NORTHUMBRIAN WATER GROUP

Annual report and financial statements 2010

Northumbrian Water Group plc
is an independent company quoted on the FTSE 250 Index of the London Stock Exchange. The Group principally works in the provision of water supply and waste water services.

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

Contents

Highlights

Revenue:
(2009: £694.1m)

£704.7m

Profit before interest:
(2009: £273.6m)

£275.8m

Profit before tax:
(2009: £152.7m)

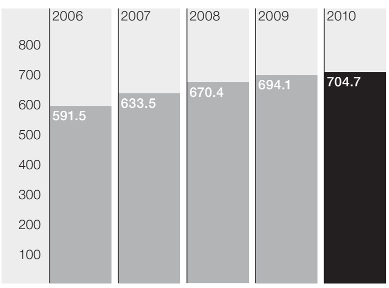
£170.2m

Profit/(loss) for the year:
(2009: (£11.9m))

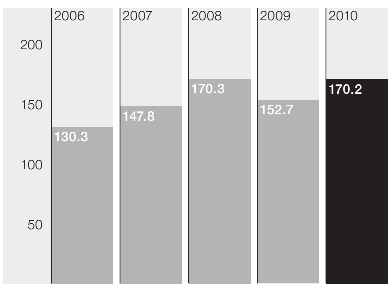
£122.9m

- Revenue increase mainly reflects the uplift in tariffs to support ongoing high capital investment
- Continued high levels of customer satisfaction
- Decreased interest charges reflecting lower RPI on index linked bonds (£29.0 million), offset by increased pension financing costs (£10.3 million) and higher net interest payable (£3.1 million)
- Entire electricity requirement procured through to March 2015
- Funds in place to meet all the requirements of the business to the end of 2011 (cash and short term deposits at 31 March 2010 £189.1 million)
- Capital investment in the period of £207.6 million (2009: £228.9 million) on regulatory outputs, including an extended sewer flooding programme
- Started work to increase capacity at Abberton Reservoir in Essex
- Proposed final dividend of 8.85 pence (2009: 8.50 pence) per share to be paid on 10 September 2010, giving a full year ordinary dividend of 13.24 pence (2009: 12.79 pence) per share, an increase of 3.5%
- The conclusion and acceptance of the price review to March 2015; current progressive dividend policy with annual real growth of 3% continues over next regulatory period

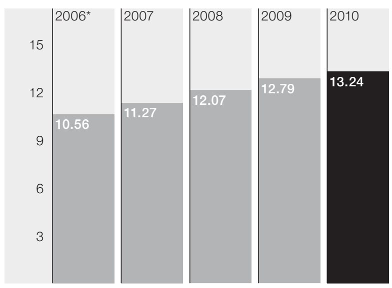
Revenue £m



Profit before tax £m



Dividend per share pence

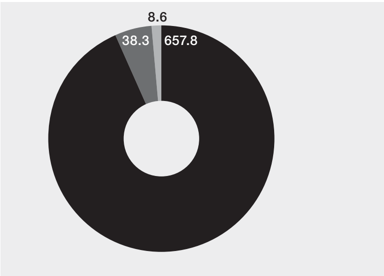


*2006 excludes special dividend of 2.82 pence.

NWG at a glance

Our mission is to be the national leader in the provision of sustainable water and waste water services.

NWG revenue £m



Northumbrian Water Group plc

Northumbrian Water Group plc (NWG or the Company) owns a number of companies which, together with NWG, form the Group. The largest of these companies, Northumbrian Water Limited (NWL), is one of the 10 regulated water and sewerage businesses in England and Wales. The emphasis given to NWL throughout this report, reflects its importance to the overall performance of the Group.

Northumbrian Water Limited

NWL operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water. Northumbrian Water currently provides water and sewerage services to 2.7 million people and Essex & Suffolk Water provides water services to 1.8 million people.

