

NORTHUMBRIAN WATER LIMITED
FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2006

Registered no: 2366703

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FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2006

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DIRECTORS' REPORT

For the year ended 31 March 2006

The directors present their report and the audited financial statements for the year ended 31 March 2006.

Results and dividends

The company's profit after taxation for the year ended 31 March 2006 amounts to £96.5m (2005: £103.3m). The directors recommend a final ordinary dividend amounting to £36.9m (2005: £25.7m) which, together with the interim dividend of £36.9m (2005: £41.9m), makes a total for the year of £73.8m (2005: £67.6m).

During the year the company implemented FRS 21, "Events after the Balance Sheet Date". Dividends are now recognised in the financial statements in the year in which they are paid or, in the case of a final dividend, when approved by the shareholders. As such the amount of £62.6m recognised in the 2006 financial statements, as described in note 9, is made up of the 2005 final dividend and the 2006 interim dividend, which have both been paid in the year ended 31 March 2006. Accordingly the balance sheet for 2005 has been restated to reflect this change in accounting policy.

Principal activities and review of the business

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.

The company maintained its high standards on water and waste water compliance and continued to perform well on most of Ofwat's customer service standards. As with last year, the only shortcoming related to sewer flooding where intense summer storms caused the company's performance to slip on this measure.

Turnover increased from £504.3m in 2004/05 to £550.5m for the year to 31 March 2006. This increase is mainly due to the application of new regulatory pricing which resulted in an average price increase to tariff income of 9.95% in April 2005. This price increase included an uplift for RPI of 3.45%.

Operating costs, excluding capital maintenance costs, have increased from £218.5m to £228.4m, principally reflecting the impact of inflation plus increases in market prices for power and increased pension contributions following an actuarial review of the pension scheme. These increases have been partially offset by efficiency savings. Operating costs for the appointed business in 2005/06 are £0.1m lower than those estimated in the 2004 final determination for the year.

Capital maintenance costs have increased from £87.8m to £93.2m, reflecting additional depreciation charges arising from the commissioning of new assets.

Net interest payable increased by £8.8m from £68.9m in 2004/05 to £77.7m in 2005/06. The increase is due partly to one-off benefits which arose in 2004/05 relating to the release of an interest rate hedge (£4.3m) and interest on sums recovered in respect of prior year tax claims (£1.9m). Additional interest has been incurred due to an increase in the average net debt from £1,445m in 2004/05 to £1,487m in 2005/06.

Key Performance Indicators (KPIs)

The NWL group of companies (note 11) use many performance indicators, both financial and non-financial, to monitor its progress, many of which are combined into a balanced scorecard that is used to calculate employees' bonuses.

a) Financial performance against KPIs

| KPI | Target | Performance | |
|-----------------------|---------------------|--------------|---------------|
| | | Current year | Previous year |
| Gearing to RCV | <70% ⁽¹⁾ | 66% | 68% |
| Cash interest cover | >3.0x | 3.3x | 3.4x |
| Cash flow to net debt | >13% | 17% | 17% |

(1) Less than 65% for the appointed business.

Gearing decreased to 66% for the NWL group and to 58% for the appointed business.

DIRECTORS' REPORT (continued)

Key Performance Indicators (continued)

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

b) Performance against non-financial KPIs

| Target | Performance | |
|----------------------------|---------------------|---------------|
| | Current year | Previous year |
| Customer service standards | See narrative below | |
| Customer satisfaction | | |
| - overall service | 91% | 88% |
| - value for money | 83% | 74% |
| Drinking water quality | 99.9% | 99.9% |
| Environmental performance | 100% | 100% |

The company maintained its high level of service, continuing to achieve greater than 99.9% compliance with drinking water regulations, 100% compliance with Look Up Table (LUT) effluent consents, and a star rating on most Director General (DG) measures. The only shortcoming related to DG5, which measures performance on sewer flooding. Due to intense summer storms, the company's performance slipped on this measure. Whether such storms are rare events, unlikely to recur in the near future, or reflect changed weather patterns associated with climate change, remains to be seen.

Customer satisfaction surveys showed sustained customer satisfaction and perceived value for money.

Financial statements preparation and going concern

The directors consider it is appropriate to prepare the financial statements for the financial year on the going concern basis. The directors have arrived at their decision based on consideration of the company's detailed budget for 2006/07 and the forecast for the following three years. Their analysis included a review of the capital expenditure and investment plans, the anticipated funding requirements and facilities available, and the reasonableness of the underlying assumptions of both the budget and the forecast.

Research and development

The company places a high priority on research and technological innovation to serve the needs of customers. The company maintains a programme of research and development activities appropriate to its operations and incurred costs of research and development in the year of £2.3m (2005: £5.0m).

Company payment policy

The company's policy is to agree and adhere to payment terms with suppliers when agreeing the terms of each transaction, also ensuring that suppliers are made aware of, and comply with, the terms of payment. The year end trade creditors expressed as a number of days of purchases made during the year is 18 days (2005: 27 days).

Fixed assets

Freehold land and buildings are carried in the financial statements at historical cost with a net book value of £57.9m (2005: £59.4m). In the opinion of the directors, at 31 March 2006, 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 (continued)

Financial review

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

During the year, the company issued two guaranteed Index Linked Eurobonds through its subsidiary Northumbrian Water Finance plc, £150m of Eurobonds were issued in September 2005, maturing in July 2036, and a further £60m of Eurobonds were issued in January 2006, maturing in January 2041.

Treasury operations

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

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

Risks arising from the company's financial instruments

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

Liquidity risk

As regards day to day liquidity, the company is responsible for cash management and has sufficient committed facilities to cover 18 months forecast cash outflow. The Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50m and with a bank agreement availability period of no less than 3 months.

Interest rate risk

The company finances its operations through a mixture of retained profits and borrowings. It borrows at both fixed and floating rates of interest and, as noted above, on occasion uses derivatives to generate the desired interest profile and to manage its exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60 per cent of its borrowings at fixed rates of interest. At 31 March 2006, 80% (2005: 88%) of the borrowings of the Group were at fixed rates of interest. At 31 March 2006, the Group had £275.0m available in standby committed bank facilities.

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 2006, the company had no currency exposures (2005: 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.

