative** – we continuously strive for innovative and better ways to deliver our business.

**Ethical** – we are open and honest in meeting our commitments, with a responsible approach to the environment and our communities.

## DIRECTORS' REPORT and OFR (continued)

### OUR PERFORMANCE MEASURES

We monitor performance using a range of financial and non-financial KPIs. Performance against these indicators is reported within the 'our financial performance' and 'our operating performance' sections later in this report.

Looking forward, the financial KPIs remain unchanged for 2011/12. However, in order to measure delivery of the Company business plan and goals, a balanced scorecard of KPIs has been introduced, which replaces the existing non-financial KPIs. These indicators are spread across the themes of customer, competitiveness, people, environment and communities and targets have been set on a trajectory to deliver the company vision of being 'the national leader in water and waste water services'.

In order to ensure alignment of the management team, this balanced scorecard now represents 80% of the criteria contributing to their annual bonus, with a further 20% available for the achievement of bespoke personal targets.

The table below details those KPIs and the targets that have been set for 2011/12. A full explanation of each target follows.

Strategic theme	Scorecard measure	Target 2011/12	Contribution to available bonus (%)
Customer	Customer satisfaction		
	- SIM quantitative score	174	2
	- SIM qualitative score	4.4	2
	Unplanned interruptions >6 hours		
	- north	900	4
	- south	600	4
	Coliform incidents (no.)	15	4
Competitiveness	Profit before tax	Set by Board	36
	Capital efficiency	Set by Board	4
People	Engagement and satisfaction index (%)	81	4
	Lost time reportable accidents (no.)	11	4
Environment	Leakage (Mld)		
	- north	147	4
	- south	66	4
	Sewage treatment works compliance (%)	100	4
	Pollution incidents (categories 1 & 2)	3	4
Communities	FTSE4Good accreditation	Retain	4
	BITC Platinum Plus accreditation	Retain	4
Personal targets	Bespoke	Bespoke	20

## DIRECTORS' REPORT and OFR (continued)

### OUR PERFORMANCE MEASURES (continued)

Measure	Definition of measure
<b>Customer</b>	
Customer satisfaction – SIM quantitative score	SIM quantitative measure, based on customer contacts. Contacts are normalised per thousand connected properties and multiplied by a weighting factor for each 'unwanted' category. Categories include unwanted customer calls, abandoned calls, first stage written complaints, second stage written complaints and CCWater investigations. The lower the score the higher the customer satisfaction.
Customer satisfaction – SIM qualitative score	SIM qualitative measure, assessing satisfaction of consumers across their experience from first correspondence to final resolution, through independent surveys. Surveys are carried out four times a year for water, waste water and billing contacts and the average score taken. A score of 5 indicates maximum satisfaction.
Unplanned interruptions >6 hours	A weighted scoring of the number of properties affected by interruptions to supply of more than six hours duration which are unplanned or unwarned (excluding overruns of planned and warned interruptions) except for those caused directly by third parties. It includes interruptions for which customers are notified less than 48 hours in advance. The scoring weights interruptions which exceed 12 hours, and heavily weights those which exceed 24 hours.
Coliform incidents	Total number of coliform failures in regulatory samples at water treatment works and service reservoirs. One coliform or more is a failing sample.
<b>Competition</b>	
Profit before tax	Actual profit before tax compared to the budget approved by the Board, adjusted for the impact of variances related to indexation on index linked bonds, which depends on the July RPI. Profit before tax has been chosen because it is a primary financial measure for the Group for which the executive directors are accountable.
Capital efficiency	An assessment of the efficiency of the NWL capital investment programme undertaken annually by the Board.
<b>People</b>	
Engagement and satisfaction index (%)	The Engagement and Satisfaction Index is calculated from scores for 13 items selected from the annual employee survey. These items align to the Sunday Times Best Companies survey and give a measure of employee satisfaction.
Lost time reportable accidents (no.)	Accidents reportable to the Health and Safety Executive resulting in more than three days lost from work.
<b>Environment</b>	
Leakage (Mld)	Water network leakage for the financial year, as reported to Ofwat.
Sewage treatment works compliance (%)	Percentage of population equivalent served by sewage treatment works compliant with Environment Agency (EA) look-up table consents.
Pollution incidents (categories 1 & 2.)	Number of category 1 and 2 pollution incidents in the calendar year, as defined by the EA. Category 1 is a major water pollution incident and category 2 is a significant water pollution incident.
<b>Communities</b>	
FTSE4Good accreditation	Accreditation by FTSE4Good index series, which has been designed to objectively measure the performance of companies that meet globally recognised corporate responsibility standards.
BITC Platinum Plus accreditation	Accreditation by Business In The Community (BITC) at Platinum Plus level, the highest level in their corporate responsibility index. BITC is a national business-led charity which advises, challenges and supports its members to create a sustainable future for people and the planet and to improve business performance.

## DIRECTORS' REPORT and OFR (continued)

### OUR FINANCIAL PERFORMANCE

We use a range of indicators to monitor performance. The definition, purpose and source of each financial KPI are shown on page 30. Performance against the financial KPIs is set out below:

KPI	Target	Performance	
		Current year	Previous year
Gearing to RCV – NWL group (see note 11) (%)	<70	56	61
Gearing to RCV – Appointed business only (%)	<65	56	60
Cash interest cover (times)	>3.0	4.0	3.9
Cash flow to net debt (%)	>13	20	18

All financial KPIs remained better than the target for the year. Gearing for the Company and for the regulated business, has reduced to 56% from 61% and 60% respectively. This is due to the impact of the high RPI increase on the RCV and a reduction in net debt over the period of £28.5m to £1,868.3m, due to the timing of the payment of dividends which were paid after the balance sheet date.

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

#### Financial results and dividends

The Company's profit and loss account and balance sheet are set out on pages 32 and 33. The financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. The key accounting policies are summarised in note 1 to the statutory financial statements on pages 34 to 37 and these have been applied consistently throughout the current and preceding periods.

Turnover was £682.8m for the year ended 31 March 2011 (2010: £651.5m). The increase is mainly due to the application of the final determination increase of 5.0%, and 0.3% in respect of RPI, on water and sewerage charges. Demand from both domestic and industrial customers has remained steady.

Operating costs, excluding capital maintenance costs, have decreased from £283.6m in 2009/10 to £280.5m in 2010/11, principally reflecting the impact of increases in pension charges and water efficiency costs, more than offset by savings on power (£6.1m), other efficiencies and one-off charges in the prior year, both for restructuring costs (£5.4m) and for bad debt relating to the closure of a major customer (£1.7m).

Capital maintenance costs have increased from £112.5m in 2009/10 to £120.7m in 2010/11, reflecting increased depreciation arising from the commissioning of new assets.

Net interest payable increased from £76.8m in 2009/10 to £102.0m in 2010/11, an increase of £25.2m within which net cash interest charges increased by £3.4m. The non-cash elements of the increase principally reflects inflation of the principal on the index linked bonds (£28.5m) and an increase in the interest cost of pension plan obligations (£7.2m), partially offset by better than expected returns on pension assets (£13.9m).

Profit on ordinary activities before taxation for the year was £179.6m (2010: £178.6m). The current tax charge of £35.6m (2010: £42.8m) principally reflects increased profitability, more than offset by adjustments in respect of prior periods. The deferred tax credit of £8.7m (2010: £7.2m) reflects a decrease in the deferred tax liability following the enactment of a reduction in the UK corporation tax rate from 28.0% to 26.0% with effect from 1 April 2011, partly offset by adjustments in respect of prior periods and a reduction in discount as a result of decreases in the post-tax yields on Government gilts.

## **DIRECTORS' REPORT and OFR (continued)**

### **Financial results and dividends (continued)**

Profit for the financial year was £152.7m (2010: £143.0m).

The directors recommend a final ordinary dividend amounting to £46.7m (2010: £43.8m) which, together with the interim dividend proposed of £46.3m (2010: £43.4m), makes a total for the year of £93.0m (2010: £87.2m), which was paid on 7 April 2011. This applies the stated dividend policy for the appointed business of 2.1% real annual growth (see note 9 to the statutory financial statements). The Board has proposed a dividend policy consistent with the underlying growth assumptions adopted by Ofwat at its price review in 2009.

Early in the year, we instigated an efficiency programme focused on identifying and implementing sustainable operating cost efficiencies in order to achieve our medium term goal of being in the top efficiency band for both water and sewerage, as measured by Ofwat, by 2013/14. This programme has progressed well and, as a result, we are ahead of our final determination profile. Further information on this programme is provided on page 14.

### **Capital investment**

Capital investment in the regulated business for the period was £221.5m, under regulatory accounting guidelines (2010: £218.3m). This is slightly lower than the final determination profile deflated by the Construction Industry Price Index (COPI), due to some delays in maintenance investment as a result of the severe winter weather, but this should be recovered in future years. It is difficult to assess any potential outperformance over the AMP5 period at this early stage given the volatile nature of COPI but we remain focused on delivering our regulatory programme.

We have recently tendered our major procurement arrangements covering water treatment, waste water treatment and waste water networks and have appointed 19 contractors and consultants to framework agreements covering an estimated £1.5 billion of investment over the next ten years, commencing 1 April 2011. In addition, we are currently undertaking a tender process to appoint additional contractors in readiness for the transfer of responsibility for private drains and sewers on 1 October 2011.

After 17 years in the planning, the £150m Abberton construction scheme to help secure water supply to 1.5m customers in Essex made good progress in its first year.

The reservoir, near Colchester, will be enlarged by 58% with its footprint extended by 40%, and the increased capacity will be in service in 2014. Over the last year, significant progress has been made and two important milestones have now been reached. Water is now flowing into the reservoir via the newly completed reservoir inlet structure at Broadmeadows and work has begun on the construction of two major raw water pipeline routes. These 1.2 metre diameter, 16 kilometre long, steel pipelines will transfer water from the River Stour at Wormingford to Abberton.

### **Cash flows and liquidity**

The level of capital expenditure that we are obliged to incur is such that NWL cannot be wholly financed by internally generated sources. As a result, we 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. Our strategy is to finance such investment by raising medium to long term debt, providing a balance sheet match with long term assets, and to fix a major proportion of interest rates.

The Company received approval for a new £150.0m facility from the European Investment Bank (EIB) which will be drawn down in three £50.0m tranches, in the calendar years 2011 to 2013, at interest rates to be determined at the time of drawdown. The Company has substantial cash resources and undrawn committed bank facilities available to maintain general liquidity. Total cash and short term cash deposits available at 31 March 2011 amounted to £123.2m (2010: £89.4m). This, and the new EIB facility, is sufficient to meet the requirements of the business through to the end of March 2014.

## DIRECTORS' REPORT and OFR (continued)

### Credit rating

The credit rating for NWL has remained consistent throughout the year at BBB+ stable (Fitch and S&P) and Baa1 stable (Moody's).

### Treasury policies

The Board is responsible for the financing strategy of the Company which is determined within treasury policies set by NWG. The Group's treasury function carries out treasury operations on behalf of the Company and its main purposes are to assess the ongoing capital requirement, to maintain short term liquidity, ensuring access to medium term committed back up facilities, and to raise funding, taking advantage of any favourable market opportunities.

It also invests any surplus funds the Company may have, based on its forecast requirements and in accordance with the Group's treasury policy. On occasions, derivatives are used as part of this process, but the treasury policy prohibits their use for speculation.

## OUR OPERATING PERFORMANCE

We use a range of KPIs to measure non-financial performance in the business and these indicators are reviewed by the management team each month. Performance for the year is reported in this section. The definition, purpose and source of each KPI are shown on pages 30 to 31.

These measures have been reviewed in the year, as outlined in 'Our performance measures' on pages 7 to 8, and a new balanced scorecard of KPIs has been introduced for 2011/12.

### Customer

#### Putting customers first

Customer service is at the heart of the company and the culture of getting things "right first time every time" is embedded in the business. We keep customers informed about our activities through leaflets with bills and our websites at [www.nwl.co.uk](http://www.nwl.co.uk) and [www.eswater.co.uk](http://www.eswater.co.uk). The sites include information about our services and now allow customers to ask questions and investigate work being carried out in their area. If customers are directly affected by any work, we give advance warning and explain the need for the timing of such work. We also communicate more broadly with local communities through public meetings and customer information events.

#### Customer satisfaction

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

Customer research is carried out each quarter in the regions served and the table below shows the key results for overall satisfaction with service and value for money.

	Target 2010/11	Performance 2010/11
Overall service (%) <sup>1</sup>	91	89
Value for money (%) <sup>1</sup>	87	85

Note:

1. Satisfaction measured on a net basis (see appendix to the directors' report and OFR).

## DIRECTORS' REPORT and OFR (continued)

### Customer service

The performance against standards of service is shown below:

	North (N) South (S)	Target 2010/11	Performance 2010/11
Properties at risk of low pressure	N S	256 55	230 41
Properties subject to unplanned interruption of six hours or more	N S	1,700 1,100	1573 700
Properties subject to hosepipe bans at any time during the year	N/S	0	0
Properties subject to sewer flooding (other causes)	N	150	253
Properties at risk of sewer flooding (once in ten years or twice in ten years)	N	688	487
Billing contacts responded to (within five working days) (%)	N S	99.3 99.3	99.3 99.7
Written complaints responded to (within ten working days) (%) <sup>1</sup>	N S	n/a n/a	99.9 99.8
Bills based on meter readings (%)	N S	99.9 99.9	99.87 99.83

Note:

1. New SIM measures were introduced in 2010/11, which incorporate this KPI, therefore no separate target set.

In addition, Ofwat introduced the SIM in the year, which monitors both quantitative and qualitative aspects of customer service. This new mechanism financially incentivises the best performing companies and penalises the worst, endeavouring to simulate competition and encourage excellent service throughout the industry. Our aim is to be the leading company for SIM.

The quantitative aspect of SIM includes metrics for all lines busy and abandoned calls, unwanted calls, written complaints and CCWater investigations, each of which are worth a number of penalty points depending upon the severity. Results across all metrics improved during the year, customer complaints continue to reduce and our quantitative SIM score for 2010/11 was 211, a significant improvement compared to 2009/10 when our score equated to 331.

The qualitative aspect of SIM takes the form of a survey, which is conducted each quarter across every water company and asks customers who have made contact with us about their experience. Our cumulative score for the four quarterly surveys was 4.14 out of 5, an improvement on the previous year's score of 4.10.

The way we handle customer complaints is reviewed annually by the CCWater who assess cases against a range of criteria. During 2010/11, 96% of all cases reviewed were assessed as good. We value the feedback CCWater provide us and actively use their suggestions to further improve the customer experience.

## **DIRECTORS' REPORT and OFR (continued)**

### **Affordability**

We aim to provide accurate, clear and timely bills which encourage prompt payment. Customers who deliberately avoid paying charges are actively pursued. In the current economic climate, we know that affordability continues to be a genuine concern for many customers and we continue to be considerate of their circumstances, ensuring they can choose suitable payment options and that our recovery techniques are appropriate and effective. However, customers who deliberately avoid paying charges are actively pursued and we are working closely with Ofwat and Defra to seek changes to legislation which will assist the industry to identify those responsible for charges more easily.

The Flood and Water Management Act 2010 outlines how sewerage service providers may operate concessions for surface water drainage charges, to protect certain community groups and premises from unaffordable charges. We have decided to introduce an interim concessionary charge for the charging year 1 April 2011 to 31 March 2012 and will carry out consultation with CCWater to determine the longer term future of any concessions in the coming months.

### **Business customers**

The economic situation has had a significant impact on some business sectors which are important in our operating regions and we have been working closely with major customers in those sectors to mitigate the impact where possible. While economic conditions remain challenging, industrial demand has stabilised this year following, for example, the development of the former Artenius site by Lotte Chemical UK Limited. The agreement for the takeover of the Corus site by SSI should help stabilise industrial demand going forward.

We are active in the business communities where we are a member of the CBI and Chambers of Commerce. By supporting these and smaller groups NWL can help business growth and development in the areas we serve as well as retaining contact with organisations which represent customers. Business customer satisfaction is also tracked on a regular basis and levels of satisfaction are high.

### **Leisure customers**

We continue to develop our leisure facilities at all strategic sites including investment in fishing facilities, holiday accommodation and supporting 'access for all'. Occupancy of the log cabins at Kielder was 85% and we have 5,814 fishing members registered. The combined activity of our reservoirs rates this business the largest of its kind in the UK, with a high customer satisfaction at all sites. We are also an active member of the Kielder Water & Forest Park Development Trust.

### **Working in partnership**

We always aim to exceed the expectations of our customers by taking personal responsibility for delivering and communicating a good service and keeping promises. We aim to work in partnership with our major business customers as we know that a key factor for them in their business is reliability and security of our services.

Tees Valley crisp manufacturer KP Foods (KP) is a major customer of our Billingham sewage treatment works. To improve KP's economic performance and enhance the sustainability of its operations, KP proposed to construct a membrane bioreactor to enable water to be treated and re-circulated at its plant. Our account manager worked with KP to ensure that the proposed development did not detrimentally impact on NWL's sewage compliance while providing advice and support. Both parties have benefited from the close, honest working relationship which has resulted in a great deal of trust and respect:

- water consumption has been reduced meaning less abstraction, treatment and pumping for NWL and lower water bills for KP; and
- the trade effluent discharge is cleaner and requires less treatment, reducing the cost of power and de-sludging for NWL, and has resulted in lower trade effluent discharge costs for KP.

NWL and KP have each increased their competitiveness by improving their efficiency.

## **DIRECTORS' REPORT and OFR (continued)**

### **Competitiveness**

Early in the year we instigated an efficiency programme focused on identifying and implementing sustainable operating cost efficiencies in order to achieve our medium term goal of being in the top efficiency band for both water and sewerage, as measured by Ofwat.

#### **Efficiency programme**

The efficiency programme has identified around 100 projects and initiatives from across the whole business, ranging from large scale strategic reviews to smaller improvements at a local level. Examples of some of the changes underway include consolidating all chemical analysis for our northern operating region at one laboratory; the implementation of site-specific energy management plans to reduce energy usage; increasing the capability of our website to enable improved customer self-service; investigating opportunities for co-digestion of external waste streams at our advanced anaerobic digestion plant at Bran Sands and insourcing activities where it is more efficient and effective to do so.