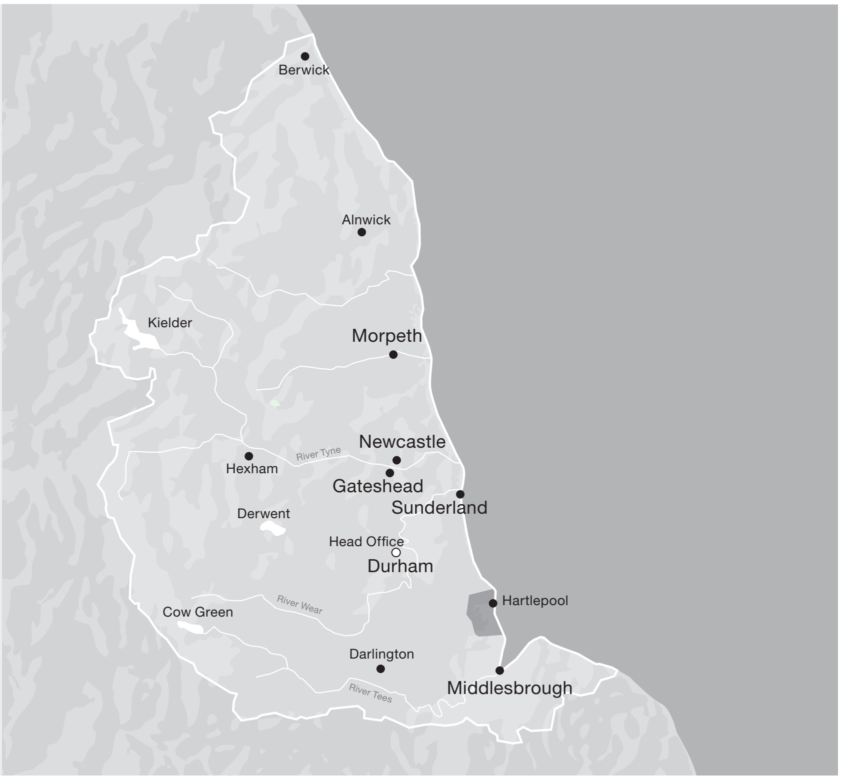
Water and waste water contracts

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

Other

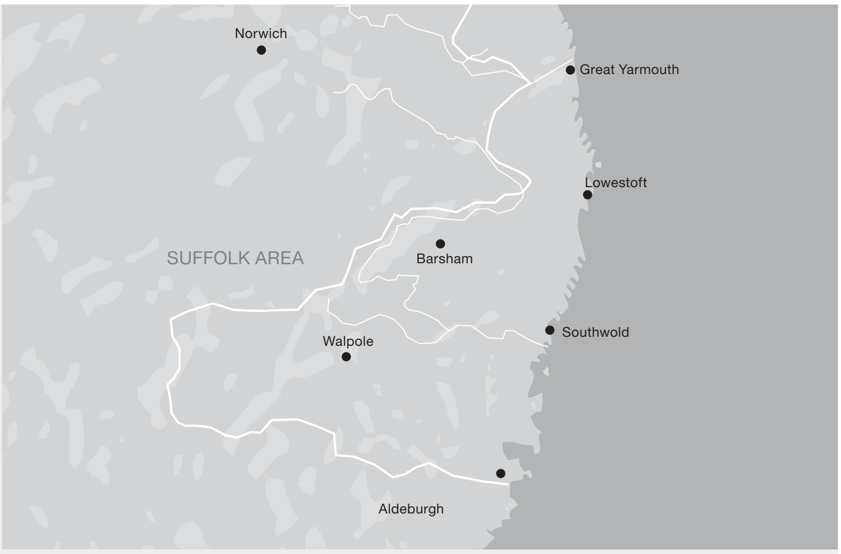
SA Agrer NV (Agrer) carries out project work in developing countries through a number of overseas aid funded agencies.

North east England
Northumbrian Water provides water and sewerage services to 2.7 million people in the north east of England. The major population centres of Tyneside, Wearside and Teesside are in our area but we also serve large rural areas in Northumberland and County Durham (provision of waste water services only in Hartlepool).



South east England
Essex & Suffolk Water provides water services to two separate supply areas. We serve a population of 0.3 million in our Suffolk area, which is mainly rural with the biggest towns being Great Yarmouth and Lowestoft.

Our Essex area, which has a population of 1.5 million, is part rural and part urban with the main areas of population being in Chelmsford, Southend and the London Boroughs of Barking and Dagenham, Havering and Redbridge.