DIRECTORS' REPORT (continued)

Directors

The directors who served during the year were as follows:

Professor Sir F G T Holliday CBE (retiring July 2006)
Non-Executive Chairman

J A Cuthbert
Executive Managing Director

C M Green
Executive Finance Director

G Neave
Executive Operations Director

A C Jones
Executive Regulation and Compliance Director

A G Balls
Independent Non-Executive Director

A M Frew
Independent Non-Executive Director

A J Scott-Barrett
Independent Non-Executive Director – appointed 1 November 2005

Sir D Wanless
Non-Executive Director – appointed 1 January 2006

Sir A P Brown
Non-Executive Director – appointed 1 January 2006

R K Lepin
Non-Executive Director – appointed 1 January 2006

M A B Nègre
Non-Executive Director – appointed 1 January 2006

J M Williams
Non-Executive Director – appointed 1 January 2006

R R Allan
Independent Non-Executive Director – retired 28 July 2005

B Guirkingier
Non-Executive Director – resigned 28 April 2005

C Cros
Non-Executive Director – resigned 28 April 2005

DIRECTORS' REPORT (continued)

Employees and employment policies

Equal Opportunities

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

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

Training and Development

Training and development of employees is a priority of the company. The company has developed a management development programme from which all senior managers in the business have benefited. The programme has been extended to team leaders. The company also has an accelerated development programme for employees with management potential. Annual appraisals are conducted and training needs properly assessed.

Communication

Throughout the year, the company continued to communicate effectively with its employees. Publications such as Watermark, Hel'eau and Low down have ensured consistent delivery of business and employee messages. In support of this, both informal and formal links are used to inform the communication process to ensure a constant and open flow of information and equal representation. All methods of internal communications for the company will be reviewed and updated during 2006/07.

Health and Safety

Health and safety policies are maintained and implemented through the company's health and safety team. Occupational health services are provided by the company's medical adviser, Grosvenor Health. Most employees are members of a company-wide corporate health care plan.

Share Incentive Plan

The directors believe that employee investment strengthens the ties between its employees and NWG by enabling employees to participate more closely in the Group's economic performance.

In January 2004, NWG launched its Share Incentive Plan (SIP). All UK based employees of the Group are eligible to participate in the SIP. The SIP enables Group employees to purchase ordinary shares in NWG in a flexible and tax efficient way. In addition, for every three shares purchased, employees receive one free share. Shares must be held in the plan for five years to obtain the full tax benefits.

Directors' remuneration and interests

Information about directors' remuneration and their interests in the shares of the company is contained in note 5 to the financial statements.

Indemnification of directors

The Group has in place Director's and Officers' insurance and, on 28 November 2005, entered into a deed of indemnity to grant the director's of the Group and its subsidiaries further protection against liability to third parties.

Pensions

Information about the pension schemes operated by the Group is contained in note 27 to the financial statements.

DIRECTORS' REPORT (continued)

Charitable and political contributions

During the year, the company made charitable donations of £122,411 (2005: £89,369) and political donations of £3,857 (2005: £1,497).

It is the Group's policy that it does not, directly or through any subsidiary, make what are commonly regarded as donations to any political party. The definition of donations in the Political Parties, Elections and Referendums Act 2000 (PPERA 2000) is wide and covers activities that form part of the normal relationship between the Group and political organisations (such as sponsoring receptions and fringe meetings at party conferences and taking tables at dinners) intended to heighten awareness within the political arena of key industry issues and matters affecting Group companies. Approval will be sought from Group shareholders at its forthcoming AGM to permit the Group and the company to make political donations as defined in PERA 2000 up to a maximum of £20,000 in the 15 month period commencing on the date of the AGM or until the date of the 2007 AGM whichever is sooner. During the year, the company made political donations, applying the wide definitions from the PERA 2000, as follows:

| Name of EU Political Organisation | Donations for the period |
|--|---------------------------------|
| | £ |
| Labour | 2,785 |
| Liberal Democrats | 484 |
| Conservative | 588 |
| Total | 3,857 |

Environment policy

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

Sustainable development policy

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

Future developments

Ofwat's review of the company's price limits in its final determination in 2004 sets the framework for the five years to 2010. The determination included assumptions on operating and capital efficiencies, as follows:

- annual average operating efficiency improvements of 1.2% for water and 2.0% for sewerage;
- overall capital maintenance efficiency improvements of 3.6% for water and 3.9% for sewerage (for the full five year period); and
- overall capital enhancement improvements of 14.8% for water and 14.6% for sewerage (for the full five year period).

Price limits allowed in 2005/06 increased by 6.5% before inflation and for the next four years the increases above inflation are 3.7%, 3.2%, 1.0% and 0.6%.

Financial performance for the appointed business has been broadly in line with Ofwat's assumptions this year, but the cost of power and abstraction charges is rising significantly above the rate of inflation. In this context, Ofwat's efficiency assumptions for future operating costs will be challenging.

DIRECTORS' REPORT (continued)

Investment aspects

Over the five years to 2010, the company will invest around £1 billion. This will include maintenance of its existing assets as well as further improvements to the quality of drinking water, sewerage assets, discharges to the environment, and levels of service provided to customers.

The company is increasing its investment to maintain its above ground sewerage assets. These have been assessed by Ofwat as 'deteriorating' but the increased capital maintenance investment will achieve and maintain a 'stable' performance. The company will also continue to invest in new and improved sewage treatment works, to meet the discharge standards required for the protection of environments designated as 'sensitive' and the requirements of the EU Freshwater Fish Directive, and in improvements to unsatisfactory sewage overflows and in reducing odours from a number of its sewage treatment works.

The extent and impact of flooding from sewers is a concern to the company, its customers and CCWater. The allowance in price limits for this service improvement will not eradicate the problem, but it will mean that the worst cases can be addressed on the basis of priorities agreed with Ofwat and CCWater.

The planning application to enlarge Abberton reservoir in Essex is due to be submitted in 2006 and, provided the planning process proceeds smoothly, construction will begin in 2010. When it is filled in 2014, the capacity of the enlarged reservoir will be some 60% greater than it is today.

The company has almost completed its 20 year mains rehabilitation programme and has now started its mains flushing programme to reduce the incidence of discoloured water. Investment at three water treatment works to provide additional protection against pesticides is well underway.

Future trends and factors

There are a number of known changes, both short term and longer term, that may have an impact on the future development, performance and position of the company including:

- the introduction of new UK and EU legislation (such as the Traffic Management Bill and Water Framework Directive), the deadlines in existing legislation (such as the lower lead in drinking water requirement in 2013) and proposals for future legislation (such as the proposal for water and sewerage companies to adopt private sewers);
- the impact of changes in population and industry levels, particularly with the development of the Thames Gateway area on the demand for, and supply of, water; and
- the impact of climate change, particularly where it relates to the increased incidence of flooding and changes in rainfall patterns.