These efficiencies are additional to the benefits already secured through procuring our full energy requirements to March 2015 and the headcount reductions resulting from severances and early retirements, for which provision was made last year.

Delivery of the programme is on schedule and, as a result, we are ahead of the final determination profile. However, these benefits are partially offset by the impact of the changes to the Carbon Reduction Commitment Energy Efficiency Scheme announced by the Government in its Comprehensive Spending Review in October 2010, which is expected to increase energy costs by around £3.0m next year with further increases of up to £1.5m by 2014/15, and which was not funded in the final determination.

Other aspects of performance in relation to our competitiveness theme are included in 'our financial performance' on page 9.

#### **Research and development**

As part of our competitiveness theme, we run a programme of research and development linked to our operations, which includes the development of technical solutions for water and waste water management, collaborative research within the sector and partnerships with academic and research organisations and actively encourages innovation. This has supported the invention, development, trial and/or implementation of:

- advanced automatic control systems for waste water treatment process;
- a device for reducing flooding and pollution;
- microbial fuel cells and electrochemical cells, which, respectively, generate electricity or hydrogen from waste water;
- novel instruments for monitoring the quality of waste water effluent;
- beneficial re-uses for water treatment sludge;
- low power de-watering and thickening of water treatment sludge;
- internal inspection of water distribution pipes while in service;
- lining systems for extending the life expectancy of water distribution pipes;
- water efficient and rapid disinfection of water mains;
- novel processes for drinking water production and waste water treatment;
- renewable energy production using biogas;
- regeneration of brownfield land using water treatment by-products;
- early warning system for leaks and bursts; and
- remote pipeline condition assessment.

## DIRECTORS' REPORT and OFR (continued)

### Research and development (continued)

During the year, the Company invested £2.3m (2010: £2.1m) in research and development.

Research carried out by London Economics for Professor Martin Cave's 'Independent Review of Competition and Innovation in Water Markets' found that, in terms of innovation infrastructure, we are one of the companies best equipped to promote innovation in terms of the resources dedicated.

### People

#### Employee policy

We have developed employee policies, reflecting the framework set out in NWG's 'Our Code of Conduct'. These policies are tailored to our specific business objectives and operating environments. We aim to recruit and retain the best people, with a diverse range of skills, experience and backgrounds, who are committed to making the Company successful. In return, we aim to provide opportunities and training for employees to develop their skills and capabilities to equip them to meet the challenges of their roles, while rewarding the contributions of both teams and individuals. The CEO, has responsibility at Board level for human resources issues.

#### Employees

We ensure our terms and conditions both attract and retain the best people in the areas we serve. Employee turnover is relatively low at 5.8%, below the UK water industry average of 9.4%.

Our current level of sickness absence is 3.1%, which is well below the norm for the sector.

	Target 2010/11	Performance 2010/11
Employee turnover (%)	9.4 <sup>1</sup>	5.8
Lost time reportable accidents (per 1,000 employees)	4.3	4.1
Sickness absence (%)	2.9	3.1

Notes:

1. No target set, industry average provided for information.

The active involvement and engagement of everyone across the business is an important part of delivering performance and we continue to seek the views of employees through an annual employee engagement survey. This year's survey had the largest response rate ever, at 75%, and the feedback covered working life, training, communications, managers and the company. All employees were invited to workshops to consider the results and identify areas for improvement in their working practices and environment, the outputs contributing to the development of departmental action plans. In addition, 80% of respondents told us they are proud to work for the Company, 81% would recommend working for the Company and 77% believe that NWL is a great organisation to work for.

For the first time NWL took part in the Sunday Times Best Companies survey and achieved 'one to watch' status, an excellent achievement on first time entry.

Our employees also have access to a scheme which provides a wide range of benefits including tax efficient benefits such as childcare vouchers, water services, cars for personal use and discounted store vouchers. Currently 73% of employees participate in the scheme, up from 72% last year.

## **DIRECTORS' REPORT and OFR (continued)**

### ***Equality and diversity***

We operate an equal opportunity policy designed to ensure that no job applicant or employee receives less favourable treatment on the grounds of age, gender, marital status, disability, race, ethnic or national origin, religion or sexual orientation. We monitor our workforce profile against census and sector data and aim to be recognised as an employer of choice within the diverse communities we serve, ensuring we take full advantage of the rich backgrounds and abilities of current and potential employees.

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

### ***Consultation and engagement***

We engage with our employees through a variety of means appropriate to our working environment. The importance of an inclusive and engaging management style is fully recognised. In 2010, we continued to build on its award-winning approach by engaging with all employees over some 120 departmental workshops facilitated by senior managers and 51 interactive roadshows facilitated by the directors. These were all structured to outline our vision and values, encourage a dialogue on improvements to working practices and environment and to seek views on our people strategy. This has been further developed to include leadership events held bi-annually engaging the most senior managers in the continuous development of plans to enable the achievement of the vision.

### ***Training and development***

We train and develop our employees to benefit both the Company and the individual. Annual appraisals are given high priority, as is the identification of training needs, in recognition of the importance of training and development in achieving the Company's goals and policies. During the year, a 360° feedback mechanism, which evaluates performance against the company values, has been introduced for all senior managers. The results of the feedback are discussed at annual appraisal meetings.

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

We signed the Government's Skills Pledge at the end of 2007, publicly committing to develop 90% of the workforce, around 2,600 employees, to at least National Qualification Framework (NQF) Level 2 – the equivalent of five GCSEs at grades A to C – by the end of 2010. This was achieved by July 2010 with 90.2% qualified to NQF Level 2 or above. National Vocational Qualifications continue to be delivered in customer and operational areas. In addition, we currently have seven graduates on our Graduate Development Programme and 29 apprentices.

We continue to implement our Management Development Framework which is structured to cover the training needs of those who show the potential for management right through to development at director level. As part of this framework we are working in partnership with Newcastle Business School to provide qualifications, from a Diploma to a Masters degree, in leadership and management. In 2010, we introduced our LEADer programme, which is the next step in our Management Development Framework, to some of our operational departments. This development programme for supervisors, team leaders and works managers includes assessment against NQF Levels 2, 3 and 5 management standards, as appropriate, supported by formal development and coaching.

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

## **DIRECTORS' REPORT and OFR (continued)**

### ***Communication***

We use a wide range of communication methods including magazines, brochures, leaflets, newsletters, intranet, notice boards and regular team meetings. We issue all employees with a series of information booklets clearly explaining areas such as the Company's vision and values, terms, conditions and benefits of employment, and occupational health and wellbeing programmes.

### ***Disclosure (Whistleblowing)***

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

### ***Health and safety***

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

Our emphasis on the importance of health and safety has resulted in major improvements to our safety record in recent years. This year we experienced nine reportable accidents and incidents per 1,000 employees, which continues the improving trend achieved over the last seven years.

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

We proactively support and encourage employees to strive for high standards of health and wellbeing by providing a wide range of services, support and resources relating to occupational health, with the Group's medical advisor providing comprehensive occupational health services, general health promotion and stress management. Our employees also have on and off-site access to specialist advice and treatment to support recovery from musculoskeletal disorders (MSD). We have reduced sickness absence due to MSD by 39% over the year. In 2010, we introduced NWL Support. Part of this service is an Employee Wellbeing Programme which gives employees and their immediate family access to face to face or telephone counselling on a range of subjects regardless of whether or not the issues are work related. In addition, it also provides a telephone based case management service for employees who have either a stress related or mental health condition. We have reduced stress related sickness absence by 16% in the first year.

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

### ***Quality***

We have successfully extended our scope of certification to the international occupational health and safety management standard OHSAS 18001:2007 to include Scientific Services, thus now ensuring companywide coverage.

### ***Employee Share Incentive Plan (SIP)***

The directors believe that employee investment strengthens the ties between the Company's employees and the Group. More than a third of employees participate in the SIP, and together have an interest in 0.6% 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. Employees participating in the SIP are given the opportunity to exercise their voting rights through the Trustee.

## DIRECTORS' REPORT and OFR (continued)

### Environment

#### **Water quality**

The quality of water is critical to our customers and samples are taken on a daily basis for analysis under regulations monitored by the DWI. The quality in all areas served remained high.

	North (N) South (S)	Target 2010/11	Performance 2010/11
DWI Mean Zonal Compliance (%)	N S	99.85 99.95	99.95 99.94
DWI Operational Performance Index (%)	N S	99.65 99.98	99.84 99.97
Distribution Maintenance Index (%)	N S	99.70 99.85	99.70 99.93

Compliance at water treatment works has improved significantly in 2010 with fewer microbiological failures than any previous year. This reflects the work being undertaken to achieve internal medium term targets for performance. In addition, service reservoir maintenance has been enhanced, with inspection rates now three times higher than historical frequencies. The aim of this work is to sustain a higher level of microbiological compliance while ensuring the integrity of the asset base for the long term.

Work using new cleaning techniques to refurbish more than 150 kilometres of the large diameter pipe network is well advanced. The network supplies drinking water to over half a million customers in south east Northumberland and parts of Tyneside. The majority of the cleaning works have now been delivered and the programme is due to be completed in June 2011, achieving a significant reduction in customer complaints about discoloured water. Progress has been maintained despite the unusually harsh winter.

#### **Water resources**

Water resource availability is a key issue in our Essex and Suffolk areas. Work continued throughout 2010 on increasing the capacity of Abberton reservoir, near Colchester, by 58%. Good progress was made and the project remains on programme.

In early 2011, construction of two new pipelines to bring water from Norfolk commenced. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke, in Norfolk, and we are working closely with the EA on progressing this. Once this scheme is operating, in 2014, we do not expect to have to develop further major resources in Essex for the next 25 years.

In addition to improving the supply of water, we believe it is important to manage the demand for water so that it does not exceed levels that can be supplied in a sustainable way. Metering has an important role to play in this regard. For several years we have been installing water meters upon change of occupier in properties in the Essex area. This is in addition to the optional metering scheme available to all customers. Around 48% of domestic households in Essex and 60% in Suffolk are now metered. In the north east, where supplies are more plentiful, 24% of households are metered.

New water efficiency targets were introduced in 2010/11 to reduce per capita consumption across the Company's domestic customers by one litre per property per day. These targets apply in all areas served and the award-winning work previously carried out in Essex was extended to the rest of the Company. New initiatives have been developed, including an innovative theatre production called 'Little Green Riding Hood', with Fame Factory Spotlight, which took the water efficiency message to 36,500 school children over the last year. We met our water efficiency targets before the end of the year.

## DIRECTORS' REPORT and OFR (continued)

### Water resources (continued)

We continue to monitor the weather patterns and the early part of 2011 has proved to be dry with little rainfall. The resource situation is still good with adequate resources in storage to meet demand. There are no plans for restrictions although the company will continue to use awareness campaigns to encourage customers to control demand in dry periods.

Our assets, once again, proved very resilient during the most severe December weather for more than 100 years, a 1 in 120 year event in the north east of England. It proved very challenging but we were able to maintain supplies to customers largely due to the exemplary efforts of our employees who worked tirelessly in difficult conditions. The severe freeze and subsequent thaw inevitably resulted in a significant increase in burst pipes and leakage, both on our own network and customer premises. As a result, in our northern operating region, the water lost over the winter period meant we, along with other companies, did not meet our annual leakage target. In our southern region, conditions were not quite so severe and we achieved our target. We have recovered from the effects of the winter through implementing an action plan which will position us well to meet the target in the following year.

### Waste water

Our exceptional performance for sewage treatment works continued with all numerically consented works again remaining compliant for the year.

	Target	Performance
(northern operating area only)	2010/11	2010/11
Sewage treatment works (%)	100.0	100.0
Bathing waters Mandatory Standard (%)	100.0	97.0
Pollution incidents (category 1, 2 and 3)	102	100

The advanced anaerobic digestion plant at Bran Sands is now fully operational and generating the expected volumes of biogas and electricity. The re-organisation, to operate the plant at much lower manning levels than previously, has been successfully implemented. Construction is now underway on a similar plant at Howdon, on Tyneside, to process the remainder of NWL's sludge.

A total of 33 of the 34 bathing waters in the north east passed the required mandatory standard and 28 met the more demanding guideline standard. The single mandatory failure was Saltburn and we are carrying out a detailed investigation on whether any of our assets could be contributing to this and working with other agencies to determine how they may be impacting on this bathing water.

The number of properties experiencing internal flooding due to hydraulic overloading reduced significantly in 2010/11. This can be attributed to a combination of less frequent and intense summer storms in 2010 and the cumulative effect of our sewer flooding investment programme. Enhanced resolution rain radar has now been in place in the north east since 2009 allowing us to identify severe weather across the region.

During 2010/11 we completed 43 schemes at a cost of £17.5m that resulted in the removal of 178 properties from flooding registers. Planning to identify schemes for coming years forms a key part of our investment programme and is well advanced, with a further 270 properties to be addressed in 2011/12. Additionally, in line with our serviceability action plan for sewer flooding, we have embarked on a programme of increased mitigation. This covers not only properties where a scheme is not cost beneficial but also properties where a solution may not be implemented quickly.

The number of properties flooded due to other causes also reduced significantly in 2010/11. This reduction has been influenced by increased sewer cleansing activity as well as better weather.

## **DIRECTORS' REPORT and OFR (continued)**

### **Carbon management plan**

The water industry is one of the largest users of energy in the UK and we aim to play a full part in support of the Government's plans to reduce emissions. We have been working hard over recent years to reduce our carbon footprint while preparing ourselves for the future challenges of a change in climate and the weather events we may face as a consequence.

We have published our carbon management plan to meet the target of a 35% reduction in operational emissions by 2020, from a 2008 base.

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

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

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

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

### **Changing weather patterns**

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

In past years, we have carried out research into the likely impact of climate change on all our assets and water resources and this has been incorporated in our climate change policy as part of our corporate responsibility work. This work is continuing, based on the latest UKCP09 projections published in 2009 by the UK Climate Impacts Programme.

Over the course of the past year we have incorporated this work into our response to the new adaptation reporting power granted to the Government by the 2008 Climate Change Act. This work has highlighted that increasing rainfall intensity is the most significant short term threat that we will face as a result of the changing climate. This represents a serious challenge if we are to manage successfully the higher level of risk of sewer flooding that will result. We have already begun to take actions that will better prepare us for this challenge, including investment in weather radar, remote monitoring of the sewer network and joint working with other drainage agencies. These will all contribute to our better understanding and management of the threat.

## **DIRECTORS' REPORT and OFR (continued)**

### **Changing weather patterns (continued)**

More positively we have found that the anticipated drier summers of the future are less of a concern for NWL than for many other companies in our industry. The ongoing investment to increase the capacity of Abberton reservoir plays a big part in this for our Essex operating area. Work is now underway on this project that has been in development for over 15 years, a reflection of the long lead times for such environmentally sensitive schemes. The presence of Kielder Water helps protect the north east region to an even greater extent. Despite this, we anticipate that we will need to monitor and formally update our understanding of the threat from the changing weather at regular intervals.

### **Quality**

We have maintained our certification to the international quality standard ISO 9001:2008 and to the international environmental standard ISO 14001:2004 across all areas of the business, including operational sites and office based teams.

### **Communities**

We support the communities we serve in a number of different ways. We have been widely recognised as leaders in our support for projects that make the areas we serve better places in which to live, work or invest. This year the company has been re-accredited by FTSE4Good and is awaiting re-accreditation as a Platinum Plus company by Business in the Community. The Queen's Award for Industry is still in place as it is awarded for a five year period. This year, the Company was also recognised by Ethisphere, an American-based international think-tank, as one of the 110 most ethical companies in the world and was one of only five UK-based companies.

The support we give to our communities focuses on five broad areas.

#### **Investment in our communities**

This year the Group made charitable donations totalling £152,000. In addition, and in line with previous years, we have contributed resources with a value equivalent to at least 1% of our annual pre-tax profits (through cash, employee time and expertise, or use of our facilities) to projects which benefit the communities we serve. Our employees raised £69,000 for charities this year.

The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments over £16,000 for charities nominated by employees (Great North Air Ambulance Service, Royal National Lifeboat Institution (RNLI), Myelin Project, Zoe's Place, Macmillan Cancer Support, St Cuthbert's Hospice and East Anglian Children's Hospice). Since it began in 2004 over £326,000 has been raised for charity.

Community Foundations covering our areas of supply hold endowment funds totalling nearly £1.0m contributed by NWL over the last 19 years. These are long term investments with the income from the funds used to support community and environmental initiatives. Community groups are chosen by committees of our own employees (44 recipients this year).

In addition to cash donations, we seek to support many projects through in-kind giving and support. Through 'Good Moves' we aim to put NWL estates into productive community use. Working in partnership with artists' groups CoExist and Metal, we have developed a temporary art project at our empty Southend complex to provide space for a temporary gallery, studio and small creative business complex.

We have focused on developing affordable rural housing to contribute to the sustainability and vitality of those communities, including support of the Prince of Wales' Affordable Rural Housing Initiative since it was launched in 2003. As part of this commitment we are working with Hastoe Housing on a project for 12 houses on land close to Hanningfield water treatment works in Essex and these are due for completion in 2011.

## **DIRECTORS' REPORT and OFR (continued)**

### **Investment in our communities (continued)**

The Kielder Partnership was created in 1994 and consisted of private, public and voluntary sector partners committed to the development of Kielder Water & Forest Park as a tourism, leisure and recreation destination. Activity has focused on delivering the Partnership's vision – 'Kielder Big Picture' – including the use of the fabulous tracks and trails developed in 2008/09. The 26 mile Lakeside Way, a multi-user track, is now used by 45% of all visitors. This trail was used for the first Kielder Marathon in October 2010, dubbed the most beautiful in Britain and organised by Olympic athlete Steve Cram. This, combined with other activities including the development of mountain bike trails and the increasingly popular Kielder Observatory, has helped to increase visitor numbers between 2008 and 2010 by 9.4% to 306,250, creating an additional 66 direct and indirect jobs and boosting the spend in the local economy by 20% to £15.5m. In December 2010, the structure of the Partnership was formalised by forming a registered charity called the Kielder Water & Forest Park Development Trust which will continue to deliver the vision and 25 year investment plan for the area. The website [www.visitkielder.com](http://www.visitkielder.com) provides further details of all facilities.