Directors' declaration

In accordance with the Companies Audit, Investigations and Enterprise Act 2004, as far as each director is aware, there is no relevant audit information of which the company's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

Auditors

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

DIRECTORS' REPORT (continued)

Statement of Directors' responsibilities

Company law requires the directors to prepare the Annual Report and the financial statements in accordance with applicable United Kingdom law and United Kingdom Generally Accepted Accounting Practice.

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing those financial statements, the directors are required to:

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

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

BY ORDER OF THE BOARD

M Parker

Company Secretary

5 June 2006

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF NORTHUMBRIAN WATER LIMITED

We have audited the financial statements of the company for the year ended 31 March 2006 which comprise the Profit and Loss Account, the Balance Sheet, the Statement of Total Recognised Gains and Losses and the related notes 1 to 29. These financial statements have been prepared under the accounting policies set out therein.

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

Respective responsibilities of directors and auditors

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

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

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

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

Basis of opinion

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

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

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 March 2006 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the directors' report is consistent with the financial statements.

Ernst & Young LLP
Registered Auditor
Newcastle-upon-Tyne

5 June 2006

**PROFIT AND LOSS ACCOUNT
for the year ended 31 March 2006**

| | Note | 2006 | 2005 |
|--|------|---------|---------|
| | | £'m | £'m |
| Turnover | 2 | 550.5 | 504.3 |
| Operating costs | 3(a) | (228.4) | (218.5) |
| Capital maintenance costs | 3(b) | (93.2) | (87.8) |
| Total operating costs | | (321.6) | (306.3) |
| OPERATING PROFIT | | 228.9 | 198.0 |
| Net interest payable | 4 | (77.7) | (68.9) |
| PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION | 3(c) | 151.2 | 129.1 |
| Taxation | 8(a) | (54.7) | (25.8) |
| PROFIT FOR THE FINANCIAL YEAR | 25 | 96.5 | 103.3 |

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
for the year ended 31 March 2006**

There are no recognised gains and losses other than the profit attributable to shareholders of the company of £96.5m for the year ended 31 March 2006 and the profit of £103.3m for the year ended 31 March 2005.

In addition the effect of implementing FRS 21 is that an amount of £25.7m, previously included within creditors as a proposed dividend at 31 March 2005, has been added back to the profit and loss reserve at 31 March 2005.

BALANCE SHEET
at 31 March 2006

| | Note | 2006 | 2005 restated |
|--|------|------------------|------------------|
| | | £'m | £'m |
| FIXED ASSETS | | | |
| Tangible assets | 10 | 2,866.8 | 2,738.7 |
| Investments | 11 | 160.6 | 160.6 |
| | | <u>3,027.4</u> | <u>2,899.3</u> |
| CURRENT ASSETS | | | |
| Stocks | 12 | 2.8 | 3.0 |
| Debtors due in less than one year | 13 | 102.8 | 98.7 |
| Debtors due in more than one year | 14 | 3.6 | - |
| Investments | 15 | 57.7 | - |
| Cash at bank and in hand | | 1.9 | 2.1 |
| | | <u>168.8</u> | <u>103.8</u> |
| CREDITORS | | | |
| Amounts falling due within one year | 16 | (181.9) | (239.8) |
| | | <u>(13.1)</u> | <u>(136.0)</u> |
| NET CURRENT LIABILITIES | | | |
| | | <u>(13.1)</u> | <u>(136.0)</u> |
| TOTAL ASSETS LESS CURRENT LIABILITIES | | | |
| | | <u>3,014.3</u> | <u>2,763.3</u> |
| CREDITORS: Amounts falling due after more than one year | | | |
| | 17 | (1,540.3) | (1,362.9) |
| PROVISIONS FOR LIABILITIES AND CHARGES | | | |
| | 22 | (204.7) | (175.9) |
| ACCRUALS AND DEFERRED INCOME | | | |
| | 23 | (373.3) | (362.4) |
| | | <u>(2,118.3)</u> | <u>(1,901.2)</u> |
| NET ASSETS | | | |
| | | <u>896.0</u> | <u>862.1</u> |
| CAPITAL AND RESERVES | | | |
| Called up share capital | 24 | 122.7 | 122.7 |
| Profit and loss account | 25 | 773.3 | 739.4 |
| EQUITY SHAREHOLDERS' FUNDS | | | |
| | 25 | <u>896.0</u> | <u>862.1</u> |

Approved on behalf of the board

J A Cuthbert

C M Green

5 June 2006

NOTES TO THE FINANCIAL STATEMENTS for the year ended 31 March 2006

1. STATEMENT OF ACCOUNTING POLICIES

These financial statements have been prepared in accordance with applicable Accounting Standards in the United Kingdom. A summary of the principal accounting policies is set out below. These have been applied consistently throughout the current and preceding periods, with the exception of accounting for dividends, as a result of the adoption of FRS 21 (see 1b below).

(a) Basis of accounting

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

(b) Prior year adjustment

The company has adopted FRS 21 'Events after the Balance Sheet Date' in these financial statements. Dividends are now accrued where an obligation exists at the balance sheet date. Consequently, dividends which the company approves in a general meeting after the balance sheet date are no longer accrued, but are required to be disclosed in the notes to the financial statements (see notes 9,16 and 25). The prior year comparative figures have been restated to reflect the dividends paid in that year, in accordance with the first year adoption requirements of FRS 21.

(c) Turnover

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

(d) Cash flow statement

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

(e) Tangible fixed assets and depreciation

Tangible fixed assets comprise:

(i) Infrastructure assets

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

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

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

The depreciation charge for infrastructure assets is based on the company's independently certified asset management plan which has estimated the level of expenditure required over the next ten years to maintain the operating capability of the network.

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(e) Tangible fixed assets and depreciation (continued)

(ii) Non-infrastructure assets

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

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.

(f) 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.

(g) 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.

(h) 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.

(i) Pension costs

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

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

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(j) Taxation

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

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

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

As permitted by FRS19, the company has decided to adopt a policy of discounting deferred tax assets and liabilities to reflect the time value of money over the period between the balance sheet date and the dates on which it is estimated that the underlying timing differences will reverse. The discount rates used reflect the post-tax yields to maturity that can be obtained at the balance sheet date on UK government bonds with similar maturity dates to those of the deferred tax assets or liabilities.

(k) 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.

(l) Research and development

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

(m) Investments

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

(n) 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.

(o) Liquid resources

Liquid resources comprise external deposits.

1. STATEMENT OF ACCOUNTING POLICIES (continued)

(p) 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.

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:

| | 2006 | 2005 |
|---------------------------|--------|--------|
| | £'m | £'m |
| Materials and consumables | 14.9 | 14.8 |
| Other external charges | 56.7 | 54.5 |
| Manpower costs (note 7a) | 81.9 | 73.5 |
| Other operating charges | 96.9 | 94.7 |
| Own work capitalised | (22.0) | (19.0) |
| | 228.4 | 218.5 |

(b) Capital maintenance costs comprise:

| | 2006 | 2005 |
|---|-------|-------|
| | £'m | £'m |
| Depreciation: | | |
| Non-infrastructure assets | 61.5 | 56.6 |
| Non-infrastructure assets held under finance leases | 3.9 | 2.9 |
| Infrastructure assets | 32.9 | 30.1 |
| Amortisation of capital grants and contributions | (3.5) | (3.7) |
| (Profit) / loss on disposal of fixed assets | (1.6) | 1.9 |
| | 93.2 | 87.8 |

(c) Profit on ordinary activities before taxation:

| | 2006 | 2005 |
|---|------|-----------------|
| | £'m | restated £'m |
| Profit on ordinary activities before taxation is stated after charging: | | |
| Auditors remuneration: Audit fees | 0.2 | 0.2 |
| Non-audit fees | 0.1 | 0.1 |
| Operating leases: Plant and machinery | 0.1 | 0.1 |
| Other assets | 0.8 | 0.8 |
| Costs of research and development | 2.3 | 5.0 |
| Directors' emoluments (note 5) | 1.0 | 0.9 |

Auditor's remuneration in respect of the statutory audit amounted to £91,917 (2005: £91,000). Auditors' remuneration for the regulatory audit amounted to £15,405 (2005: £15,000). Fees of £26,702 and £12,324 (2005: £26,000 and £12,000) were also incurred in the auditing of RAG 5 information and the June Return respectively.

4. NET INTEREST PAYABLE

| | 2006 | 2005 |
|--|-------|-------|
| | £'m | £'m |
| Net interest payable comprises: | | |
| Interest payable: | | |
| Bank loans and overdrafts | 19.7 | 23.3 |
| Group loans | 66.4 | 57.6 |
| Debenture stock interest | 0.5 | 1.0 |
| Financing charges payable under finance leases | 3.0 | 3.0 |
| Total interest payable | 89.6 | 84.9 |
| Interest receivable: | | |
| Group interest | (9.9) | (8.8) |
| External interest | (2.0) | (2.9) |
| Gain on interest rate hedge | - | (4.3) |
| Net interest payable | 77.7 | 68.9 |

5. DIRECTORS' EMOLUMENTS AND INTERESTS

(a) Directors' remuneration

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

| | 2006 | 2005 restated |
|---|-------|------------------|
| | £'000 | £'000 |
| Emoluments (including benefits in kind) | 991.3 | 906.6 |

For those directors holding office with both NWL and NWG, costs are apportioned between the companies. This note reflects only the proportion of costs charged to NWL. Four of the directors at 31 March 2006 were members of a defined benefit pension scheme where the company makes contributions towards the cost (March 2005: 4).

The directors who held office at 31 March 2006 had no interest in the shares of the company.

The directors who held office as at 31 March 2006 had the following interests in the debentures of the Company's immediate parent company, Northumbrian Services Limited (NSL):

| Name of Director | Class of Debentures | Amount of debentures held as at 1 April 2005 | Amount of debentures held as at 31 March 2006 |
|------------------|----------------------|---|---|
| J A Cuthbert | 8.625% bonds 28/6/06 | 40,000 | 40,000 |
| C M Green | 8.625% bonds 28/6/06 | 25,000 | 25,000 |

The directors who held office as at 31 March 2006 had the following interests in the Ordinary 10p shares of the Group:

| Name of Director | Class of Shares | Number of shares held as at 1 April 2005 or subsequent date of appointment | Number of shares held as at 31 March 2006 |
|--------------------|-----------------|---|--|
| †Sir A P Brown | Ordinary 10p | 43,000 | 43,000 |
| J A Cuthbert | Ordinary 10p | 100,000 | 100,000 |
| C M Green | Ordinary 10p | 65,000 | 65,000 |
| Sir F G T Holliday | Ordinary 10p | 8,700 | 8,700 |
| A C Jones | Ordinary 10p | 4,433 | 4,433 |
| †M A B Nègre | Ordinary 10p | 190,000 | 190,000 |
| †Sir D Wanless | Ordinary 10p | 30,000 | 30,000 |
| †J M Williams | Ordinary 10p | 6,000 | 6,000 |

†Appointed on 1 January 2006.

5. DIRECTORS' EMOLUMENTS AND INTERESTS (continued)

(a) Directors' remuneration (continued)

The directors who held office as at 31 March 2006 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 | Class of Shares | Number of shares held as at 1 April 2005 | Number of shares held as at 31 March 2006 | Number of shares held as at 6 June 2006 |
|------------------|-----------------|--|---|---|
| J A Cuthbert | Ordinary 10p | 1,716 | 2,780 | 3,565 |
| C M Green | Ordinary 10p | 1,716 | 2,780 | 3,565 |
| A C Jones | Ordinary 10p | 1,716 | 2,780 | 3,565 |

The directors who held office as at 31 March 2006 held the following conditional interests in Ordinary 10p shares of the Group, awarded in accordance with the terms of its Long Term Incentive Plan:

| Name of Director | Award date | Awards held at the start of the year or subsequent date of appointment | Awarded during the year | Awards vested/lapsed during the year | Awards held as at 31 March 2006 |
|------------------|-------------------------|--|-------------------------|--------------------------------------|---------------------------------|
| J A Cuthbert | 27.1.04 ⁽¹⁾ | 85,603 | | | |
| | 22.12.04 ⁽²⁾ | 67,001 | | | |
| | 9.12.05 ⁽³⁾ | | 75,903 | - | |
| Totals | | 152,604 | 75,903 | - | 228,507 |
| C M Green | 27.1.04 ⁽¹⁾ | 56,618 | | | |
| | 22.12.04 ⁽²⁾ | 44,221 | | | |
| | 9.12.05 ⁽³⁾ | | 50,602 | - | |
| Totals | | 100,839 | 50,602 | - | 151,441 |
| A C Jones | 27.1.04 ⁽¹⁾ | 22,463 | | | |
| | 22.12.04 ⁽²⁾ | 20,100 | | | |
| | 9.12.05 ⁽³⁾ | | 26,506 | - | |
| Totals | | 42,563 | 26,506 | - | 69,069 |
| G Neave | 27.1.04 ⁽¹⁾ | 40,000 | | | |
| | 22.12.04 ⁽²⁾ | 25,125 | | | |
| | 9.12.05 ⁽³⁾ | | 32,530 | - | |
| Totals | | 65,125 | 32,530 | - | 97,655 |