### **Participation in our communities**

As part of NWL's in-kind giving, we encourage employees to volunteer their time, skills and expertise through our 'Just an hour' volunteering scheme. We support our people to actively participate in their local communities by giving them work time to volunteer in projects of their choice. During the year our people have helped hundreds of community projects, completing tasks as varied as beach clean ups, organising charity balls and taking on ambitious gardening and decorating challenges.

For example, a group of employees volunteered their time to support people with disabilities to participate in an activity weekend organised by the charity Leonard Cheshire Disability. Together, volunteers and service users enjoyed outdoor activities including abseiling and taking a zip wire across a river. Further highlights came from the Essex based employees who collected over 1,000 boxes of food supplies as part of the Harvest for the Hungry campaign 2010. This important contribution helped the humanitarian campaign to provide an essential lifeline to villages and communities scattered across Eastern Europe.

Currently 27% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 7,600 hours to the community. Over 870 different organisations were given financial and in-kind support during the year.

### **Educating our communities about their environment**

Key partnerships have been developed by NWL to help the conservation of biodiversity on our sites, to facilitate public access and to develop conservation education. Our contribution includes funding project officers and providing expertise to the organisations. Our current partnerships include:

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

A wide range of targeted educational materials are available on our websites for children and teachers. We promote the use of these materials and celebrate innovative approaches to environment and health education via our support of the Northumbrian Water Schools Awards in the north east and Cash for Schools Awards in Essex.

We also lead on specific environmental education initiatives such as the innovative 'Northumbrian Water GLOBE' project. This year the project, in collaboration with The Climate Change Schools Project, ClimateNE, EA and GLOBE UK, is supporting five schools to take control of capturing and analysing local weather data, patterns and extreme events (using weather stations and training provided by NWL). Ultimately, children involved will become 'community scientists' to drive behavioural change at local levels.

## **DIRECTORS' REPORT and OFR (continued)**

### **Supporting healthy communities**

We continue to promote the health benefits of drinking tap water and our 'Water for health' campaign aims to encourage people to lead a healthy lifestyle. To date, over £341,000 has been provided to fund free mains-fed water coolers in schools and around 740 have been supplied in nearly 410 schools. We also continue to promote bottle-free water coolers as a sustainable alternative to bottle-fed coolers. Similarly, we use our 'tap into' initiative to donate bottled tap water to community sporting events in order to promote the importance of rehydration during exercise. This year we donated 82,300 bottles of tap water to events.

Working with a wide and diverse range of sporting partners is a natural extension of our 'Water for health' campaign and we work with them to support grassroots sporting activities to get people active as well as educating them on healthy eating and good hydration.

Through our partnerships we have reached over 96,000 children and adults. We provide:

- links and networks to enable sporting partners to get together to share ideas and resources;
- financial support of approximately £50,000 per annum which then levered over £600,000 from other sources;
- advice and marketing support on programme development;
- bottled tap water, sports bottles, water jugs or mains-fed bottle-free coolers to reinforce the importance of drinking tap water to rehydrate during sporting activities; and
- help with fundraising and raising the profile of the partnerships to attract additional investment.

We have linked our 'Good moves' initiative and our 'Water for health' campaign to develop Healthworks. This is a unique project utilising one of our redundant buildings to help tackle the poor long term health of the residents in Easington, County Durham, by granting a 99 year lease to County Durham Primary Care Trust and working in partnership to develop services for the local community in an area where census records show one of the worst health records in the country.

We are represented on the steering group for Healthworks and provide research, marketing and communications support. The centre has received almost 20,000 visits to date and now provides over 58 health and community support services including a GP led walk-in health centre open 8am to 8pm 365 days a year. It acts as a community focal point where service providers and community groups can come together to address issues that affect the quality of life in their local community.

### **Supporting developing communities through WaterAid**

We continue 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, as it has since the charity was formed by the water industry in 1981.

The employee fundraising committee has raised more than £4m, since 1997, with the help of the company and last year focused its fundraising support on specific projects in Ethiopia. We support our employees to become ambassadors for the charity and encourage annual supporter trips to see WaterAid projects. This year, Asset Manager Craig Holliday visited Bangladesh and saw first hand how our adopted international charity saves lives.

## **OUR RISKS AND UNCERTAINTIES**

NWG requires all subsidiaries within the Group to identify and assess the impact of risks to their business using a standard risk model. For each risk identified, the model records the uncontrolled magnitude and likelihood of the risks occurring as well as the controls in place to mitigate those risks before assessing the controlled magnitude. NWG's view of acceptable risk is based on a balanced view of all of the risks in the operating environment. It aims to ensure an appropriate balance between risk aversion and opportunities.

## **DIRECTORS' REPORT and OFR (continued)**

### **OUR RISKS AND UNCERTAINTIES (continued)**

NWG sets the tone for risk management within the Group and determines the appropriate risk appetite. It monitors the management of fundamental risks and approves major decisions affecting the Group's risk profile. Senior management implements policies on risk management and internal control.

At NWL, the management team reviews the approach to risk management in detail every year and the Audit Committee considers the outcome. The management team reviews the significant risks every month and a full review of the model for emerging significant risks is carried out quarterly. Any issues that arise from these management team reviews are reported by the CEO to the board.

The system of internal control incorporates risk management. It encompasses a number of elements that together facilitate an effective and efficient operation, enabling the company to respond to a variety of risks. These elements include:

- **Policies and procedures**  
Attached to fundamental risks are a series of policies that underpin the internal control process. Written procedures support the policies where appropriate.
- **Business planning and budgeting**  
The business planning and budgeting process is used to set objectives, agree action plans and allocate resources. Progress against meeting business plan and budget objectives is monitored regularly.
- **Risk register**  
The risk register identifies key risks, each with a risk owner who is responsible for evaluating the risk on a regular basis. As a way of ensuring that risk management is embedded into the business, the risk owners have the management of these risks as a personal KPI.
- **Strategic risk model**  
Risks that are known but not yet well defined enough for the likelihood and consequence to be reasonably foreseen are included in a strategic risk model.
- **Audit Committee**  
The Audit Committee reports to the board on internal controls and alerts the board to any emerging issues. In addition, the Audit Committee oversees internal audit, external audit and management, as required, in its review of internal controls.

Last year, the Audit Committee commissioned an additional risk and assurance mapping report from Ernst & Young, the objective of which was to provide NWL management and the Audit Committee with a view of the different assurance functions within the company and the extent to which they provide assurance that the control activities are operating. An assurance map now forms a permanent part of the process and, for each risk, highlights who provides assurance that the control activities are in place and operating effectively.

## DIRECTORS' REPORT and OFR (continued)

Risk description	Mitigation measures
Funding and liquidity risk	The financial ratios, financial results, liquidity position and credit ratings are described in the financial performance section on pages 9 to 11. See below for details on the Company's strategy and treasury operations for managing its capital; its exposures to liquidity risk, interest rate risk and foreign currency risk. The Group reviews the treasury strategy periodically and approves specific proposals.
Unfavourable changes to the regulatory structure, as a result of the Water White Paper	We play a leading role in the policy debate, through Water UK, direct lobbying and forging positive relationships with relevant parties. We respond positively to consultation papers.
Unfavourable changes to the regulatory structure or price setting mechanism by Ofwat	We play a leading role in consultation groups with Ofwat and other stakeholders. We respond positively to consultation papers.
Impact of the transfer of private drains and sewers is greater than anticipated	An internal project team has been established to understand and prepare the business for the transfer. We maintain sound financial documentation to support a future claim for tariff increases in order to recover additional costs borne. We maintain close liaison with the rest of the industry and have had constructive dialogue with Ofwat regarding the process.
Unexpected shift in climate change impact	We have processes in place to anticipate and plan for the impact of climate change. While these have long time horizons, they are reviewed regularly to ensure that any changes are identified early.
Loss of supply due to failure of strategic water main. This covers catastrophic failure that is greater than the response capability of the company	In most cases, duplicate mains and diversion of supplies would limit supply consequences. Comprehensive plans exist to provide a minimum emergency service to customers until repairs are completed, including mutual aid arrangements with other water companies. A proactive inspection regime is in place along with longer term reviews of network resilience.
Sewer flooding failures	A sewer flooding group, comprising stakeholders from various teams, is responsible for managing the process, flood reporting, network capacity studies and prioritisation of investment to reduce risk. Significant additional capital expenditure has been invested to address affected properties. The recently constructed rain radar station for the region is now operational and provides improved data. However, controls are not yet sophisticated enough to predict or prevent consequences of severe rainfall.
Pesticides lead to prescribed concentration or value failure and possible enforcement action	Undertakings have been agreed with the DWI to carry out certain actions to mitigate pesticide issues (metaldehyde and clopyralid). While specific treatment processes, such as carbon dosing, are undertaken at treatment works, proactive catchment management is also being carried out. This involves working with farmers, regulators and other stakeholders to advise on improved storage and application techniques for such pesticides. This is a more sustainable solution than the alternative of constructing major new treatment processes.
Loss of income through closure of large customers or lower industrial volumes	It is not possible to directly influence industrial volumes, however, our account managers liaise closely with significant customers to provide support where possible.
Incident at Bran Sands waste water treatment works causes business interruption	We have a number of contracts to treat industrial waste streams at our Bran Sands works. The liability under each contract is capped except, in certain cases, where NWL is in wilful breach. A site-specific management regime is in place incorporating additional monitoring and a greater amount of standby assets.
Risk of increasing pension contributions resulting from increasing longevity and the impact of economic conditions on investment returns	The defined benefit scheme was closed to new entrants, benefits restructured and employee contributions increased in 2008. Advance contributions have been made to the scheme, including deficit funding allowed in the final determination. The scheme Trustee determines investment policy and monitors performance of investment managers. Triennial actuarial valuations of the scheme are carried out, with the latest currently underway.
Health and safety prosecution	Our health and safety policy and safety management system define clear arrangements and responsibilities for implementation and management throughout the company. This is audited as part of our quality and environmental management system. Visible high level support for health and safety is provided by the Board and management team. Long term plans and targets are set to promote continuous improvement.

## **DIRECTORS' REPORT and OFR (continued)**

### **Risks arising from the Company's financial instruments**

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

#### **Liquidity risk**

The Company is responsible for cash management. The Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0m and with a bank agreement availability period of no less than 3 months. At 31 March 2011, NWL had £35.0m (2010: £75.0m). A further £70.0m of committed bank facilities were entered into on 7 April 2011.

#### **Interest rate risk**

The Company finances its operations through a mixture of retained profits and borrowings. It borrows at both fixed and floating rates of interest and, as noted above, on occasion uses derivatives to generate the desired interest profile and to manage its exposure to interest rate fluctuations. The Company's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2011, 70% (2010: 71%) of the borrowings of the Company were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

#### **Foreign currency risk**

The Group's policy is that any foreign currency exposure in excess of £100,000 sterling equivalent of a transactional nature, or £3m sterling equivalent of a translation nature, should be covered immediately on recognition. At 31 March 2011, the Company had no currency exposures (2010: nil).

#### **Market price risk**

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

## **OUR 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. Our stakeholders also expect us to:

1. behave fairly and responsibly;
2. use resources wisely;
3. improve quality of life; and
4. contribute to economic development.

We believe that sustainability helps to improve the performance of the company and to achieve our business strategy and objectives. This is reflected in our business plan where our sustainability objectives are woven into our core business strategy. Our credentials for our work have been recognised and these are outlined on page 21. Our customer research also highlights that customers value the work of the company in the community and for the environment and it helps to build their trust in our work. Each aspect of the highlighted work in this report has a direct benefit to the Company, its community and its environment, such as cost saving, carbon reduction, environmental impact, skills development or leverage.

## DIRECTORS' REPORT and OFR (continued)

### OUR CORPORATE RESPONSIBILITY (continued)

To ensure that sustainability runs throughout the business, we ensure that all parts of the Company are involved from the Board through to all employees. Governance of our sustainability activity is led by our Corporate Responsibility Committee (CRC), a subcommittee of the NWL board. The CRC comprises non-executive directors, executive directors, the CEO (who is directly accountable to the NWL and NWG boards for both the environment and sustainable development policies) and senior managers from across the business. In addition, a CR Advisory Group (CRAG) acts as a critical friend, helping to validate, guide and challenge NWL's sustainability strategy and activities. The CRAG is made up of senior representatives from partner organisations to reflect the key areas of our communities' strategy.

### OTHER DISCLOSURES

#### Political

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

We do not support any political party and we do not, directly or through any subsidiary, make what are commonly regarded as donations to any political party or other political organisation. However, the wide definition of donations in the Political Parties, Elections and Referendums Act 2000 covers activities which form part of the necessary relationship between the Group and political parties and political organisations. These activities include attending party conferences, as these provide the best opportunity to meet a range of stakeholders, both national and local, to explain our activities, as well as local meetings with MPs, MEPs and their agents. The costs associated with these activities during 2010/11 were as follows:

Name of political party	£
Conservative	3,422
Labour	4,104
Liberal Democrats	1,656
<b>Total</b>	<b>9,182</b>

NWG shareholder authority to permit the Company to continue with these activities until the 2012 AGM will be sought at this year's AGM.

#### Company payment policy

The Company's policy is to agree payment terms with suppliers and to pay on time according to those agreed terms. The Company's policy is to make payment not more than 30 days after receipt of a valid invoice, except as otherwise agreed. The ratio, expressed in days, between the amount invoiced by its suppliers during the year and the amount owed to its trade creditors at 31 March 2011, was 21 days (2010: 16 days).

#### Fixed assets

Freehold land and buildings are carried in the financial statements at historical cost with a net book value of £82.9m (2010: £79.1m). In the opinion of the directors, at 31 March 2011, there is no significant difference between the net book value and market value of property capable of disposal within the foreseeable future. Note 10 gives more details of the fixed asset movements during the year.

## **DIRECTORS' REPORT and OFR (continued)**

### **Pensions**

The Group operates both a defined benefit pension scheme, of which the Company is the principal member, which is closed to new, and an occupational defined contribution.

The deficit (under FRS 17) of the defined benefit scheme has decreased from £133.1m, at 31 March 2010, to £46.0m at 31 March 2011. This is due to a reduction in the liabilities of the scheme (£37.2m) and an increase in the value of scheme assets (£49.9m). The valuation of the scheme liabilities has taken account of legislative changes which mean that future statutory deferred revaluations and statutory pension increases will be linked to the Consumer Price Index (CPI). As a consequence, CPI increases have been applied for deferred pensions in all sections of the scheme and to those sections where the scheme rules link increases to the Government's pension increase orders. This has given rise to a reduction in the scheme liabilities of around £36.0m.

Following the 2004 actuarial valuation, the Group prepaid contributions for the period to 31 December 2010. In place of recommencing regular contributions from 1 January 2011, the Group agreed to pay further advance contributions to the scheme totalling £70.0m for the period to 31 March 2015. Amounts totalling £22.9m were paid in the period to 31 March 2011 and a further £47.1m was paid in April 2011. These payments comprise employers' contributions and the deficit recovery funding assumed in the final determination.

A full actuarial valuation of the scheme as at 31 December 2010 is underway.

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

### **Directors' remuneration**

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

### **Indemnification of directors**

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

### **Directors' declaration**

As required under section 418 of the Companies Act 2006, so far as each current director is aware, there is no relevant audit information of which the Company's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

### **Auditors**

Pursuant to s487 of the Companies Act 2006, the auditors are deemed to be re-appointed for the ensuing year.

## **DIRECTORS' REPORT and OFR (continued)**

### **Financial statements preparation and going concern**

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

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

- the acceptance of the 2009 Final Determination by the Board;
- the financial strength of the Company at the balance sheet date and performance during 2010/11;
- the strength of the key financial ratios over the planning horizon of the Company's one year budget and medium term plan to 2015 as reflected in strong investment grade credit ratings;
- the fact that the Company already has funding and facilities in place to meet all operational and capital investment requirements to March 2014;
- its contractual arrangements with suppliers for key materials and support services and its capital framework arrangements;
- its robust People Plan for 2010-15 which underpins the employment resources to fulfil all operational requirements; and,
- the Company's formal risk and governance arrangements which are monitored by the Audit Committee and Board.

### **Statement of Directors' responsibilities**

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

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

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

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

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

By order of the Board

**Martin Parker**  
Company Secretary  
13 July 2011

## APPENDIX TO THE DIRECTORS' REPORT and OFR

### DEFINITION OF KEY PERFORMANCE INDICATORS

#### Financial KPIs

##### Gearing to RCV

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

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

**Source of underlying data:** The RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Net debt is calculated from the balance sheet in the audited financial statements.

##### Regulatory gearing

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

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

**Source of underlying data:** The RCV is calculated by Ofwat and published each year. Ofwat also publishes anticipated values up to five years ahead, based on its last price determination. Net debt is disclosed in the audited regulatory accounts.

##### Cash interest cover

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

**Purpose:** Measures the ability of the Company to service its debt.

**Source of underlying data:** Audited financial statements.

##### Cash flow to net debt

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

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

**Source of underlying data:** Audited financial statements.

#### Non-financial KPIs

##### Customer satisfaction

**Definition and calculation:** Domestic customers' satisfaction with overall service and overall value for money, expressed as satisfaction averaged over the surveys carried out during the year. Average satisfaction is based on a scale of 1 to 10 using the score of 6 and above as satisfied. Net scores are used to show true satisfaction by taking into consideration those who are dissatisfied who score between 1 and 3.

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

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

##### Customer – levels of service

**Definition and calculation:** Customer service standards are established by Ofwat and calculated using source data in the Company.