Notes

- 1) The market value of the shares on the date of the award was 113.5 pence per share. The three year performance period runs from 1 October 2003 to 30 September 2006.
- 2) The market value of the shares on the date of the award was 174.5 pence per share. The three year performance period runs from 1 October 2004 to 30 September 2007.
- 3) The market value of the shares on the date of the award was 249.16 pence per share. The three year performance period runs from 1 October 2005 to 30 September 2008.

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

5. DIRECTORS' EMOLUMENTS AND INTERESTS (continued)

(a) Directors' remuneration (continued)

As at 31 March 2006, no directors hold any other interests required to be disclosed, in accordance with Schedule 7 of the Companies Act 1985.

(b) Highest paid director

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

| | 2006 | 2005 restated |
|---|--------------|------------------|
| | £'000 | £'000 |
| Emoluments (including benefits in kind) | <u>278.5</u> | <u>250.8</u> |

The accrued pension entitlement under the company's defined benefit scheme of the highest paid director at 31 March 2006 was £125,900 (31 March 2005: £108,687).

6. TRANSACTIONS WITH DIRECTORS AND OFFICERS

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

7. EMPLOYEE INFORMATION

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

| | 2006 | 2005 |
|---|-------------|-------------|
| | £'m | £'m |
| Costs charged to the profit and loss account: | | |
| Wages and salaries | 50.3 | 46.5 |
| Social security costs | 4.2 | 4.3 |
| Other pension costs | 5.8 | 4.3 |
| | <u>60.3</u> | <u>55.1</u> |
| Costs charged to capital schemes: | | |
| Wages and salaries | 18.0 | 15.6 |
| Social security costs | 1.5 | 1.4 |
| Other pension costs | 2.1 | 1.4 |
| | <u>21.6</u> | <u>18.4</u> |
| Total employee costs | <u>81.9</u> | <u>73.5</u> |

(b) The average monthly number of employees on the payroll during the financial year was as follows:

| | 2006 | 2005 |
|-------------------------|--------------|--------------|
| | Number | Number |
| Average during the year | <u>2,541</u> | <u>2,475</u> |
| Total at the year end | <u>2,553</u> | <u>2,529</u> |

8. TAXATION

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

| | 2006 | 2005 |
|---|-------|--------|
| | £'m | £'m |
| Current tax: | | |
| UK corporation tax on profits for the year at 30% (2005:30%) | 15.6 | 3.0 |
| Adjustments in respect of prior periods | (0.6) | 3.2 |
| Payable in respect of group relief for the current year at 30% (2005:30%) | 10.3 | 7.1 |
| Adjustments in respect of prior years | 0.6 | - |
| Total current tax charge (note 8b) | 25.9 | 13.3 |
| Deferred tax: | | |
| Origination and reversal of timing differences in the year | 18.3 | 27.5 |
| Adjustments in respect of prior periods | 0.7 | (4.1) |
| | 19.0 | 23.4 |
| (Decrease) / increase in discount | 9.8 | (10.9) |
| Total deferred tax (note 22) | 28.8 | 12.5 |
| Tax on profit on ordinary activities | 54.7 | 25.8 |

Tax losses have provisionally been claimed from other Group companies in the current year of £33.0m (2005: £22.5m) for which payment will be made at the rate of 30% (2005:30%).

Post-tax yields on UK government gilts have fallen during the year such that the total discount on deferred tax has reduced (note 22).

(b) Factors affecting the tax charge for the financial year:

The tax assessed for the year is lower than the standard rate of corporation tax in the UK (30%) (2005: 30%). The differences are explained below:

| | 2006 | 2005 |
|---|--------|--------|
| | £'m | £'m |
| Profit on ordinary activities before tax | 151.2 | 129.1 |
| Profit on ordinary activities multiplied by standard rate of UK corporation tax 30% (2005: 30%) | 45.4 | 38.7 |
| Effects of: | | |
| Expenses not deductible for tax purposes | 0.3 | 0.3 |
| Non-taxable income | (2.6) | (2.5) |
| Depreciation in respect of non-qualifying items | 1.1 | 1.1 |
| Capital allowances in excess of depreciation | (19.2) | (26.2) |
| Other timing differences | 0.9 | (1.4) |
| Adjustments in respect of previous years | - | 3.3 |
| Transfer pricing adjustments | (0.4) | (0.4) |
| Balancing payment payable | 0.4 | 0.4 |
| Current tax charge (note 8a) | 25.9 | 13.3 |

8. TAXATION (continued)

(c) Factors that may affect future tax charges:

The company expects to continue to incur high levels of capital expenditure and to be able to claim capital allowances in excess of depreciation for the remainder of the current regulatory period. The annual excess is expected to reduce, resulting in increased current tax charges, as tax deductions for deferred revenue expenditure move to a depreciation basis (as set out in HM Revenue and Customs' Tax Bulletin 53).

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

| | 2006 | 2005 |
|---|-------------|-----------------|
| | £'m | Restated £'m |
| Equity: | | |
| Dividends paid: | | |
| Final paid for the year ended 31 March 2005 of 20.95p (12 months to December 2003: 34.41p) per share on an aggregated basis | 25.7 | 42.2 |
| Final paid for 3 months ended 31 March 2004 of 17.21p per share on an aggregated basis | - | 21.1 |
| Interim paid of 30.07p (2005: 34.16p) per share on an aggregated basis | 36.9 | 41.9 |
| Total dividends paid in the year | <u>62.6</u> | <u>105.2</u> |
| Dividends proposed: | | |
| Final proposed for year ended 31 March 2006 of 30.07p (year ended 31 March 2005: 20.95p) per share on an aggregated basis | <u>36.9</u> | <u>25.7</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 maintained its policy of steady real growth per annum for the appointed business dividend and has also re-based the dividend in line with Ofwat's assumptions for dividends in the final determination. Dividends from the non-appointed business are determined by the directors and are based on performance.