**Purpose:** To monitor customer service performance of NWL.

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

## APPENDIX TO THE DIRECTORS' REPORT and OFR (continued)

### DEFINITION OF KEY PERFORMANCE INDICATORS (continued)

#### 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.

#### 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.

#### Water quality

**Definition and calculation:** Compliance with drinking water regulations as monitored by the DWI.

**Purpose:** To monitor drinking water quality.

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

#### Sewage treatment works

**Definition and calculation:** Percentage of population equivalent served by non-compliant works failing look-up table consents, as defined by the EA.

**Purpose:** To monitor the performance of NWL's sewage treatment works and their impact on the environment.

**Source of underlying data:** Information recorded by NWL and the EA and reported on by the latter.

#### Bathing waters Mandatory Standard

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

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

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

#### Pollution incidents

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

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

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

## SECTION A – STATUTORY FINANCIAL STATEMENTS

**PROFIT AND LOSS ACCOUNT**  
**for the year ended 31 March 2011**

	Note	<u>2011</u> £'m	<u>2010</u> £'m
Turnover	2	682.8	651.5
Operating costs	3(a)	(280.5)	(283.6)
Capital maintenance costs	3(b)	<u>(120.7)</u>	<u>(112.5)</u>
Total operating costs		<u>(401.2)</u>	<u>(396.1)</u>
<b>OPERATING PROFIT</b>		281.6	255.4
Net interest payable	4	<u>(102.0)</u>	<u>(76.8)</u>
<b>PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION</b>		179.6	178.6
Taxation	8(a)	(26.9)	(35.6)
<b>PROFIT FOR THE FINANCIAL YEAR</b>	24	<u><u>152.7</u></u>	<u><u>143.0</u></u>

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**  
**for the year ended 31 March 2011**

	Note	<u>2011</u> £'m	<u>2010</u> £'m
Profit for the financial year		152.7	143.0
Pension liability actuarial gain in the year	26	74.4	1.1
Deferred tax related to pension adjustments	26	<u>(22.1)</u>	<u>(0.3)</u>
Total recognised gains and losses relating to the year		<u><u>205.0</u></u>	<u><u>143.8</u></u>

**BALANCE SHEET**  
**at 31 March 2011**

	Note	<u>2011</u> £'m	<u>2010</u> £'m
<b>FIXED ASSETS</b>			
Tangible assets	10	3,466.5	3,377.9
Investments	11	<u>160.9</u>	<u>160.9</u>
		<u>3,627.4</u>	<u>3,538.8</u>
<b>CURRENT ASSETS</b>			
Stocks	12	2.8	2.8
Debtors due in less than one year	13	138.4	123.0
Debtors due in more than one year	14	3.1	3.2
Investments	15	116.9	88.2
Cash at bank and in hand		<u>6.3</u>	<u>1.2</u>
		267.5	218.4
<b>CREDITORS</b>			
Amounts falling due within one year	16	<u>(181.4)</u>	<u>(173.0)</u>
<b>NET CURRENT ASSETS</b>			
		<u>86.1</u>	<u>45.4</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>			
		<u>3,713.5</u>	<u>3,584.2</u>
CREDITORS: Amounts falling due after more than one year	17	(1,899.1)	(1,901.0)
PROVISIONS FOR LIABILITIES AND CHARGES	21	(207.4)	(219.0)
ACCRUALS AND DEFERRED INCOME	22	<u>(386.1)</u>	<u>(386.7)</u>
		(2,492.6)	(2,506.7)
<b>NET ASSETS EXCLUDING PENSION LIABILITY</b>			
		<u>1,220.9</u>	<u>1,077.5</u>
Pension Liability	26	(34.0)	(95.6)
<b>NET ASSETS INCLUDING PENSION LIABILITY</b>			
		<u>1,186.9</u>	<u>981.9</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	23	122.7	122.7
Profit and loss account	24	<u>1,064.2</u>	<u>859.2</u>
<b>EQUITY SHAREHOLDERS' FUNDS</b>	24	<u>1,186.9</u>	<u>981.9</u>

Approved by the Board and signed on their behalf by:

C M Green

A C Jones

13 July 2011

**NOTES TO THE STATUTORY FINANCIAL STATEMENTS  
for the year ended 31 March 2011**

**1. STATEMENT OF ACCOUNTING POLICIES**

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

**(a) Basis of accounting**

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

**(b) Turnover**

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

**(c) Cash flow statement**

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

**(d) Tangible fixed assets and depreciation**

Tangible fixed assets comprise:

**(i) Infrastructure assets**

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

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

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

**(ii) Non-infrastructure assets**

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

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

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

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

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

**(iii) Assets in the course of construction**

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

**(e) Grants and contributions**

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

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

**(f) Hire purchase and leasing**

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

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

**(g) Stocks**

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

**(h) Pension costs**

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

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

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

## 1. STATEMENT OF ACCOUNTING POLICIES (continued)

### (i) Taxation

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

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

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

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

### (j) Foreign currency

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

### (k) Research and development

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

### (l) Fixed Asset Investments

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

### (m) Derivative financial instruments

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

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

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

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

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

### (n) Liquid resources

Liquid resources comprise external deposits and cash.

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

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

**(p) Share based payments**

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

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

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

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

**2. TURNOVER, PROFIT BEFORE TAX AND NET ASSETS**

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

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

	2011	2010
	£'m	£'m
Materials and consumables	19.8	19.3
Other external charges	75.0	78.6
Net manpower costs (note 7)	102.5	102.9
Other operating charges	111.9	110.4
Own work capitalised	(28.7)	(27.6)
	280.5	283.6

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

	2011	2010
	£'m	£'m
Depreciation:		
Non-infrastructure assets	78.9	73.9
Infrastructure assets	42.8	38.8
Assets held under finance leases	4.6	4.3
Amortisation of capital grants and contributions	(4.6)	(4.3)
Profit on disposal of fixed assets	(1.0)	(0.2)
	<u>120.7</u>	<u>112.5</u>

**(c) Profit on ordinary activities before taxation:**

	2011	2010
	£'m	£'m
Profit on ordinary activities before taxation is stated after charging:		
Operating leases:		
Plant and machinery	0.1	0.2
Other assets	1.1	1.0
Costs of research and development	2.3	2.1
Directors' emoluments (note 5)	1.3	1.2
	<u>1.3</u>	<u>1.2</u>

Auditors' remuneration in respect of the statutory audit amounted to £114,935 (2010: £106,900). Auditors' remuneration for the regulatory audit amounted to £18,424 (2010: £17,916). Fees of £12,693 and £13,735 (2010: £14,773 and £15,787) were also incurred in the auditing of RAG 5 information and the June Return respectively. The remuneration to auditors for non-audit services is disclosed on a consolidated basis in the group financial statements of the ultimate parent company.

**4. NET INTEREST PAYABLE**

	2011	2010
	£'m	£'m
Net interest payable comprises:		
Interest payable:		
Bank loans and overdrafts	17.0	18.3
Group loans	92.7	63.8
Financing charges payable under finance leases	5.1	4.0
Total interest payable	<u>114.8</u>	<u>86.1</u>
Interest receivable:		
Group interest	(10.5)	(13.7)
External interest	(0.1)	(0.1)
Total interest receivable	<u>(10.6)</u>	<u>(13.8)</u>
Other finance (income) / charges relating to pension scheme (note 26)	(2.2)	4.5
Net interest payable	<u>102.0</u>	<u>76.8</u>

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

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

	<u>2011</u>	<u>2010</u>
	£'000	£'000
Emoluments (including benefits in kind)	<u>1,370.7</u>	<u>1,172.6</u>

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

Three of the directors at 31 March 2011 were members of a defined benefit pension scheme where the Company makes contributions towards the cost (2010: 4).

One of the directors at 31 March 2011 was a member of a defined contribution scheme where the Company makes contributions towards the cost (2010: 1).

The directors who held office as at 31 March 2011 held the following conditional interests in the ordinary 10p shares of the Group, awarded in accordance with the terms of its Long Term Incentive Plan (LTIP):

Name of Director	Award date	Awards held at the start of the year	Awards during the year	Awards lapsed during the year	Awards vested during the year	Awards held as at 31 March 2011
H Mottram	8.12.2010 <sup>5</sup>	-	96,212	-	-	96,212
Totals		-	96,212	-	-	96,212
C M Green	13.12.07 <sup>1</sup>	61,620	-	31,525	30,095 <sup>2</sup>	-
	15.12.08 <sup>3</sup>	78,650	-	-	-	78,650
	4.1.10 <sup>4</sup>	83,240	-	-	-	83,240
	8.12.2010 <sup>5</sup>	-	68,551	-	-	68,551
Totals		223,510	68,551	31,525	30,095	230,441
A C Jones	13.12.07 <sup>1</sup>	22,450	-	11,486	10,964 <sup>2</sup>	-
	15.12.08 <sup>3</sup>	28,850	-	-	-	28,850
	4.1.10 <sup>4</sup>	34,429	-	-	-	34,429
	8.12.10 <sup>5</sup>	-	25,887	-	-	25,887
Totals		85,729	25,887	11,486	10,964	89,166
G Neave	13.12.07 <sup>1</sup>	27,470	-	14,054	13,416 <sup>2</sup>	-
	15.12.08 <sup>3</sup>	34,800	-	-	-	34,800
	4.1.10 <sup>4</sup>	41,606	-	-	-	41,606
	8.12.10 <sup>5</sup>	-	31,209	-	-	31,209
Totals		103,876	31,209	14,054	13,416	107,615

**5. DIRECTORS' EMOLUMENTS (continued)****Notes:**

1. The market value of the shares on the date of the award was 334.00 pence per share. The three year performance period ran from 1 October 2007 to 30 September 2010.
2. Shares vested on 13 December 2010 and the closing price on that date was 332.00 pence per share.
3. The market value of the shares on the date of the award was 251.50 pence per share. The three year performance period runs from 1 October 2008 to 30 September 2011.
4. The market value of the shares on the date of the award was 272.50 pence per share. The three year performance period runs from 1 October 2009 to 30 September 2012.
5. The market value of the shares on the date of the award was 328.70 pence per share. The three year performance period runs from 1 October 2010 to 30 September 2013.
6. The cost of conditional awards is charged to the profit and loss account over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.1m was charged to the profit and loss account (2010: £0.6m).
7. Details of the performance conditions are shown in Note 11 (iv) of the Regulatory Accounts.
8. The market price of the shares on 31 March 2011 was 332.20 pence per share. During the year, the highest market price was 364.00 pence per share and the lowest market price was 245.10 pence per share.
9. Aggregate gross gains made by directors on exercise of awards at date of vesting was £180,966 (2010: £156,111).
10. Some or all of the shares will vest only if specified performance targets are achieved during the three year performance period. For further information, please refer to the Directors' Remuneration Report in the NWG accounts and to Note 11 to the Regulatory Accounts.

The directors who held office as at 31 March 2011 held the following interests in the ordinary 10p shares of the Group, purchased and held in accordance with the terms of the Share Incentive Plan:

Name of Director	Number of SIP shares held as at 1 April 2010	Number of SIP shares held as at 31 March 2011
H Mottram	-	606
C M Green	5,653	6,372
A C Jones	5,653	6,372
G Neave	590	590

**(b) Highest paid director**

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

	2011	2010
	£'000	£'000
Emoluments (including benefits in kind)	399.4	300.0

In 2009/10, the highest paid director was a member of the defined benefit scheme and had an accrued pension entitlement of £172,000.

In 2010/11, the highest paid director was a member of the defined contribution scheme and the payments made to that scheme (£30.5k) are included within the emoluments figure above.

**6. TRANSACTIONS WITH DIRECTORS AND OFFICERS**

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

## SECTION A – STATUTORY FINANCIAL STATEMENTS

**7. EMPLOYEE INFORMATION**

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

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Gross costs charged to the profit and loss account:		
Wages and salaries	62.9	64.5
Social security costs	5.2	5.3
Other pensions costs	<u>11.5</u>	<u>11.9</u>
	<u>79.6</u>	<u>81.7</u>
Costs recharged to other group companies:		
Wages and salaries	2.0	2.0
Social security costs	0.2	0.2
Other pensions costs	<u>0.3</u>	<u>0.4</u>
	<u>2.5</u>	<u>2.6</u>
Net costs charged to the profit and loss account:		
Wages and salaries	60.9	62.5
Social security costs	5.0	5.1
Other pensions costs	<u>11.2</u>	<u>11.5</u>
	<u>77.1</u>	<u>79.1</u>
Costs charged to capital schemes and infrastructure renewals:		
Wages and salaries	20.2	18.7
Social security costs	1.7	1.6
Other pensions costs	<u>3.5</u>	<u>3.5</u>
	<u>25.4</u>	<u>23.8</u>
Total net employee costs	<u><u>102.5</u></u>	<u><u>102.9</u></u>

The average monthly number of employees on the payroll during the financial year was 2,875 (2010: 2,930) and the total at the year end was 2,866 (2010: 2,894).

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

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Current tax:		
UK corporation tax on profits for the year at 28% (2010: 28%)	41.5	38.9
Adjustments in respect of prior years	(9.4)	(1.3)
Payable in respect of group relief for the current year at 28% (2010: 28%)	3.6	5.0
Adjustments in respect of prior years	<u>(0.1)</u>	<u>0.2</u>
Total current tax charge (note 8b)	<u>35.6</u>	<u>42.8</u>
Deferred tax:		
Reduction due to opening tax rate change	(31.8)	-
Decrease in discount arising from above rate change	<u>13.1</u>	<u>-</u>
Net reduction in opening deferred tax	<u>(18.7)</u>	<u>-</u>
Movement in the year at 26% (2010: 28%):		
Origination and reversal of timing differences in the year	6.2	6.0
Adjustments in respect of prior periods	<u>6.9</u>	<u>0.3</u>
	13.1	6.3
Increase in discount arising from current year movements	<u>(3.1)</u>	<u>(13.5)</u>
Movement in the year (note 21)	<u>10.0</u>	<u>(7.2)</u>
Total deferred tax credit (note 21)	<u>(8.7)</u>	<u>(7.2)</u>
Tax on profit on ordinary activities	<u>26.9</u>	<u>35.6</u>

The rate of UK corporation tax was reduced from 28% to 27% by the Finance (No. 2) Act 2010 with effect from 1 April 2011. The rate was further reduced to 26% with effect from the same date, on the passing of a resolution under the Provisional Collection of Taxes Act 1968 on 29 March 2011 at which point the new rate was substantively enacted. As a result, deferred tax was restated as at 1 April 2010 at the rate at which timing differences are expected to reverse.

Tax losses have provisionally been claimed from other group companies in the current year of £9.8m (2010: £13.6m) for which payment will be made at the rate of 28% (2010: 28%). Further payments are due to group companies of £0.9 m (2010: £1.2m) in respect of UK:UK transfer pricing adjustments.

Discount has fallen mainly due to the impact of the opening reduction in the corporation tax rate.

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

	2011	2010
	£'m	£'m
Profit on ordinary activities before tax	179.6	178.6
Profit on ordinary activities multiplied by standard rate of corporation tax of 28% (2010: 28%)	50.3	50.0
Effects at 28% (2010: 28%) of:		
Expenses not deductible for tax purposes	0.1	0.2
Non-taxable income	(2.1)	(2.0)
Depreciation in respect of non-qualifying items	5.2	5.1
Industrial buildings allowances claimed in the year	(1.7)	(3.4)
Accelerated tax depreciation	(8.5)	(11.5)
Pension deficit	(3.5)	4.0
Other timing differences	5.3	1.5
Adjustments in respect of prior periods	(9.5)	(1.1)
Transfer pricing adjustments	(0.9)	(1.2)
Balancing payment payable	0.9	1.2
Total current tax charge (note 8a)	<u>35.6</u>	<u>42.8</u>

**(c) Factors that may affect future tax charges:**

The government has stated its intention to reduce the UK rate of corporation tax by a further 1% per annum until it reaches 23% on 1 April 2014. Had that rate applied in 2010/11 the closing deferred tax liability would have been reduced by £25.8m to £167.0m and the current year's corporation tax charge would have been reduced by £8.1m to £37.0m.

The Company expects to continue to incur high levels of capital expenditure during the 2010-15 regulatory review period which, under current tax legislation, should result in claims for tax reliefs in excess of depreciation. However, it is expected that capital allowances will be claimed at a slower rate in future because Finance (No. 3) Bill 2011 contains clauses to reduce rates from 20% to 18% (general plant pool) and from 10% to 8% (special rate pool) with effect from 1 April 2012.

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

**9. DIVIDENDS**

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Equity:		
Dividends paid:		
Final paid for the year ended 31 March 2010 of nil (year ended 31 March 2009: 34.64p) per share on an aggregated basis	-	42.5
Interim paid of nil (2010: 35.43p) per share on an aggregated basis	<u>-</u>	<u>43.4</u>
Total dividends paid in the year	<u>-</u>	<u>85.9</u>
Dividends proposed:		
Interim proposed for the year ended 31 March 2011 of 37.75p (proposed and paid in year ended 31 March 2010: 35.43p) per share on an aggregated basis	46.3	43.4
Final proposed for the year ended 31 March 2011 of 38.05p (year ended 31 March 2010: 35.75p) per share on an aggregated basis	<u>46.7</u>	<u>43.8</u>
	<u>93.0</u>	<u>87.2</u>

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

The Company has applied a dividend policy of steady real growth of 2.1% per annum for the appointed business dividend. Dividends from the non-appointed business are determined by the directors and are based on performance.

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

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

**10. TANGIBLE FIXED ASSETS**

	Freehold land and buildings	Infrastructure assets	Operational structures, plant and machinery	Fixtures, fittings, tools and equipment	Assets in the course of construction	Total
	£'m	£'m	£'m	£'m	£'m	£'m
Cost:						
At 1 April 2010	114.9	1,984.2	2,171.1	170.2	117.1	4,557.5
Additions	-	-	-	-	215.2	215.2
Schemes commissioned	3.7	87.7	73.7	13.1	(178.2)	-
Reclassifications	2.8	-	(2.5)	(0.3)	-	-
Disposals	(0.5)	(6.7)	(2.3)	-	-	(9.5)
At 31 March 2011	<u>120.9</u>	<u>2,065.2</u>	<u>2,240.0</u>	<u>183.0</u>	<u>154.1</u>	<u>4,763.2</u>
Depreciation:						
At 1 April 2010	35.8	330.5	691.7	121.6	-	1,179.6
Charge for the year	2.2	43.3	70.5	10.3	-	126.3
Reclassifications	-	-	(0.3)	0.3	-	-
Disposals	-	(6.7)	(2.5)	-	-	(9.2)
At 31 March 2011	<u>38.0</u>	<u>367.1</u>	<u>759.4</u>	<u>132.2</u>	<u>-</u>	<u>1,296.7</u>
Net book value:						
At 31 March 2011	<u>82.9</u>	<u>1,698.1</u>	<u>1,480.6</u>	<u>50.8</u>	<u>154.1</u>	<u>3,466.5</u>
At 31 March 2010	<u>79.1</u>	<u>1,653.7</u>	<u>1,479.4</u>	<u>48.6</u>	<u>117.1</u>	<u>3,377.9</u>
Leased assets included above:						
Net book value:						
At 31 March 2011	<u>-</u>	<u>47.3</u>	<u>22.0</u>	<u>-</u>	<u>-</u>	<u>69.3</u>
At 31 March 2010	<u>-</u>	<u>47.8</u>	<u>23.6</u>	<u>-</u>	<u>-</u>	<u>71.4</u>

**11. FIXED ASSET INVESTMENTS**

	Loans to Group Companies £'m
At 1 April 2010	160.9
Capitalised	<u>-</u>
At 31 March 2011	<u><u>160.9</u></u>

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

In May 2004 NWL made a loan of £1.5m to Bakethin Holdings Limited, a quasi subsidiary company, maturing in January 2034. The interest on the loan is capitalised and at 31 March 2011 the balance was £1.9m (2010: £1.9m).

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

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

**12. STOCKS**

	<u>2011</u> £'m	<u>2010</u> £'m
Raw materials and consumables	<u>2.8</u>	<u>2.8</u>

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

**13. DEBTORS DUE IN LESS THAN ONE YEAR**

	<u>2011</u> £'m	<u>2010</u> £'m
Trade debtors	71.5	65.4
Amounts owed by other group companies	4.2	4.2
Other debtors	8.0	4.9
Prepayments and accrued income	<u>54.7</u>	<u>48.5</u>
	<u><u>138.4</u></u>	<u><u>123.0</u></u>

Trade debtors are shown net of bills raised in advance.

**14. DEBTORS DUE IN MORE THAN ONE YEAR**

	<u>2011</u> £'m	<u>2010</u> £'m
Interest rate hedge	<u>3.1</u>	<u>3.2</u>

SECTION A – STATUTORY FINANCIAL STATEMENTS

**15. INVESTMENTS**

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Short term deposits with NSL	<u>116.9</u>	<u>88.2</u>

**16. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR**

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Obligations under finance leases (note 19)	7.2	7.0
Loans (note 18)	23.1	17.7
Trade creditors	11.8	6.0
Amounts owed to other group companies	9.9	12.1
Taxation and social security	2.3	2.2
Corporation tax	2.1	7.9
Other creditors	11.6	12.4
Receipts in advance	19.1	16.5
Accruals and deferred income	<u>94.3</u>	<u>91.2</u>
	<u>181.4</u>	<u>173.0</u>

Accruals and deferred income includes accruals related to capital projects of £35.1m (2010: £31.8m).

Included in amounts owed to other group companies is £8.2m (2010: £10.4m) payable in respect of tax losses surrendered from fellow group companies.

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

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Obligations under finance leases (note 19)	103.5	104.1
Loans (note 18)	321.7	344.7
Amounts owed to other group companies (note 20)	1,473.7	1,451.7
Other creditors	<u>0.2</u>	<u>0.5</u>
	<u>1,899.1</u>	<u>1,901.0</u>

SECTION A – STATUTORY FINANCIAL STATEMENTS

**18. LOANS**

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Loans are repayable as follows:		
Within one year (note 16)	23.1	17.7
Between one and two years	73.9	23.0
Between two and five years	86.7	131.5
After five years	<u>161.1</u>	<u>190.2</u>
	<u><u>344.8</u></u>	<u><u>362.4</u></u>

Loans wholly repayable within 5 years amount to £50.2m (2010: £58.0m).

Loans not wholly repayable within 5 years amount to £294.6m (2010: £304.4m) and bear interest rates in the range 1.18% to 7.27%.

**19. OBLIGATIONS UNDER FINANCE LEASES**

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

Obligations under finance leases are as follows:

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Amounts due:		
Within one year	7.2	7.0
Between one and two years	6.5	6.7
Between two and five years	17.0	16.8
After five years	<u>151.6</u>	<u>154.6</u>
	182.3	185.1
Less:		
Finance charge allocated to future periods	<u>(71.6)</u>	<u>(74.0)</u>
	<u><u>110.7</u></u>	<u><u>111.1</u></u>
Disclosed as due:		
Within one year (note 16)	7.2	7.0
After more than one year (note 17)	<u>103.5</u>	<u>104.1</u>
	<u><u>110.7</u></u>	<u><u>111.1</u></u>

The aggregate gross amount of obligations under hire purchase contracts and finance leases, any part of which falls due for repayment in five years or more, is £182.3m (2010: £185.1m).

**20. AMOUNTS DUE TO OTHER GROUP COMPANIES**

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

	2011	2010
	£'m	£'m
After five years	<u>1,473.7</u>	<u>1,451.7</u>

NWF issued £200.0m and £150.0m Guaranteed Eurobonds in February 1998 and September 2001 respectively, maturing February 2023, with an annual coupon of 6.875%. The issues were guaranteed by the Company who received the issue proceeds by way of inter-company loans of £194.2m and £163.2m respectively. Finance costs allocated during the year amounted to £0.2m (2010: £0.2m). Amortisation of loan issue receipts during the year amounted to £0.3m (2010: £0.3m).

NWF issued £300.0m Guaranteed Eurobonds in December 2001, maturing October 2017, with an annual coupon of 6.0%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £301.0m. Amortisation of loan receipts during the year amounted to £0.1m (2010: £0.1m).

NWF issued £250.0m and £100.0m Guaranteed Eurobonds in December 2002 and December 2004, maturing April 2033 with an annual coupon of 5.625%. Both issues were guaranteed by the Company who received the issue proceeds by way of inter-company loans of £246.6m and £100.8m respectively. Finance costs allocated during the year amounted to £0.2m (2010: £0.2m).

NWF issued £150.0m Guaranteed Index Linked Eurobonds in September 2005, maturing July 2036, with a real coupon of 2.033%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £150.0m. Indexation accretion / (amortisation) during the year amounted to £8.1m (2010: £(2.5)m).

NWF issued £60.0m Guaranteed Index Linked Eurobonds in January 2006, maturing January 2041, with a real coupon of 1.6274%. The issue was guaranteed by the Company who received the issue proceeds by way of an inter-company loan of £60.0m. Indexation accretion / (amortisation) during the year amounted to £3.2m (2010: £(1.0)m).

NWF issued two £100.0m Guaranteed Index Linked Eurobonds in June 2006 with real coupons of 1.7118% and 1.7484% and with maturities of 2049 and 2053 respectively. Both issues were guaranteed by the Company who received the issue proceeds by way of two inter-company loans of £100.0m. Indexation accretion / (amortisation) during the year amounted to £10.6m (2010: £(3.2)m).

**21. PROVISIONS FOR LIABILITIES AND CHARGES**

	£'m
Pension provision for former employees:	
At 1 April 2010	2.4
Utilised during the year	<u>0.2</u>
At 31 March 2011	<u>2.6</u>
Deferred tax:	
At 1 April 2010	216.6
Total movement in the year (note 8a)	(8.7)
Included above relating to pensions (note 26)	<u>(3.1)</u>
At 31 March 2011	<u>204.8</u>
Provisions for liabilities and charges	<u><u>207.4</u></u>

**21. PROVISIONS FOR LIABILITIES AND CHARGES (continued)**

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

The provision for deferred tax comprises:

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Accelerated depreciation	474.7	507.2
Other timing differences	<u>(51.9)</u>	<u>(62.6)</u>
Undiscounted provision for deferred tax	422.8	444.6
Discount	<u>(218.0)</u>	<u>(228.0)</u>
Discounted provision for deferred tax	<u><u>204.8</u></u>	<u><u>216.6</u></u>

**22. ACCRUALS AND DEFERRED INCOME**

	<u>Gilt lock</u>	<u>Capital grants and contributions</u>	<u>Proceeds from Kielder securitisation</u>	<u>Total</u>
	£'m	£'m	£'m	£'m
At 1 April 2010	0.5	216.0	170.2	386.7
Additions	-	11.1	-	11.1
Amortised / transferred during the year	<u>-</u>	<u>(4.7)</u>	<u>(7.0)</u>	<u>(11.7)</u>
At 31 March 2011	<u><u>0.5</u></u>	<u><u>222.4</u></u>	<u><u>163.2</u></u>	<u><u>386.1</u></u>

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

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

**23. CALLED UP SHARE CAPITAL**

	<u>2011</u>	<u>2010</u>
	£'m	£'m
Authorised:		
122,650,000 Ordinary Shares of £1 each (2010: 122,650,000)	<u>122.7</u>	<u>122.7</u>
	<u>2011</u>	<u>2010</u>
	£'m	£'m
Allotted, called-up and fully paid:		
122,650,000 Ordinary Shares of £1 each (2010: 122,650,000)	<u>122.7</u>	<u>122.7</u>

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

	Profit and loss account	Total shareholders' funds
	£'m	£'m
At 31 March 2010	859.2	981.9
Profit for the year	152.7	152.7
Actuarial gain on pension liability in the year (note 26)	74.4	74.4
Deferred tax related to actuarial gain on pension liability in the year (note 26)	(22.1)	(22.1)
At 31 March 2011	<u>1,064.2</u>	<u>1,186.9</u>

## 25. COMMITMENTS

### (a) Capital expenditure:

	2011	2010
	£'m	£'m
Expenditure contracted for but not provided for	<u>222.3</u>	<u>85.3</u>

### (b) Lease commitments:

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

	2011	2010
	£'m	£'m
Land and buildings:		
Leases which expire:		
After one year but not more than five	0.1	0.1
In five years or more	0.5	0.5
	<u>0.6</u>	<u>0.6</u>
Other:		
Leases which expire:		
Between two and five years	0.1	0.1

**26. PENSIONS**

NWL participates in the Group defined benefit pension scheme, Northumbrian Water Pension Scheme (NWPS or the scheme), providing benefits based on final pensionable remuneration to 1,908 active members at 31 March 2011 (2010: 2,033).

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

The most recent actuarial valuation of the NWPS was at 31 December 2007. At that date the value of assets amounted to £732.3m and the funding level was 106.1%.

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

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

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

Following the 2004 actuarial valuation, the employers had prepaid contributions to the scheme up to 31 December 2010. The scheme actuary recommended that regular contributions should recommence from 1 January 2011. However, the Group made an alternative proposal, which was accepted by the NWPS Trustees, to make new capital injections of £70.0m to cover the period 1 January 2011 to 31 March 2015. These payments comprise employers' contributions and the deficit recovery funding assumed in the final determination. Amounts totalling £22.9m have been paid in the period, of which £0.5m was paid by a jointly controlled entity. The remaining £47.1m was paid in April 2011 which, along with other payments of an estimated £1.9m relating to early retirements, will bring total contributions to the scheme next year to £49.0m. A full actuarial valuation of the scheme as at 31 December 2010 has commenced.

The scheme also has a defined contribution section which had 460 active members at 31 March 2011 (2010: 389). 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 by the Company in the year totalled £0.8m (2010: £0.6m).

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

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

A qualified actuary, using revised assumptions that are consistent with the requirements of FRS 17, has updated the actuarial valuation described above as at 31 March 2011. Investments have been valued, for this purpose, at fair value.

The valuation of the scheme liabilities has taken account of legislative changes which mean that future statutory deferred revaluations and pension increases will be linked to the Consumer Price Index (CPI). As a consequence, CPI increases have been applied for deferred pensions in all sections of the scheme and to those sections where the scheme rules link increases to the Government's pension increase orders. This has given rise to a reduction in the actuarial valuation of the liabilities of around £36.0m.

**26. PENSIONS (continued)**

FRS 17 actuarial assumptions:	2011	2010
Pay increases <sup>1</sup>	4.5%	4.7%
Retail price index inflation	3.5%	3.7%
Consumer price index inflation	2.8%	n/a
Pension increases linked to RPI	3.5%	3.7%
Pension increases linked to CPI	2.8%	n/a
Discount rate	5.5%	5.5%
Mortality assumptions <sup>2</sup>	PCMA/PCFA00	PCMA/PCFA00
- Life expectancy for a member aged 65 - female (years)	23.0	23.0
- Life expectancy for a member aged 65 - male (years)	20.7	20.7

1. including promotional salary scale

2. 115% of PCMA00/PCFA00 (year of birth with medium cohort improvements).

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

	Long term expected rate of return 2011	2011	Long term expected rate of return 2010	2010
	%	£'m	%	£'m
Equities	7.3	511.8	7.5	499.3
Corporate bonds	5.5	62.1	5.5	70.7
Government bonds	4.3	63.9	4.5	27.2
Property	5.8	71.6	6.0	66.6
Cash	3.8	3.9	3.9	14.3
Loan to Scheme from NSL	-	-	0.5	(14.7)
Total fair value of assets		713.3		663.4
Present value of liabilities		(759.3)		(796.5)
Deficit under FRS17		(46.0)		(133.1)
Past service cost owed from group company		-		0.3
Related deferred tax <sup>1</sup>		12.0		37.2
Net pension liability		(34.0)		(95.6)

1. The movement in deferred tax of £25.2m comprises an opening restatement of £2.7m to reflect the 2% cut in the rate of UK corporation tax and £19.4m relating to the actuarial gain in the year (which are both recognised as charges in the statement of total recognised gains and losses) and £3.1m relating to items which are recognised as a charge in the profit and loss account.

SECTION A – STATUTORY FINANCIAL STATEMENTS

**26. PENSIONS (continued)**

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

	2011	2010
	£'m	£'m
Current service cost	13.5	9.9
Past service cost	0.4	4.6
Recognised in operating costs in arriving at operating profit	<u>13.9</u>	<u>14.5</u>
	2011	2010
	£'m	£'m
Interest cost on plan obligations	43.3	36.1
Expected return on plan assets	<u>(45.5)</u>	<u>(31.6)</u>
Recognised in net interest (receivable) / payable (note 4)	<u>(2.2)</u>	<u>4.5</u>

Analysis of the actuarial gain that has been recognised in the statement of total recognised gains and losses:

	2011	2010
	£'m	£'m
Net actuarial gain by NWL	74.4	1.1
Cash paid by other group company	<u>(0.4)</u>	<u>-</u>
Net actuarial gain to the overall scheme	74.0	1.1
Cumulative amounts recognised since adopting the standard	<u>(6.1)</u>	<u>(80.5)</u>

History of experience gains and losses:

	2011	2010	2009	2008	2007
Fair value of assets	713.3	663.4	478.6	666.7	710.8
Present value of defined benefit obligation	<u>(759.3)</u>	<u>(796.5)</u>	<u>(598.0)</u>	<u>(576.3)</u>	<u>(668.1)</u>
(Deficit) / surplus	(46.0)	(133.1)	(119.4)	90.4	42.7
Experience adjustments arising on plan assets	10.7	177.4	(205.3)	(93.4)	0.6
Experience adjustments arising on plan liabilities	<u>-</u>	<u>-</u>	<u>18.7</u>	<u>0.6</u>	<u>1.7</u>

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

	2011	2010
	£'m	£'m
At 1 April	796.5	598.0
Current service cost	13.5	9.9
Past service cost	0.4	4.6
Interest cost	43.3	36.1
Contributions by plan participants	0.1	0.1
Actuarial (losses) / gains on obligations	<u>(63.3)</u>	<u>176.3</u>
Benefits paid	<u>(31.2)</u>	<u>(28.5)</u>
At 31 March	<u>759.3</u>	<u>796.5</u>

**26. PENSIONS (continued)**

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

	2011	2010
	£'m	£'m
At 1 April	663.4	478.6
Expected return on plan assets	45.5	31.6
Actuarial gains / (losses) on plan assets	10.7	177.4
Contributions by employer	24.8	4.2
Contributions by plan participants	0.1	0.1
Benefits paid	(31.2)	(28.5)
At 31 March	<u>713.3</u>	<u>663.4</u>

Sensitivity to key assumptions:

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

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

A reduction in the net discount rate will increase the assessed value of liabilities, as a higher value is placed on benefits paid in the future. A rise in the net discount rate will have an opposite effect of similar magnitude. The overall effect of a change in the net discount rate of 0.1% would change the liabilities by around £14.8m.

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

The disclosures have been prepared using the mortality assumptions adopted for the 2007 formal valuation – namely the PCMA/PCFA00 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 65 at 31 March 2011 of 20.7 years (2010: 20.7 years) for males and 23.0 years (2010: 23.0 years) for females.

The effect of increasing the assumed life expectancies by one year would be to increase the value of liabilities by around 2.8%.

**27. SHARE INCENTIVE PLANS****(a) Long Term Incentive Plan (LTIP)**

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Group. Further details of the LTIP can be found in the directors' remuneration report on pages 39 and 40.

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

	March 2011 Number	March 2010 Number
Outstanding at 1 April	1,242,293	1,190,034
Granted during the year	378,503	414,679
Forfeited/lapsed during the year	(351,299)	(238,686)
Exercised	(148,556)	(123,734)
Outstanding at 31 March	1,120,941	1,242,293
Exercisable at 31 March	4,649	4,724

The weighted average exercise price throughout the year was £nil (2010: £nil). The fair value of conditional share awards granted during the year was £nil (2010: £0.1m).

The weighted average share price at the date of exercise for the conditional share awards is 324.79 pence (2010: 268.71 pence).

For the conditional awards outstanding as at 31 March 2011, the weighted average remaining contractual life is 1.7 years (2010: 1.8 years).