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

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

10. TANGIBLE FIXED ASSETS

| | Freehold land and buildings | Infra- structure assets | Operational structures, plant and machinery | Fixtures, fittings, tools and equipment | Assets in the course of construction | Total |
|----------------------------------|-----------------------------------|-------------------------------|--|--|--|---------|
| | £'m | £'m | £'m | £'m | £'m | £'m |
| Cost: | | | | | | |
| At 1 April 2005 | 86.4 | 1,478.6 | 1,651.5 | 134.1 | 74.7 | 3,425.3 |
| Additions | - | - | - | - | 226.9 | 226.9 |
| Schemes commissioned | 0.7 | 93.0 | 103.0 | 11.6 | (208.3) | - |
| Reclassifications | (1.2) | 15.8 | 16.2 | (22.9) | (7.3) | 0.6 |
| Disposals | (0.2) | (12.1) | (0.5) | 0.1 | - | (12.7) |
| At 31 March 2006 | 85.7 | 1,575.3 | 1,770.2 | 122.9 | 86.0 | 3,640.1 |
| Depreciation: | | | | | | |
| At 1 April 2005 | 27.0 | 177.9 | 397.5 | 84.2 | - | 686.6 |
| Charge for year | 1.4 | 32.9 | 58.7 | 5.3 | - | 98.3 |
| Reclassifications | - | 0.9 | - | - | - | 0.9 |
| Disposals | (0.6) | (12.1) | 0.3 | (0.1) | - | (12.5) |
| At 31 March 2006 | 27.8 | 199.6 | 456.5 | 89.4 | - | 773.3 |
| Net book value: | | | | | | |
| At 31 March 2006 | 57.9 | 1,375.7 | 1,313.7 | 33.5 | 86.0 | 2,866.8 |
| At 31 March 2005 | 59.4 | 1,300.7 | 1,254.0 | 49.9 | 74.7 | 2,738.7 |
| Leased assets included above: | | | | | | |
| Net book value | | | | | | |
| At 31 March 2006 | - | 2.2 | 24.0 | - | - | 26.2 |
| At 31 March 2005 | - | 2.2 | 25.9 | 0.3 | - | 28.4 |

11. FIXED ASSET INVESTMENTS

| | <u>Loans to Group Companies</u> |
|-----------------------------------|-------------------------------------|
| | £'m |
| At 1 April 2005 and 31 March 2006 | <u>160.6</u> |

In May 2004 NWL made a loan of £159.0m to NSL, maturing in January 2034.

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>2006</u> | <u>2005</u> |
|-------------------------------|-------------|-------------|
| | £'m | £'m |
| Raw materials and consumables | 2.8 | 3.0 |

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>2006</u> | <u>2005</u> |
|---------------------------------------|--------------|-------------|
| | £'m | £'m |
| Trade debtors | 48.4 | 52.1 |
| Amounts owed by other group companies | 4.2 | 4.7 |
| Other debtors | 6.6 | 6.5 |
| Prepayments and accrued income | 43.6 | 35.4 |
| | <u>102.8</u> | <u>98.7</u> |

Trade debtors are shown net of bills raised in advance.

14. DEBTORS DUE IN MORE THAN ONE YEAR

| | <u>2006</u> | <u>2005</u> |
|---------------------|-------------|-------------|
| | £'m | £'m |
| Interest rate hedge | 3.6 | - |

15. INVESTMENTS

| | <u>2006</u> | <u>2005</u> |
|----------------------------------|-------------|-------------|
| | £'m | £'m |
| Short term loan to group company | 57.7 | - |

16. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

| | <u>2006</u> | <u>2005</u> restated |
|--|--------------|-------------------------|
| | £'m | £'m |
| Obligations under finance leases (note 20) | 4.5 | 4.5 |
| Loans (note 18) | 29.2 | 18.9 |
| Debenture stock (note 19) | - | 5.7 |
| Trade creditors | 7.8 | 10.2 |
| Amounts owed to other group companies | 15.1 | 111.0 |
| Taxation and social security | 1.7 | 1.1 |
| Corporation tax | 9.7 | 1.1 |
| Other creditors | 11.2 | 12.2 |
| Receipts in advance | 18.7 | 17.6 |
| Accruals and deferred income | 84.0 | 57.5 |
| | <u>181.9</u> | <u>239.8</u> |

Accruals and deferred income includes accruals related to capital projects of £33.2m (2005: £27.5m). Amounts owed to other group companies include amounts related to capital projects of £nil (2005: £3.9m).

Included in amounts owed to other group companies is £10.1m (2005: £7.1m) payable in respect of tax losses surrendered from fellow group companies. Also included in amounts owed to other group companies is £nil (2005 £71.5m) relating to loans repayable within one year (note 21).

The restatement of the prior year relates to the adjustment under FRS 21 of £25.7m in respect of dividends payable.

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

| | <u>2006</u> | <u>2005</u> |
|--|----------------|----------------|
| | £'m | £'m |
| Obligations under hire purchase contracts and finance leases (note 20) | 56.7 | 57.3 |
| Loans (note 18) | 276.0 | 305.2 |
| Debenture stocks (note 19) | - | 3.5 |
| Amounts owed to other group companies (note 21) | 1,207.3 | 996.2 |
| Other creditors | 0.3 | 0.7 |
| | <u>1,540.3</u> | <u>1,362.9</u> |

18. LOANS

| | <u>2006</u> | <u>2005</u> |
|---------------------------------|--------------|--------------|
| | £'m | £'m |
| Loans are repayable as follows: | | |
| Within one year (note 16) | 29.2 | 18.9 |
| Between one and two years | 20.0 | 29.2 |
| Between two and five years | 131.2 | 133.6 |
| After five years | 124.8 | 142.4 |
| | <u>305.2</u> | <u>324.1</u> |

Loans wholly repayable by instalments repayable within 5 years amount to £6.3m (2005: £14.9m). Loans repayable by instalments not wholly repayable within 5 years amount to £208.9m (2005: £219.2m) and bear interest rates in the range of 4.74% to 8.55% of which £84.2m (2005: £76.8m) falls due in less than 5 years and £124.7m (2005: £142.4m) falls due after more than 5 years.

Loans repayable otherwise than by instalments which fall due in less than 5 years amount to £90.0m (2005: £90.0m) and bear interest at rates in the range of 4.70% to 4.77%.