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

	March 2011	March 2010
Dividend yield	4.0%	4.7%
Expected share price volatility	28%	29%
Share price at award	328.70p	272.50p
Expected FTSE 250 index volatility	21%	24%
Risk free interest rate %	1.5%	2.1%
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.

**27. SHARE INCENTIVE PLANS (continued)****(b) Share Incentive Plan (SIP)**

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

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

	March 2011 Number	March 2010 Number
Outstanding at 1 April	143,201	117,687
Granted during the year	115,519	134,397
Forfeited during the year	(3,383)	(1,805)
Exercised	(95,155)	(107,078)
Outstanding at 31 March	160,182	143,201

**28. RELATED PARTY DISCLOSURES**

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

**29. ULTIMATE PARENT COMPANY**

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

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

**INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF NORTHUMBRIAN WATER LIMITED**

We have audited the financial statements of Northumbrian Water Limited for the year ended 31 March 2011 which comprise the Profit and Loss Account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, and the related notes 1 to 29. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditor**

As explained more fully in the Directors' Responsibilities Statement set out on page 29, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

**Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the directors' report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

**Opinion on financial statements**

In our opinion the financial statements:

- give a true and fair view of the state of the Company's affairs as at 31 March 2011 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

**Opinion on other matter prescribed by the Companies Act 2006**

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

**Matters on which we are required to report by exception**

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

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

Debbie O'Hanlon (Senior statutory auditor)  
for and on behalf of Ernst & Young LLP, Statutory Auditor  
Newcastle upon Tyne  
14 July 2011

SECTION B – REGULATORY FINANCIAL STATEMENTS

**HISTORICAL COST PROFIT AND LOSS ACCOUNT  
for the year ended 31 March 2011**

	Note	2011			2010		
		Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis
		£'m	£'m	£'m	£'m	£'m	£'m
Turnover	2	655.2	25.7	680.9	623.4	25.9	649.3
Operating costs		(308.0)	(13.8)	(321.8)	(311.0)	(12.6)	(323.6)
Historical cost depreciation		(79.4)	(0.5)	(79.9)	(74.1)	(0.8)	(74.9)
Operating income		1.0	-	1.0	0.2	-	0.2
OPERATING PROFIT	A	268.8	11.4	280.2	238.5	12.5	251.0
Net interest payable / receivable		(111.9)	9.9	(102.0)	(86.6)	9.8	(76.8)
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION		156.9	21.3	178.2	151.9	22.3	174.2
Taxation - current		(31.5)	(4.1)	(35.6)	(38.5)	(4.3)	(42.8)
- deferred	A	11.5	(0.2)	11.3	8.6	0.1	8.7
PROFIT FOR THE FINANCIAL YEAR		136.9	17.0	153.9	122.0	18.1	140.1
Dividends		-	-	-	(78.9)	(7.0)	(85.9)
RETAINED PROFIT FOR THE YEAR		136.9	17.0	153.9	43.1	11.1	54.2

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES  
for the year ended 31 March 2011**

	2011			2010		
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis
	£'m	£'m	£'m	£'m	£'m	£'m
Profit for the financial year	136.9	17.0	153.9	122.0	18.1	140.1
Pension liability actuarial gain in the year	72.1	1.2	73.3	1.2	-	1.2
Deferred tax related to pension adjustments	(21.4)	(0.3)	(21.7)	(0.3)	-	(0.3)
Total recognised gains and losses relating to the year	187.6	17.9	205.5	122.9	18.1	141.0

## SECTION B – REGULATORY FINANCIAL STATEMENTS

**HISTORICAL COST BALANCE SHEET****at 31 March 2011**

	Note	Appointed business £'m	Non- appointed business £'m	Aggregated basis £'m	Appointed business £'m	Non- appointed business £'m	Aggregated basis £'m
<b>FIXED ASSETS</b>							
Tangible assets	A	3,158.3	100.0	3,258.3	3,069.0	107.1	3,176.1
Investments - loans to group companies		-	160.9	160.9	-	160.9	160.9
		<u>3,158.3</u>	<u>260.9</u>	<u>3,419.2</u>	<u>3,069.0</u>	<u>268.0</u>	<u>3,337.0</u>
<b>CURRENT ASSETS</b>							
Stocks		2.5	0.3	2.8	2.5	0.3	2.8
Debtors		137.7	3.8	141.5	125.4	0.9	126.3
Cash		-	36.1	36.1	-	22.2	22.2
Short term deposits		116.9	-	116.9	88.2	-	88.2
<b>TOTAL CURRENT ASSETS</b>		<u>257.1</u>	<u>40.2</u>	<u>297.3</u>	<u>216.1</u>	<u>23.4</u>	<u>239.5</u>
<b>CREDITORS: Amounts falling due within one year</b>							
Overdrafts		(29.8)	-	(29.8)	(21.0)	-	(21.0)
Infrastructure renewals accrual		(18.8)	(1.9)	(20.7)	(16.0)	(1.9)	(17.9)
Creditors		(140.3)	(8.7)	(149.0)	(131.2)	(9.4)	(140.6)
Borrowings		(30.3)	-	(30.3)	(24.7)	-	(24.7)
Corporation tax payable		(1.4)	(0.7)	(2.1)	(7.7)	(0.2)	(7.9)
<b>TOTAL CREDITORS</b>		<u>(220.6)</u>	<u>(11.3)</u>	<u>(231.9)</u>	<u>(200.6)</u>	<u>(11.5)</u>	<u>(212.1)</u>
<b>NET CURRENT ASSETS</b>		<u>36.5</u>	<u>28.9</u>	<u>65.4</u>	<u>15.5</u>	<u>11.9</u>	<u>27.4</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		<u>3,194.8</u>	<u>289.8</u>	<u>3,484.6</u>	<u>3,084.5</u>	<u>279.9</u>	<u>3,364.4</u>
<b>CREDITORS: Amounts falling due after more than one year</b>							
Borrowings		(1,898.9)	-	(1,898.9)	(1,900.5)	-	(1,900.5)
Other creditors		(0.2)	-	(0.2)	(0.5)	-	(0.5)
<b>TOTAL CREDITORS</b>		<u>(1,899.1)</u>	<u>-</u>	<u>(1,899.1)</u>	<u>(1,901.0)</u>	<u>-</u>	<u>(1,901.0)</u>
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>							
Deferred tax provision	A	(152.3)	(1.6)	(153.9)	(166.8)	(1.6)	(168.4)
Deferred income - grants and contributions	A	(54.1)	(1.0)	(55.1)	(55.4)	(1.0)	(56.4)
Post employment liability	A	(33.2)	(0.5)	(33.7)	(93.1)	(1.5)	(94.6)
Other provisions		(2.6)	-	(2.6)	(2.4)	-	(2.4)
Other deferred income		(0.5)	(163.2)	(163.7)	(0.5)	(170.2)	(170.7)
<b>NET ASSETS EMPLOYED</b>		<u>1,053.0</u>	<u>123.5</u>	<u>1,176.5</u>	<u>865.3</u>	<u>105.6</u>	<u>970.9</u>
<b>CAPITAL AND RESERVES</b>							
Called up share capital		92.1	30.6	122.7	92.1	30.6	122.7
Profit and loss account		960.9	92.9	1,053.8	773.2	75.0	848.2
<b>CAPITAL AND RESERVES</b>		<u>1,053.0</u>	<u>123.5</u>	<u>1,176.5</u>	<u>865.3</u>	<u>105.6</u>	<u>970.9</u>

Approved by the Board and signed on their behalf by:  
C M Green  
13 July 2011

A C Jones

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### (A) RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST REGULATORY ACCOUNTS For the year ended 31 March 2011

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

	Statutory UK GAAP £'m	Regulatory £'m	Explanation of Difference
<b>PROFIT AND LOSS ACCOUNT</b>			
Turnover	682.8	680.9	Statutory accounts include provision for revenue recognition of £1.9m in accordance with Note G of FRS5, which is disappplied for regulatory purposes (see note 1( c)).
Operating Profit	281.6	280.2	Adjustments relating to the amortisation of infrastructure income (£1.5m) (see note 1(a)(ii)) and additional charge in statutory accounts for VLS pension scheme (£0.1m).
Deferred tax credit	8.7	11.3	Adjustments relating to amortisation of infrastructure income (£0.4m), Section 19 'overlap' (£0.8m) and discount (£3.8m).
<b>BALANCE SHEET</b>			
Tangible fixed assets (net book value)	3,466.5	3,258.3	Adjustments relating to infrastructure grants and contributions netted off (£188.5m), Section 19 'overlap' (£40.4m) and infrastructure renewals provision (£20.7m).
Provisions for liabilities and charges - deferred tax	204.8	153.9	Adjustments relating to amortisation of infrastructure income (5.2m), Section 19 'overlap' (£10.5m) and discount (£35.2m).
Deferred income - grants and contributions	222.4	55.1	Adjustments relating to gross up (£179.3m) and amortisation (£19.7m) of infrastructure grants and contributions.
Post employment liability	34.0	33.7	Adjustment relating to additional charge in statutory accounts for VLS pension scheme (£0.3m).

SECTION B – REGULATORY FINANCIAL STATEMENTS

**CURRENT COST PROFIT AND LOSS ACCOUNT**  
**For the year ended 31 March 2011**

	Note	2011 £'m	2010 £'m
Turnover	2	655.2	623.4
Current cost operating costs	3	(456.1)	(441.6)
Operating income	2	1.3	0.1
Working capital adjustment	2	<u>(1.6)</u>	<u>(1.0)</u>
<b>CURRENT COST OPERATING PROFIT</b>		198.8	180.9
Net interest payable		(111.9)	(86.6)
Financing adjustment		<u>83.2</u>	<u>66.6</u>
<b>CURRENT COST PROFIT BEFORE TAXATION</b>		170.1	160.9
Taxation:			
Current tax		(31.5)	(38.5)
Deferred tax		<u>11.5</u>	<u>8.6</u>
<b>CURRENT COST PROFIT ATTRIBUTABLE TO SHAREHOLDERS</b>		150.1	131.0
Dividends		-	(78.9)
<b>CURRENT COST PROFIT RETAINED</b>		<u>150.1</u>	<u>52.1</u>

All note references to the summary current cost financial statements refer to the notes to the current cost accounts on pages 65 to 67.

SECTION B – REGULATORY FINANCIAL STATEMENTS

**CURRENT COST BALANCE SHEET  
at 31 March 2011**

	Note	<u>2011</u> £'m	<u>2010</u> £'m
<b>FIXED ASSETS</b>			
Tangible assets	4	15,495.3	14,120.1
Third party contributions since 1989/90		<u>(233.1)</u>	<u>(213.9)</u>
		<u>15,262.2</u>	<u>13,906.2</u>
<b>Working capital</b>			
Short term deposits	5	33.1	30.1
Overdraft		116.9	88.2
Infrastructure renewals accrual		<u>(29.8)</u>	<u>(21.0)</u>
NET OPERATING ASSETS		<u>(18.8)</u>	<u>(16.0)</u>
		<u>15,363.6</u>	<u>13,987.5</u>
<b>NON OPERATING ASSETS AND LIABILITIES</b>			
Borrowings		(30.3)	(24.7)
Non-trade debtors		3.1	3.2
Non-trade creditors due within one year		(36.3)	(36.6)
Corporation tax payable		<u>(1.4)</u>	<u>(7.7)</u>
Total non-operating liabilities		<u>(64.9)</u>	<u>(65.8)</u>
<b>CREDITORS:AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR</b>			
Borrowings		(1,898.9)	(1,900.5)
Other creditors		<u>(0.2)</u>	<u>(0.5)</u>
Trade creditors due after more than one year		<u>(1,899.1)</u>	<u>(1,901.0)</u>
<b>PROVISIONS FOR LIABILITIES AND CHARGES</b>			
Deferred tax provision		(152.3)	(166.8)
Post employment liability		(33.2)	(93.1)
Other provisions		<u>(2.6)</u>	<u>(2.4)</u>
Total provisions		<u>(188.1)</u>	<u>(262.3)</u>
NET ASSETS		<u>13,211.5</u>	<u>11,758.4</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital		92.1	92.1
Profit and loss account		646.4	445.5
Current cost reserve	6	<u>12,473.0</u>	<u>11,220.8</u>
TOTAL CAPITAL AND RESERVES		<u>13,211.5</u>	<u>11,758.4</u>

## SECTION B – REGULATORY FINANCIAL STATEMENTS

**CURRENT COST CASH FLOW STATEMENT**  
**for the year ended 31 March 2011**

Note	2011			2010			
	Appointed business	Non-appointed business	Aggregated basis	Appointed business	Non-appointed business	Aggregated basis	
	£'m	£'m	£'m	£'m	£'m	£'m	
NET CASH FLOW FROM OPERATING ACTIVITIES	7	375.5	1.8	377.3	362.6	4.4	367.0
<b>Returns on investment and servicing of finance</b>							
Interest received		0.8	9.9	10.7	8.0	9.9	17.9
Interest paid		(88.1)	-	(88.1)	(89.1)	-	(89.1)
Interest in finance lease rentals		(4.5)	-	(4.5)	(4.1)	-	(4.1)
Net cash flow from returns on investments and servicing of finance		(91.8)	9.9	(81.9)	(85.2)	9.9	(75.3)
<b>Taxation paid</b>		(39.4)	(4.2)	(43.6)	(36.3)	(4.5)	(40.8)
<b>Capital expenditure and financial investment</b>							
Gross cost of purchase of fixed assets		(175.2)	(0.6)	(175.8)	(173.1)	(7.9)	(181.0)
Receipt of grants and contributions		10.9	0.1	11.0	12.2	0.6	12.8
Infrastructure renewals expenditure		(40.4)	(0.1)	(40.5)	(50.9)	(0.1)	(51.0)
Disposal of fixed assets		1.3	7.0	8.3	0.2	-	0.2
Net cash flow from investing activities		(203.4)	6.4	(197.0)	(211.6)	(7.4)	(219.0)
<b>Equity dividends paid</b>		-	-	-	(78.9)	(7.0)	(85.9)
<b>Management of liquid resources</b>							
Net cash flow from management of liquid resources		(28.7)	-	(28.7)	71.2	-	71.2
NET CASH FLOW BEFORE FINANCING		12.2	13.9	26.1	21.8	(4.6)	17.2
<b>Financing</b>							
Capital element in finance lease rentals		(3.4)	-	(3.4)	(3.7)	-	(3.7)
Repayment of bank loans		(17.6)	-	(17.6)	(19.1)	-	(19.1)
Net cash outflow from financing		(21.0)	-	(21.0)	(22.8)	-	(22.8)
(DECREASE) / INCREASE IN CASH		(8.8)	13.9	5.1	(1.0)	(4.6)	(5.6)

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### 1. STATEMENT OF REGULATORY ACCOUNTING POLICIES

#### (a) Historical cost information

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

The accounting policies set out on pages 34 to 37 apply to the historical cost regulatory financial information, with the exception of:

- capital grants and contributions to infrastructure assets which is not in accordance with the Companies Act 2006 (as described in (ii) below).
- infrastructure renewals accounting which, in accordance with RAG 3.06, has been accounted for in accordance with RAG 2.03, “Classification of Infrastructure Expenditure”. RAG 2.03 is not in accordance with FRS 12, “Provisions, Contingent Liabilities and Contingent Assets” and FRS 15, “Tangible Fixed Assets” as described in section (i) below.
- recognition of income relating to energy generation as described in section 1(c) below.

#### (i) Infrastructure assets

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

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

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

In accordance with RAG 3.06 the Company has not applied FRS 12 and FRS 15, in respect of infrastructure renewals accounting and has continued to charge infrastructure renewal costs (calculated in accordance with our Asset Management Plan (AMP)) to the profit and loss account. Expenditure during the year is charged to the provision.

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

- restatement of the cost and accumulated depreciation of infrastructure fixed assets to reflect infrastructure renewals expenditure, depreciation and retirement of assets since renewals accounting was first adopted. Accordingly, infrastructure renewals provisions and prepayments at years ended 31 March 2010 and 31 March 2011 would have been included within infrastructure fixed assets.
- the depreciation of infrastructure assets and the inclusion of the infrastructure renewals charge as a component of the depreciation charge for the year.
- restatement of the cost of infrastructure fixed assets to reflect the treatment of Section 19 “overlap” expenditure. The objective of the Section 19 quality programme is to address water discolouration problems caused by iron pipes, either through relining those pipes or replacing them where relining is not possible. The “overlap” represents the extra cost of replacing pipes rather than relining them where their structural condition is insufficient to withstand the relining process. Such expenditure is included in the infrastructure renewals charge in the regulatory financial statements. The statutory financial statements classify such expenditure as capital in nature and include this under infrastructure assets in the fixed asset note, resulting in a higher profit in the statutory financial statements.

#### (ii) Grants and contributions

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

Grants and contributions relating to infrastructure assets have been deducted from the cost of those assets, in accordance with RAG 3.06. This is not in accordance with the Companies Act 2006 which requires fixed assets to be stated at their purchase price or production cost without deduction of grants and contributions which are accordingly accounted for as deferred income. The effect of the departure on the value of tangible fixed assets is disclosed in note (A). The statutory financial statements reflect grants and contributions as deferred income and amortise them to profit and loss account over the expected useful economic lives of the assets, resulting in a higher operating profit in the statutory financial statements.

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### 1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)

#### (ii) Grants and contributions (continued)

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

#### (b) Current cost information

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

#### (i) Tangible fixed assets

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

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

#### • Land and Buildings

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

#### • Infrastructure assets

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

#### • Other fixed assets

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

#### • Surplus land

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

#### • Grants and contributions

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

#### (ii) Real financial capital maintenance adjustments

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

#### (iii) Working capital adjustment

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

#### (iv) Financing adjustment

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

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### 1. STATEMENT OF REGULATORY ACCOUNTING POLICIES (continued)

#### (c) Turnover recognition

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

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

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

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

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

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

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

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

SECTION B – REGULATORY FINANCIAL STATEMENTS

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

	2011			2010		
	Water services	Sewerage services	Aggregated basis	Water services	Sewerage services	Aggregated basis
	£'m	£'m	£'m	£'m	£'m	£'m
Unmeasured household	199.2	148.1	347.3	187.8	152.8	340.6
Unmeasured non-household	1.9	5.2	7.1	2.3	2.0	4.3
Measured household	83.2	37.3	120.5	72.9	33.8	106.7
Measured non-household	61.4	56.1	117.5	55.2	56.5	111.7
Trade effluent	-	2.5	2.5	-	2.6	2.6
Large user and special agreements	26.4	20.0	46.4	24.0	18.5	42.5
Non-potable large user and special agreements	7.3	-	7.3	8.1	-	8.1
Rechargeable works	1.2	0.1	1.3	1.0	0.4	1.4
Bulk supplies/inter-company payments	0.7	-	0.7	0.5	-	0.5
Other appointed business (third party)	1.8	0.3	2.1	1.5	0.4	1.9
Other sources	2.0	0.5	2.5	1.8	1.3	3.1
<b>Total turnover</b>	<b>385.1</b>	<b>270.1</b>	<b>655.2</b>	<b>355.1</b>	<b>268.3</b>	<b>623.4</b>
Operating income:						
Current cost profit on disposal of fixed assets	1.1	0.2	1.3	0.1	-	0.1
Working capital adjustment	(0.9)	(0.7)	(1.6)	(0.6)	(0.4)	(1.0)

**3. OPERATING COSTS**

**Cost allocation methodology**

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

SECTION B – REGULATORY FINANCIAL STATEMENTS

3. OPERATING COSTS (continued)

	Water services			Sewerage services			
	Resources & treatment	Distribution	Water services subtotal	Sewerage	Sewage treatment	Sludge treatment & disposal	Sewerage service subtotal
	£'m	£'m	£'m	£'m	£'m	£'m	£'m
Direct costs							
Employment costs	11.7	10.4	22.1	4.5	6.3	3.3	14.1
Power	6.8	8.5	15.3	3.7	7.9	(0.6)	11.0
Hired & contracted services	4.8	9.7	14.5	4.2	2.4	9.0	15.6
Associated companies	0.6	1.2	1.8	0.3	0.3	0.6	1.2
Materials and consumables	9.4	1.4	10.8	0.4	1.3	3.1	4.8
Service charges (EA)	20.8	-	20.8	0.9	1.2	-	2.1
Bulk supply imports	1.9	-	1.9	-	-	-	-
Other direct costs	0.5	2.9	3.4	1.5	0.3	0.1	1.9
Total direct costs	56.5	34.1	90.6	15.5	19.7	15.5	50.7
General and support expenditure	7.5	10.0	17.5	2.9	4.3	3.0	10.2
Total functional expenditure	64.0	44.1	108.1	18.4	24.0	18.5	60.9
Business analysis							
Customer services			16.3				7.2
Scientific services			6.2				2.9
Other business activities			0.6				0.3
Business activities sub-total			23.1				10.4
Local authority rates			19.6				5.4
Doubtful debts			10.4				7.4
Total opex less third party services			161.2				84.1
Third party services - opex			14.7				4.8
Total operating expenditure			175.9				88.9
Capital maintenance							
Infrastructure renewals charge	1.1	29.9	31.0	12.2	-	-	12.2
Current cost depreciation							
-services activities	41.7	23.3	65.0	10.2	48.1	14.7	73.0
- business activities			8.5				4.6
Amortisation of grants			(1.1)				(1.9)
Total capital maintenance			103.4				87.9
Total operating costs			279.3				176.8
CCA (MEA) Values							
Service activities			7,838.4				7,563.8
Business activities			80.6				12.5
Total			7,919.0				7,576.3

SECTION B – REGULATORY FINANCIAL STATEMENTS

**4. TANGIBLE FIXED ASSETS**

Water Services	Infrastructure assets £'m	Operational assets £'m	Other tangible assets £'m	Grand total £'m
Gross Replacement Cost:				
At 1 April 2010	6,034.5	1,877.5	122.5	8,034.5
AMP adjustment	-	459.5	(19.7)	439.8
RPI adjustment	322.6	125.4	5.5	453.5
Disposals	-	(0.5)	(2.7)	(3.2)
Additions	48.9	30.4	14.1	93.4
At 31 March 2011	6,406.0	2,492.3	119.7	9,018.0
Depreciation:				
At 1 April 2010	-	934.9	51.3	986.2
AMP adjustment	-	76.1	(5.0)	71.1
RPI adjustment	-	58.2	2.2	60.4
Disposals	-	(0.5)	(2.6)	(3.1)
Charge for year	-	59.0	6.0	65.0
At 31 March 2011	-	1,127.7	51.9	1,179.6
Net book value at 31 March 2011	6,406.0	1,364.6	67.8	7,838.4
Net book value at 31 March 2010	6,034.5	942.6	71.2	7,048.3
Sewerage Services	Infrastructure assets £'m	Operational assets £'m	Other tangible assets £'m	Grand total £'m
Gross Replacement Cost:				
At 1 April 2010	5,835.5	2,076.8	62.0	7,974.3
AMP adjustment	-	229.0	(17.4)	211.6
RPI adjustment	312.0	123.4	2.4	437.8
Disposals	-	(0.8)	(1.5)	(2.3)
Additions	29.7	42.4	6.8	78.9
At 31 March 2011	6,177.2	2,470.8	52.3	8,700.3
Depreciation:				
At 1 April 2010	-	929.8	25.1	954.9
AMP adjustment	-	56.7	(2.7)	54.0
RPI adjustment	-	55.8	1.1	56.9
Disposals	-	(0.8)	(1.5)	(2.3)
Charge for year	-	70.2	2.8	73.0
At 31 March 2011	-	1,111.7	24.8	1,136.5
Net book value at 31 March 2011	6,177.2	1,359.1	27.5	7,563.8
Net book value at 31 March 2010	5,835.5	1,147.0	36.9	7,019.4

SECTION B – REGULATORY FINANCIAL STATEMENTS

**4. TANGIBLE FIXED ASSETS (continued)**

	Infrastructure assets	Operational assets	Other tangible assets	Grand total
	£'m	£'m	£'m	£'m
<b>Retail</b>				
Gross Replacement Cost:				
At 1 April 2010	-	36.0	54.5	90.5
AMP adjustment	-	123.6	(3.8)	119.8
RPI adjustment	-	8.6	2.7	11.3
Disposals	-	-	(0.6)	(0.6)
Additions	-	3.2	5.6	8.8
At 31 March 2011	-	171.4	58.4	229.8
Depreciation:				
At 1 April 2010	-	14.8	23.3	38.1
AMP adjustment	-	74.9	1.0	75.9
RPI adjustment	-	8.8	1.4	10.2
Disposals	-	-	(0.6)	(0.6)
Charge for year	-	10.2	2.9	13.1
At 31 March 2011	-	108.7	28.0	136.7
Net book value at 31 March 2011	-	62.7	30.4	93.1
Net book value at 31 March 2010	-	21.2	31.2	52.4
<b>Grand Total</b>				
	Infrastructure assets	Operational assets	Other tangible assets	Grand total
	£'m	£'m	£'m	£'m
Gross Replacement Cost:				
At 1 April 2010	11,870.0	3,990.3	239.0	16,099.3
AMP adjustment	-	812.1	(40.9)	771.2
RPI adjustment	634.6	257.4	10.6	902.6
Disposals	-	(1.3)	(4.8)	(6.1)
Additions	78.6	76.0	26.5	181.1
At 31 March 2011	12,583.2	5,134.5	230.4	17,948.1
Depreciation:				
At 1 April 2010	-	1,879.5	99.7	1,979.2
AMP adjustment	-	207.7	(6.7)	201.0
RPI adjustment	-	122.8	4.7	127.5
Disposals	-	(1.3)	(4.7)	(6.0)
Charge for year	-	139.4	11.7	151.1
At 31 March 2011	-	2,348.1	104.7	2,452.8
Net book value at 31 March 2011	12,583.2	2,786.4	125.7	15,495.3
Net book value at 31 March 2010	11,870.0	2,110.8	139.3	14,120.1

SECTION B – REGULATORY FINANCIAL STATEMENTS

**5. WORKING CAPITAL**

	2011	2010
	£'m	£'m
Stocks	2.5	2.5
Trade Debtors:		
-measured household	16.7	12.1
-unmeasured household	38.7	32.7
-measured non-household	9.6	9.3
-unmeasured non-household	0.4	0.5
-other	3.8	3.5
Measured income accrual	44.2	40.8
Prepayments and other debtors	21.2	23.3
Trade Creditors	(11.6)	(5.9)
Deferred income - customer advance receipts	(15.1)	(12.2)
Capital Creditors	(35.0)	(31.6)
Accruals and other creditors	(42.3)	(44.9)
Total working capital	33.1	30.1

**6. MOVEMENT ON CURRENT COST RESERVE**

	2011	2010
	£'m	£'m
At 1 April	11,220.8	10,716.5
AMP adjustment	570.2	(16.7)
RPI adjustments:		
-fixed assets	775.1	590.9
-working capital	1.6	1.0
-financing	(83.2)	(66.6)
-grants and third party contributions	(11.5)	(4.3)
At 31 March	12,473.0	11,220.8

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

	2011	2010
	£'m	£'m
Current cost operating profit	198.8	180.9
Working capital adjustment	1.6	1.0
Movement in working capital	(6.4)	(1.1)
Current cost depreciation (net of grant amortisation)	148.1	130.6
Current cost profit on sale of fixed assets	(1.3)	(0.1)
Infrastructure renewals charge	43.2	42.3
Other non-cash profit and loss items	(8.5)	9.0
Net cash flow from operating activities	375.5	362.6

SECTION B – REGULATORY FINANCIAL STATEMENTS

**8. ANALYSIS OF NET DEBT FOR THE APPOINTED BUSINESS**

	Interest rate risk profile			Total £'m
	Fixed rate £'m	Floating rate £'m	Index linked £'m	
Maturity profile:				
Less than one year	24.6	1.2	-	25.8
Between one and two years	30.5	45.5	-	76.0
Between two and five years	89.9	-	-	89.9
Between five and twenty years	812.4	59.1	-	871.5
Over twenty years	345.3	43.4	477.3	866.0
Total borrowings	1,302.7	149.2	477.3	1,929.2
Overdraft				29.8
Short term deposits				(116.9)
Net debt at 31 March 2010				1,842.1

**9. DISCLOSURE OF TRANSACTIONS WITH ASSOCIATES**

**Services supplied by the appointee to associated companies:**

Associate	Service	December 2010 or March 2011		Value £'m
		Turnover £'m	Terms of Supply	
Vehicle Lease and Service Limited (VLS)	Rental of garage and service charges	13.3	Negotiated	0.1

**Services supplied to the appointee by associated companies:**

Associate	Service	December 2010 or March 2011		Value £'m
		Turnover £'m	Terms of Supply	
Northumbrian Water Group plc	Holding company charges	5.3	No market	0.5
Three Rivers Insurance Company Limited	Public liability insurance (deductible infill policy)	0.4	No market	0.4
Vehicle Lease and Service Limited	Vehicle maintenance and capital finance charge	13.3	Competitive letting	6.3

**Information in relation to allocations and apportionments**

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

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

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

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

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### 9. DISCLOSURE OF TRANSACTIONS WITH ASSOCIATES (continued)

#### Amounts borrowed by the appointee from associated companies

The Company has loans amounting to £1,473.7m due to NWF, a subsidiary company. Details of these loans and the associated guarantees are provided in note 20 of the statutory financial statements.

The Company acquires vehicles from VLS, an associated company, on a finance lease basis. During the year, new finance leases of £2.5m were entered into and capital repayments of £3.0m were made. The year end finance lease creditor was £8.2m. All leases are at a fixed interest rate of 6%.

#### Amounts lent by the appointee to associated companies

NWL had short-term deposits amounting to £116.9m with NSL at the year end, representing surplus cash invested via the Group's treasury function.

#### Guarantees or other forms of security

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

#### Dividends paid and proposed

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

	£'m
Dividends paid:	
Final paid for the year ended 31 March 2010	-
Interim paid for the year ended 31 March 2011	-
Total dividends paid in the year	-
Dividends proposed:	
Interim proposed for the year ended 31 March 2011	42.8
Final proposed for year ended 31 March 2011	43.2
Total dividend proposed for the year ended 31 March 2011	86.0

The Company has applied a dividend policy of steady real growth of 2.1%.

#### Omission of right

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

#### Waivers

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

The information in this note has been produced to comply with the requirements of RAG 5.04, 'Transfer Pricing in the Water Industry' and the disclosures required by paragraph 6 of Condition F of the Company's operating licence.

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

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### 10. REGULATORY CAPITAL VALUE AT 2010/11 PRICES

Data from the 2005-10 Final Determination	2010/11 £'m
Closing Regulatory Value at 31 March 2010 (March 2010 prices)	3,094.6
RPI from March 2010 to March 2011 (5.3%)	165.5
Opening regulatory capital value at 1 April 2010	3,260.1
Infrastructure renewals expenditure (IRE)	56.3
Infrastructure renewals charge (IRC)	(48.1)
Capital expenditure (excluding IRE)	218.6
Grants and contributions	(9.4)
Current cost depreciation	(156.3)
Outperformance adjustment	(2.7)
Closing regulatory capital value at 31 March 2011	3,318.5
Year average regulatory capital value	3,204.4

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

Differences between the above figures and actual capital expenditure, infrastructure renewals expenditure, infrastructure renewals charge, grants and contributions and current cost depreciation do not affect the price limits set for the period 2010-15. They were taken into account in the calculation of outperformance adjustments at the Periodic Review in 2014.

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

### 11. STATEMENT ON DIRECTORS' PAY AND STANDARDS OF PERFORMANCE

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

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

- the setting of base salaries is largely influenced by individual contributions and internal relativities rather than external comparators (although for 2010/11 and 2011/12 the Committee was influenced by general economic conditions);
- the annual bonus plan recognises the interests of all of NWG's stakeholders (including shareholders, customers and employees) rather than being focused solely on profit; and
- management shares in the longer term value created for NWG's investors and the serviceability of the Company's regulated assets.

During the year, the Committee:

- agreed bonuses for 2009/10;
- set performance targets for executive directors and senior managers;
- agreed salaries for 2011/12;
- determined the vesting percentage to be applied to the LTIP awards made on 13 December 2007, which vested on 13 December 2010;
- granted LTIP awards on 8 December 2010 (to vest, subject to performance and continued service, on 8 December 2013); and
- reviewed the pension contributions payable in respect of executive members of the Company's defined contribution pension scheme.

Following the year end, the Committee wrote to its largest shareholders and the major representative bodies to consult on a number of changes to executive remuneration arrangements for 2011/12. In summary, these changes were to introduce an executive tier to the defined contribution pension scheme, expand the range of annual bonus metrics to include a balanced scorecard, increase maximum bonus potential for executive directors from 70% to 100% of base salary and introduce bonus deferral and claw-back. Further details of the changes are set out below. No changes were made to long term incentive provisions.

## SECTION B – REGULATORY FINANCIAL STATEMENTS

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

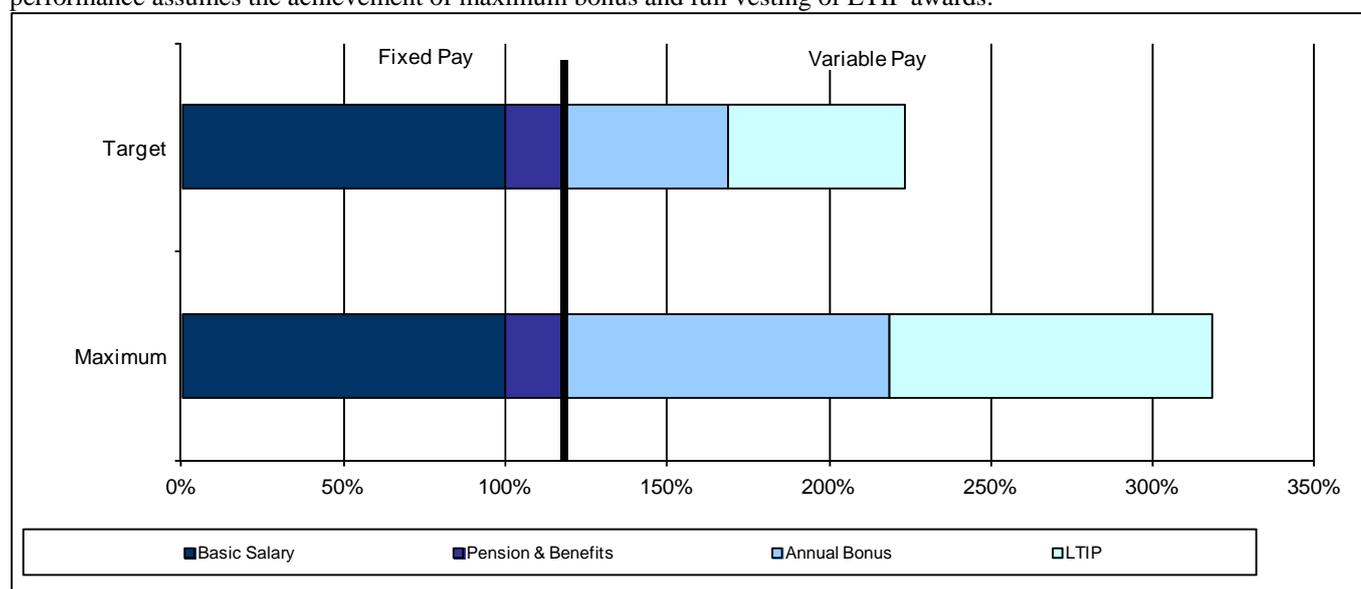
As the Committee works closely with the Remuneration Committee, Committee papers and minutes are circulated to all NWG and NWL non-executive directors, who can give their views direct to the Committee Chairman and can attend meetings if they wish.