19. DEBENTURE STOCKS

| | <u>2006</u> | <u>2005</u> |
|--|-------------|-------------|
| | £'m | £'m |
| Debenture stocks are repayable as follows: | | |
| Total due in less than one year | - | 5.7 |
| Between two and five years £1, 11.2% Redeemable 2006/09 | - | 3.5 |
| Total due in more than one year | - | 3.5 |
| At 31 March | <u>-</u> | <u>9.2</u> |

Apart from £9,672 of irredeemable debentures, all other debentures were repaid during the year.

20. OBLIGATIONS UNDER FINANCE LEASES

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

| | 2006 | 2005 |
|--|--------|--------|
| | £'m | £'m |
| Amounts due: | | |
| Within one year | 4.5 | 4.5 |
| Between one and two years | 4.3 | 4.0 |
| Between two and five years | 13.3 | 12.1 |
| After five years | 58.0 | 62.3 |
| | 80.1 | 82.9 |
| Less: | | |
| Finance charge allocated to future periods | (18.9) | (21.1) |
| | 61.2 | 61.8 |
| Disclosed as due: | | |
| Within one year (note 16) | 4.5 | 4.5 |
| After more than one year (note 17) | 56.7 | 57.3 |
| | 61.2 | 61.8 |

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 £80.1m (2005: £82.5m).

21. AMOUNTS DUE TO OTHER GROUP COMPANIES

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

| | 2006 | 2005 |
|------------------|---------|---------|
| | £'m | £'m |
| Within one year | - | 71.5 |
| After five years | 1,207.3 | 996.2 |
| | 1,207.3 | 1,067.7 |

On 31 March 2006, NWF was substituted as issuer for NSL in relation to £350.0m guaranteed Eurobonds maturing in February 2023 with an annual coupon of 6.875%. This substitution took effect following agreement reached at a bondholders meeting held on 31 March 2006. £200.0m Guaranteed Eurobonds were issued in February 1998 and a further £150.0m Guaranteed Eurobonds were issued in September 2001, maturing 6 February 2023, with an annual coupon of 6.875%. The issues were guaranteed by the company who received the issue proceeds by way of inter-company loans of £194.2m and £156.2m respectively. Finance costs allocated during the year amounted to £0.2m (2005: £0.2m). Amortisation of loan issue receipts during the year amounted to £0.3m (2005: £0.3m). Finance costs incurred for the substitution of NWF as issuer amounted to £0.3m.

NWF issued £300.0m Guaranteed Eurobonds in December 2001, maturing October 2017, with an annual coupon of 6.0%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan. Amortisation of loan receipts during the year amounted to £0.1m (2005: £0.1m).

NWF issued £250.0m Guaranteed Eurobonds during December 2002, maturing April 2033, with an annual coupon of 5.625%. NWF issued a further £100.0m Guaranteed Eurobonds during December 2004, maturing April 2033, with an annual coupon of 5.625%. Both issues were guaranteed by the company who received the issue proceeds by way of an inter-company loan. Finance costs allocated during the year amounted to £0.2m (2005: £0.1m).

21. AMOUNTS DUE TO OTHER GROUP COMPANIES (continued)

NWF issued £150.0m Guaranteed Index Linked Eurobonds in September 2005, maturing July 2036, with a real coupon of 2.033%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan. Indexation accretion during the year amounted to £2.6m.

NWF issued £60.0m Guaranteed Index Linked Eurobonds in January 2006, maturing January 2041, with a real coupon of 1.6274%. The issue was guaranteed by the company who received the issue proceeds by way of an inter-company loan. Indexation accretion during the year amounted to £0.1m.

22. PROVISIONS FOR LIABILITIES AND CHARGES

| | £'m |
|--|-------------|
| Pension provision for former directors: | |
| At 1 April 2005 | 3.0 |
| Transferred from profit and loss account | 0.7 |
| Utilised during the year | (0.3) |
| | <hr/> |
| At 31 March 2006 | 3.4 |
| Severance provision: | |
| At 1 April 2005 | 0.4 |
| Released unused to profit and loss account | (0.4) |
| | <hr/> |
| At 31 March 2006 | - |
| Deferred tax : | |
| At 1 April 2005 | 172.5 |
| Movement in the year (note 8a) | 28.8 |
| | <hr/> |
| At 31 March 2006 | 201.3 |
| | <hr/> |
| Provisions for liabilities and charges | 204.7 |
| | <hr/> <hr/> |

The pension provision for former directors relates to pensions payable to former directors of water-only companies which have since merged with the company. The provision of £3.4m represents the full future amounts payable, based on an actuarial assessment, for which the company is directly liable.

The provision for deferred tax comprises:

| | 2006 | 2005 |
|---|-------------|-------------|
| | £'m | £'m |
| Accelerated capital allowances | 524.1 | 504.2 |
| Other timing differences | (53.8) | (52.9) |
| Undiscounted provision for deferred tax | 470.3 | 451.3 |
| Discount | (269.0) | (278.8) |
| Discounted provision for deferred tax | 201.3 | 172.5 |
| | <hr/> <hr/> | <hr/> <hr/> |

23. ACCRUALS AND DEFERRED INCOME

| | Capital grants and contributions | Proceeds from Kielder Securitisation | Total |
|---------------------------|--|--|--------------|
| | £'m | £'m | £'m |
| At 1 April | 156.8 | 205.6 | 362.4 |
| Additions | 21.5 | - | 21.5 |
| Amortised during the year | (3.5) | (7.1) | (10.6) |
| At 31 March | <u>174.8</u> | <u>198.5</u> | <u>373.3</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 transaction.

24. CALLED UP SHARE CAPITAL

| | 2006 | 2005 |
|--|--------------|--------------|
| | £'m | £'m |
| Authorised: | | |
| 122,650,000 Ordinary Shares of £1 each (2005: 122,650,000) | <u>122.7</u> | <u>122.7</u> |
| | 2006 | 2005 |
| | £'m | £'m |
| Allotted, called-up and fully paid: | | |
| 122,650,000 Ordinary Shares of £1 each (2005: 122,650,000) | <u>122.7</u> | <u>122.7</u> |

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

| | Profit and loss account | Total share- holders' funds |
|---------------------------------------|----------------------------|--------------------------------|
| | £'m | £'m |
| At 31 March 2004 as previously stated | 678.0 | 800.7 |
| Prior year adjustment (note 9) | 63.3 | 63.3 |
| At 31 March 2004 restated | <u>741.3</u> | <u>864.0</u> |
| Profit for the year | 103.3 | 103.3 |
| Dividends paid as restated (note 9) | (105.2) | (105.2) |
| At 31 March 2005 restated | <u>739.4</u> | <u>862.1</u> |
| Profit for the year | 96.5 | 96.5 |
| Dividends paid (note 9) | (62.6) | (62.6) |
| At 31 March 2006 | <u>773.3</u> | <u>896.0</u> |

As stated in note 1b, reserves have been restated in respect of FRS 21 to remove dividends declared but not paid in the year.