#### Elements of remuneration

The remuneration of the executive directors comprises:

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

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



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

	Basic pay	Bonus	Other benefits	Fees	Total remuneration
	£'000	£'000	£'000	£'000	£'000
Sir D Wanless	-	-	-	79.8	79.8
H Mottram	224.0	136.6	38.8	-	399.4
C M Green	159.6	97.3	8.2	-	265.1
A C Jones	143.5	87.5	10.4	-	241.4
G Neave	173.0	102.1	14.2	-	289.3
A G Balls	-	-	-	31.9	31.9
A M Frew	-	-	-	31.9	31.9
Dr S Lyster	-	-	-	31.9	31.9
<b>Total remuneration</b>	<b>700.1</b>	<b>423.5</b>	<b>71.6</b>	<b>175.5</b>	<b>1,370.7</b>

The other benefits remuneration paid to Mrs Mottram includes £30.5k paid by the Company in respect of the defined contribution pension scheme.

## SECTION B – REGULATORY FINANCIAL STATEMENTS

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

#### (i) Executive directors: basic salary and benefits

Basic salary is the only pensionable element of the executive directors' remuneration package. The basic salaries payable to directors of NWL are not directly linked to standards of performance in connection with the carrying out of functions of a "relevant undertaker". Basic salary is reviewed annually based on individual contributions and internal relativities. The Committee also has regard to market practice in other quoted water companies and similar sized companies more generally. For 2011/12 salaries for senior executives have been increased by 3.71%. This is the same as for nearly all other employees. Benefits provided to the executive directors comprise membership of pension schemes, car allowance and healthcare.

#### (ii) Annual bonus

The annual bonus plan has been designed to reflect the interest of all of NWG's stakeholders. The executive directors were entitled to bonuses of up to 70% of salary, relating to four components, as follows:

- up to 40% related to the profit before tax performance of NWG;
- up to 5% related to NWL's predicted current year performance against industry performance. Although Ofwat no longer publishes an OPA rating, the Committee has estimated NWL's OPA score for 2010/11, on the same basis as before, as 362. This has been placed in a range for bonus purposes of 351 to 426, being the published range of performance across the 10 water and sewerage companies in 2009/10;
- up to 5% related to lost time through sickness. The actual sickness absence rate was 3.1% and bonus is calculated on a linear scale between 2.7% and 2.99% with a published target for NWL of 2.9%; and
- up to 20% related to bespoke personal targets.

The potential 5% bonus in respect of predicted OPA performance is considered to be linked to NWL's performance as a "relevant undertaker". The Remuneration Committee confirmed on 25 May that 2% would be payable against this measure reflecting the estimated score of 362 against a range between 351 to 426 points. The Remuneration Committee also confirmed that nothing would be payable in respect of time lost through sickness as the target was missed.

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

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

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

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

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

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

Taking account of performance against personal targets and the OPA, PBT and lost time performance, Mrs Mottram and Mr Green were awarded bonuses equal to 61% of their respective basic salaries. Mr Neave and Mr Jones were awarded bonuses equal to 59% and 61% of their respective basic salaries.

## SECTION B – REGULATORY FINANCIAL STATEMENTS

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

#### (ii) Annual bonus(continued)

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

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

Following consultation with NWG's largest shareholders, the range of annual bonus metrics has been expanded to include a balanced scorecard to align annual incentive pay more closely with stakeholders' wider interests for 2011/12. In addition to the introduction of the balanced scorecard, the maximum annual bonus potential for the executive directors in 2011/12 will be increased from 70% to 100% of salary and will be apportioned as follows:

Bonus metric	(% of salary)
PBT	36
Balanced scorecard measures	44
Bespoke personal targets	20
<b>Total</b>	<b>100</b>

The new metrics are firmly linked to NWG's strategic goals (customer, competitiveness, people, environment and communities). The PBT performance metric reflects 'competitiveness', along with an assessment of capital efficiency, while the other elements of the balanced scorecard are linked to the other strategic goals. The 'customer' goal underpins targets based on customer satisfaction, unplanned interruptions and water quality. The 'people' goal is reflected in targets for employee engagement and lost time reportable accidents. The 'environment' goal targets comprise leakage, sewage treatment performance and pollution incidents, while 'communities' targets are based on external recognition of the Group's corporate social responsibility achievement.

The PBT element of the bonus will be scored on a sliding scale around the target figure. A simple pass/fail measure will apply to the other targets and most of the targets have been set at levels which would require significant improvements over the 2010/11 actual results. The Committee considers the overall bonus metrics to be appreciably more stretching than before, and that they reflect operational performance and delivery to customers in a more structured way. A similar approach has been adopted in relation to executives below board level and senior managers, albeit at varying levels of bonus opportunity.

Bespoke personal targets for the executive directors for 2011/12 are set out below.

#### **Bonus deferral**

Following the increase in bonus potential, NWG has introduced bonus deferral for executive directors. Of the total bonus awarded, 70% will be payable in cash and 30% will be payable in shares, deferred for three years.

#### **Bonus and LTIP clawback**

As part of the changes introduced for 2011/12, the Committee has introduced a clawback provision which will apply in the event that results on which the bonus is paid are subsequently found to be inaccurate or there has been relevant misconduct on the part of the employee.

#### (iii) Pension

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

Mrs Mottram receives an employer contribution of 8% of salary to the money purchase section of the Northumbrian Water Pension Scheme. She makes an employee contribution of 5%. The employer's contribution of 8% is the same as is available to any other employee making a 5% contribution. Following consultation with NWG's largest shareholders and major representative bodies, the employer contributions on behalf of executive members of the defined contribution scheme have been increased from 8% to 15% of salary, with employee contributions increased from 5% to 8%, from 1 April 2011. This was thought necessary in order to make the remuneration packages available for senior recruits market competitive. Heidi Mottram is the only executive director of NWG in the defined contribution scheme.

SECTION B – REGULATORY FINANCIAL STATEMENTS

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

**(iv) Long Term Incentive Plan**

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

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

**Summary of LTIP awards and performance conditions**

<b>LTIP AWARD MADE 13 DECEMBER 2007 AND 15 DECEMBER 2008</b>	
Maximum award	100% of salary permitted. Actual grants to executive directors related to shares worth up to 100% 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.
<b>LTIP AWARD MADE 4 JANUARY 2010</b>	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth up to 100% of salary.
Performance conditions and vesting schedules	See table below.

SECTION B – REGULATORY FINANCIAL STATEMENTS

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

**Summary of LTIP awards and performance conditions (continued)**

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

The Committee is satisfied that the above metrics and targets remain appropriate for the following reasons:

- a significant part of the award based on TSR ensures alignment with investors;
- the use of an absolute ROCE target ensures that reward is directly linked to the management's delivery of the business plan;
- the serviceability targets recognise that the maintenance of NWL’s regulated assets is critical to the longer term returns for shareholders; and
- customer satisfaction is a key objective for NWL and customers are important stakeholders.

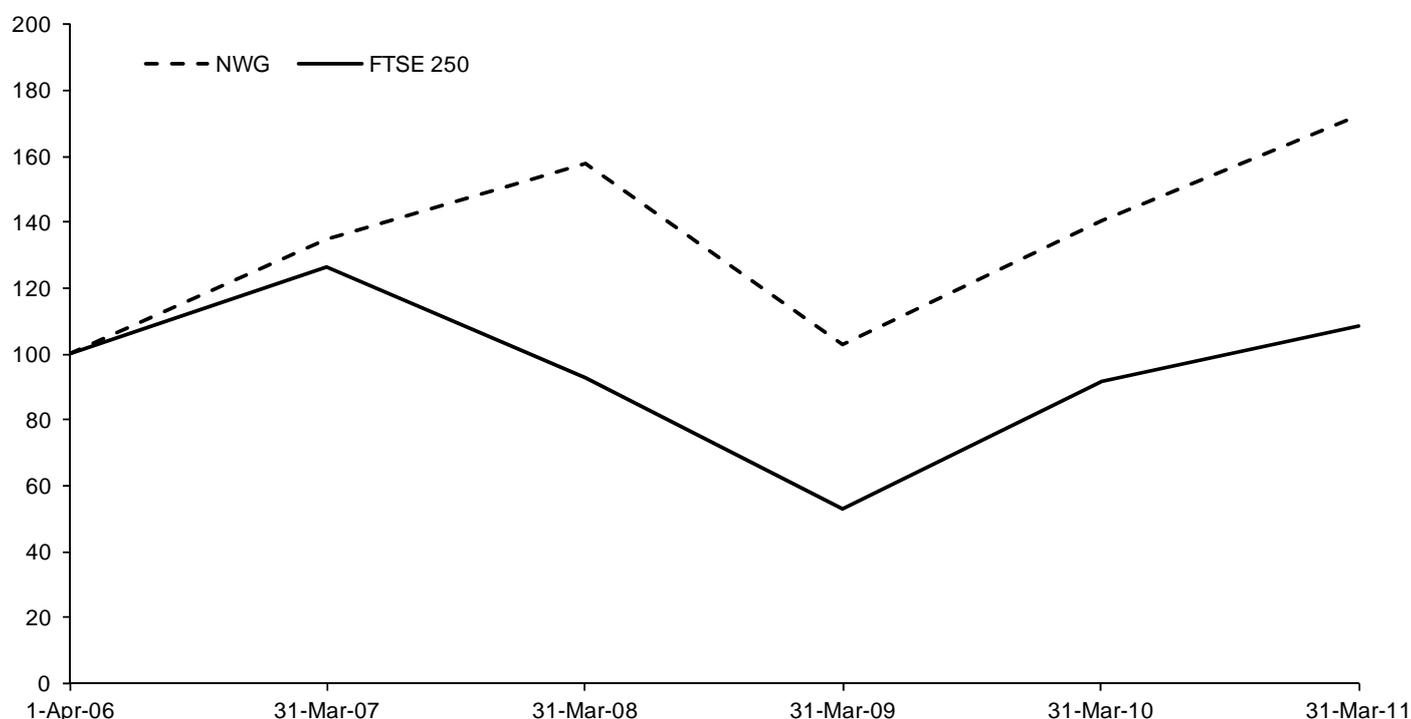
**11. STATEMENT ON DIRECTORS' PAY AND STANDARDS OF PERFORMANCE (continued)****Summary of LTIP awards and performance conditions (continued)**

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 13 December 2007 became available to vest on 13 December 2010. The Committee instructed HNBS to assess the level of vesting of this award. HNBS reported that 48.84% of the award was available to vest (being 97.68% of the award relating to the Company's TSR performance against the FTSE 250 Index and 0% of the award relating to the Company's ROCE performance against the other water companies). Prior to vesting, the Committee satisfied itself that the recorded TSR performance was a genuine reflection of the Company's underlying performance. Details of the number of awards which lapsed and those which were exercised by the directors of the Company are shown in the table on page 39.

**Performance graph**

The graph below shows a comparison between the TSR for NWG's shares for the five year period to 31 March 2011, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as NWG is a constituent of the FTSE 250.



Note:

This graph shows the value, by 31 March 2011, of £100 invested in NWG on 1 April 2006 compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

At its meeting on 18 November 2010, the Committee agreed to make conditional awards to Mrs Mottram and Mr Green with a value equal to 99% of base salary, and to Mr Neave and Mr Jones with a value equal to 59% of base salaries. The level of the awards was previously agreed in principle by the Committee, following detailed advice from HNBS. The awards were made on 8 December 2010. The higher level of awards made to Mrs Mottram and Mr Green recognise their additional roles as executive directors of NWG.

**(v) Contribution to Remuneration by NWG**

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

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

**(vi) Consideration of Ofwat Reports by Remuneration Committee**

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

**(vii) Future Targets**

For 2011/12, all four executive directors have personal targets which relate to NWL's performance as a "relevant undertaker". Their targets, in summary, are as follows:

Heidi Mottram: maintaining key financial ratios in line with the NWG and NWL approved budgets, maintaining good relationships with investors and analysts, delivering the operating efficiency plans for 2011/12 (and keeping the remainder of the plans for 2014/15 on track) and progressing the Group's strategy on advanced anaerobic digestion, co-digestion and renewable energy.

Chris Green: maintaining the key financial ratios, maintaining good relationships with investors and analysts, refreshing the risk model and preparing a high level strategic risk matrix and work on current cost depreciation and its impact on return on capital employed.

Graham Neave: continuing improvement in customer satisfaction, reviewing the employee relations framework and progressing the co-digestion strategy.

Ceri Jones: refreshing the Strategic Direction Statement, reviewing customer service and implementing strategies to further improve customer service and maintaining improvements in occupational health.

## SECTION B – REGULATORY FINANCIAL STATEMENTS

### **DIRECTORS' RESPONSIBILITIES AND DECLARATIONS for the year ended 31 March 2011**

#### **STATEMENT OF DIRECTORS' RESPONSIBILITIES**

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

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

#### **RING FENCING**

The directors confirm that, as at 31 March 2011, the Company was in compliance with paragraph 3.1 of Condition K of the Instrument of Appointment by which the Appointee had available to it sufficient rights and assets to enable a special administrator to manage the affairs, business and property of the Appointee, should a special administrative order be made.

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

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

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

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

In providing this certificate, the Directors have taken into account:

- the acceptance of the 2009 Final Determination by the Board;
- the financial strength of the Company at the balance sheet date and performance during 2010/11;
- the strength of the key financial ratios over the planning horizon of the Company's one year budget and medium term plan to 2015 as reflected in strong investment grade credit ratings;
- the fact that the Company already has funding and facilities in place to meet all operational and capital investment requirements to March 2014;
- its contractual arrangements with suppliers for key materials and support services and its capital framework arrangements;
- its robust People Plan for 2010-15 which underpins the employment resources to fulfil all operational requirements; and,
- the Company's formal risk and governance arrangements which are monitored by the Audit Committee and Board.

#### **ON BEHALF OF THE BOARD**

M Parker  
Company Secretary  
13 July 2011

## SECTION B – REGULATORY FINANCIAL STATEMENTS

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

We have audited the Regulatory Accounts of Northumbrian Water Limited (the Company) for the year ended 31 March 2011 which comprise

- the regulatory historical cost accounting statements, comprising the regulatory historical cost profit and loss account, the regulatory historical cost balance sheet, the regulatory historical cost statement of total recognised gains and losses and the historical cost reconciliation between statutory and regulatory accounts, and
- the regulatory current cost accounting statements for the appointed business, comprising the current cost profit and loss account, the current cost balance sheet, the current cost cash flow statement and the related notes to the current cost financial statements, including the statement of accounting policies.

These Regulatory Accounts have been prepared in accordance with the basis of preparation and accounting policies set out in the Statement of Accounting Policies.

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

#### **Respective responsibilities of the WSRA, the directors and auditors**

As explained more fully in the Statement of Directors' Responsibilities set out on page 83, the directors are responsible for the preparation of the Regulatory Accounts and for their fair presentation in accordance with the basis of preparation and accounting policies. Our responsibility is to audit and express an opinion on the Regulatory Accounts in accordance with International Standards on Auditing (UK and Ireland), except as stated in the 'Scope of the audit of the Regulatory Accounts' below, and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities' issued by the Institute of Chartered Accountants in England and Wales. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

#### **Scope of the audit of the Regulatory Accounts**

An audit involves obtaining evidence about the amounts and disclosures in the Regulatory Accounts sufficient to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the Regulatory Accounts. In addition, we read all the financial and non-financial information in the regulatory accounts to identify material inconsistencies with the audited Regulatory Accounts. If we become aware of any apparent misstatements or inconsistencies, we consider the implications for our report.

We have not assessed whether the accounting policies are appropriate to the circumstances of the Company where these are laid down by Condition F. Where Condition F does not give specific guidance on the accounting policies to be followed, our audit opinion includes an assessment of whether the accounting policies adopted in respect of the transactions and balances required to be included in the Regulatory Accounts are consistent with those used in the preparation of the statutory financial statements of the Company. Furthermore, as the nature, form and content of the Regulatory Accounts are determined by the WSRA, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Standards on Auditing (UK & Ireland).

## SECTION B – REGULATORY FINANCIAL STATEMENTS

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

#### Opinion on Regulatory Accounts

In our opinion, the regulatory Accounts:

- fairly present in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on pages 65 to 67, the state of the Company's affairs at 31 March 2011 on an historical cost and current cost basis, and its historical cost and current cost profit and its current cost cash flow for the year then ended; and
- have been properly prepared in accordance with Condition F, the Regulatory Accounting Guidelines and the accounting policies.

#### Basis of preparation

Without modifying our opinion, we draw attention to the fact that the Regulatory Accounts have been prepared in accordance with Condition F of the Appointment and the Regulatory Accounting Guidelines, the accounting policies set out in the statement of accounting policies and, in the case of the regulatory historical cost accounting statements, under the historical cost convention.

The Regulatory Accounts are separate from the statutory financial statements of the Company and have not been prepared under the same basis of United Kingdom Generally Accepted Accounting Principles (UK GAAP). Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in statutory financial statements prepared in accordance with the Companies Act 2006. Furthermore, the regulatory historical cost accounting statements on pages 59 to 60 have been drawn up in accordance with Regulatory Accounting Guideline 3.06, in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly, that the relevant sections of Financial Reporting Standards 12 and 15 be disapplied. The effect of this departure from Generally Accepted Accounting Practice and a reconciliation of the balance sheet drawn up on this basis to the balance sheet drawn up under the Companies Act 2006 is given on page 61.

#### Opinion on other matters prescribed by Condition F

Under the terms of our contract, we have assumed responsibility to provide those additional opinions required by Condition F in relation to the accounting records. In our opinion:

- a) proper accounting records have been kept by the Appointee as required by paragraph 3 of Condition F;
- b) the Regulatory Accounts are in agreement with the accounting records and returns retained for the purpose of preparing the Regulatory Accounts

#### Other matters

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

Our opinion of the Regulatory Accounts is separate from our opinion on the statutory financial statements of the Company for the year ended 31 March 2011 on which we report, which are prepared for a different purpose. Our audit opinion in relation to the statutory financial statements of the Company (our 'statutory audit') was made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our statutory audit was undertaken so that we might state to the Company's members those matters we are required to state to them in a statutory audit report and for no other purpose. In these circumstances, to the fullest extent permitted by the law, we do not accept or assume responsibility for any other purpose or to any other person to whom our statutory audit report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Ernst & Young LLP  
Registered auditors  
Newcastle upon Tyne

14 July 2011