26. COMMITMENTS

(a) Capital expenditure:

| | 2006 | 2005 |
|---|------|------|
| | £'m | £'m |
| Expenditure contracted for but not provided for | 96.8 | 82.4 |

(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:-

| | 2006 | 2005 |
|-----------------------|------|------|
| | £'m | £'m |
| Land and buildings: | | |
| Leases which expire: | | |
| Within one year | 0.1 | 0.1 |
| In five years or more | 0.5 | 0.5 |
| | 0.6 | 0.6 |
| | 2006 | 2005 |
| | £'m | £'m |
| Other: | | |
| Leases which expire: | | |
| Within one year | - | 0.1 |
| In five years or more | - | 0.1 |
| | - | 0.2 |

27. PENSIONS

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

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

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

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

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

27. PENSIONS (continued)

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

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

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

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

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

The employers' proposals were accepted by the NWPS Trustee.

The contributions paid to the NWPS in the year by the company totalled £14.8m, which includes £7.0m made as an advance payment.

The Group also contributes to a defined contribution scheme, the Northumbrian Water Group Personal Pension Plan (NWGPPP). Members and employers contribute 3% and 6% of salary respectively. The NWGPPP is provided by an insurance company and members have their own individual policy. There were 258 contributing members throughout the Group at 31 March 2006. The contributions paid to the NWGPPP in the year by the company totalled £0.1m. The outstanding company contributions to be paid over to the NWGPPP at 31 March 2006 totalled £nil (2005: £nil).

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

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

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

FRS 17 actuarial assumptions at 31 March:

| | Group | | |
|-------------------|-----------|-----------|-----------|
| | 2006 % | 2005 % | 2004 % |
| Pay increases | 3.6 | 3.9 | 4.0 |
| Pension increases | 2.9 | 2.9 | 3.0 |
| Price inflation | 2.9 | 2.9 | 3.0 |
| Discount rate | 4.9 | 5.4 | 5.5 |

27. PENSIONS (continued)

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

| | Long term expected rate of return 2006 | 2006 | Long term expected rate of return 2005 | 2005 | Long term expected rate of return 2004 | 2004 |
|------------------------------|--|--------------|---|---------------|---|---------------|
| | % | £'m | % | £'m | % | £'m |
| Equities | 7.2 | 452.5 | 7.7 | 373.9 | 6.8 | 335.4 |
| Corporate bonds | 4.9 | 48.4 | 5.4 | 39.7 | 5.5 | 37.7 |
| Government bonds | 4.2 | 60.5 | 4.7 | 45.2 | 4.8 | 41.8 |
| Property | 5.7 | 67.3 | 6.2 | 55.5 | 5.8 | 47.5 |
| Cash | 4.5 | 34.4 | 4.7 | 12.3 | 4.0 | 12.7 |
| Total fair value of assets | | 663.1 | | 526.6 | | 475.1 |
| Present value of liabilities | | (663.5) | | (600.2) | | (565.7) |
| Deficit | | (0.4) | | (73.6) | | (90.6) |
| Related deferred tax asset | | 0.1 | | 22.1 | | 27.2 |
| Net pension liability | | (0.3) | | (51.5) | | (63.4) |

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

| | 2006 | 2005 |
|------------------------------|------|------|
| | £'m | £'m |
| Current service cost | 12.0 | 11.8 |
| Curtailments and settlements | 0.3 | 1.2 |
| Total operating charge | 12.3 | 13.0 |

Analysis of the amount that would have been credited to net finance income under FRS 17:

| | 2006 | 2005 |
|---------------------------|--------|--------|
| | £'m | £'m |
| Expected return on assets | 36.7 | 29.9 |
| Interest on liabilities | (32.3) | (31.1) |
| Net credit / (charge) | 4.4 | (1.2) |

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

| | 2006 | 2005 |
|--|--------|-------|
| | £'m | £'m |
| Experience gains and losses arising on the liabilities | 34.0 | (4.4) |
| Changes in assumptions underlying the present value of the liabilities | (68.3) | - |
| Total experience gains and losses arising on liabilities | (34.3) | (4.4) |
| Actual return less expected return on assets | 86.8 | 28.5 |
| Actuarial gain | 52.5 | 24.1 |

27. PENSIONS (continued)

Analysis of movement in deficit during the year:

| | 2006 | 2005 |
|--|--------------|---------------|
| | £'m | £'m |
| Deficit at 1 April | (73.6) | (90.6) |
| Current service cost | (12.0) | (11.8) |
| Total other finance income | - | 0.5 |
| Actuarial gain | 52.5 | 24.1 |
| Impact of curtailments and settlements | (0.3) | (1.2) |
| Other | - | (0.9) |
| Net return | 4.4 | (1.2) |
| Contributions | 28.6 | 7.5 |
| Deficit at 31 March | <u>(0.4)</u> | <u>(73.6)</u> |

History of experience gains and losses:

| | Year to 31.3.2006 | Year to 31.3.2005 | 15 months to 31.3.2004 | Year to 31.12.2002 |
|--|----------------------|----------------------|---------------------------|-----------------------|
| Difference between the expected and actual return on assets: | | | | |
| Amount (£m) | 86.8 | 28.5 | 30.4 | 67.1 |
| Percentage of assets | <u>13.1%</u> | <u>5.4%</u> | <u>6.4%</u> | <u>17.3%</u> |
| Total experience gains and losses on liabilities: | | | | |
| Amount (£m) | (34.0) | (4.4) | 8.0 | (52.1) |
| Percentage of the present value of liabilities | <u>(5.1%)</u> | <u>(0.7%)</u> | <u>1.4%</u> | <u>(1.2%)</u> |
| Total actuarial gain recognised in the statement of total recognised gains and losses: | | | | |
| Amount (£m) | 52.5 | 24.1 | 37.6 | (141.8) |
| Percentage of the present value of liabilities | <u>7.9%</u> | <u>4.0%</u> | <u>6.7%</u> | <u>(30.5%)</u> |

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

29. ULTIMATE PARENT COMPANY

NWG, 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.