Measuring performance

NWL performance against non-financial KPIs summary (unaudited)

	North (N) South (S)	Target 2010/11	Target 2009/10	Target achieved	Performance Current year	Performance Previous year
Customer satisfaction						
Overall service (%)	N/S	91	90	✗	88	88
Value for money (%)	N/S	87	85	✗	83	84
Customer – levels of service						
Properties at risk of low pressure	N	256	274	✓	260	271
	S	55	126	✓	40	40
Properties subject to unplanned interruption of six hours or more	N	1,700	3,000	✗	8,671[1]	8,278
	S	1,100	2,000	✓	1,434	3,353
Properties subject to hosepipe bans at any time during the year	N/S	0	0	✓	0	0
Properties subject to sewer flooding (other causes)	N	150	150	✗	281	286
Properties at risk of sewer flooding (once in 10 years or twice in 10 years)	N	688	76	✗	397	559
Billing contacts responded to (within five working days) (%)	N	99.3	99.2	✓	99.4	99.2
	S	99.3	99.2	✓	99.4	99.6
Written complaints responded to (within 10 working days) (%)[2]	N	n/a	99.8	✓	99.9	99.9
	S	n/a	99.8	✓	99.9	99.7
Bills based on meter readings (%)	N	99.9	99.95	✗	99.92	99.90
	S	99.9	99.95	✗	99.93	99.95
All telephone lines busy (%)[2]	N	n/a	0.05	✗	0.17	0.07
	S	n/a	0.25	✓	0.07	0.06
Abandoned telephone calls (%)[2]	N	n/a	3.00	✗	7.43	3.43
	S	n/a	2.00	✗	4.31	1.95
Water						
DWI Mean Zonal Compliance (%)	N	99.85	99.90	✓	99.91	99.92
	S	99.95	99.98	✗	99.82	99.99
DWI Operational Performance Index (%)	N	99.65	99.65	✗	99.58	99.67
	S	99.98	99.98	✗	99.97	99.98
Distribution Maintenance Index (%)	N	99.70	99.70	✗	99.21	99.52
	S	99.85	99.85	✓	99.94	99.96
Environment						
Sewage treatment works (%)	N	100	99.7	✓	100	100
Bathing waters Mandatory Standard (%)	N	100	100	✓	100	100
Pollution incidents (category 1, 2 and 3)	N	102	89	✗	114	94
Employees						
Employee turnover (rolling %)[3]	N/S	–	Industry average 9.2	–	6.5	6.4
Lost time reportable accidents (per 1,000 employees)	N/S	4.3	10	✓	5.7	6
Sickness absence (%)	N/S	2.85	2.85	✗	3.18	2.94

Notes:
1. Performance affected by two major bursts in Tyne & Wear and Northumberland.
2. New Service Incentive Mechanism (SIM) measures have been introduced by Ofwat for 2010/11. These are being piloted and monitored during 2010/11, whereupon appropriate targets will be set.
3. No target set, data for information.

Janus Chairs, Kielder Water & Forest Park

Chairman's statement

Sir Derek Wanless, Chairman

The water industry cannot be immune from economic difficulties facing the UK. This year brought us the challenges of falling industrial demand, volatile energy costs and greater difficulty in recovering customer debt. But, as the detail in this report shows, the Group again performed well.

Ofwat confirmed price limits for the period 2010-15 in November in response to our Business Plan, which reflected closely the views of customers and other stakeholders. The Board considered carefully whether to refer Ofwat's decision to the Competition Commission. We concluded not to do so and will tackle the challenges set. These include achieving significant operational efficiencies. As a heavily regulated business, we must continue to balance the interests of all of our stakeholders and we will seek innovative ways to deliver services efficiently while ensuring they remain affordable and sustainable.

For our customers, our £1.2 billion investment plan will allow us to tackle important infrastructure developments and maintenance. In Essex, after approvals from the Environment Agency and planning authorities, work on the expansion of Abberton Reservoir began. At a cost of £150 million it will secure supplies into the future.

For our shareholders, we expect to be able to continue to maintain our progressive dividend policy with annual growth of 3%, before inflation, over the next regulatory period. We have achieved that growth rate in recent years and are recommending it again this year, despite the impact of the recession.

The conclusion of the periodic pricing review gives us some certainty looking forward and our focus moves to delivering our plans. In addition to ensuring that our water resources are sufficient for likely future needs, we will also extend our work on water efficiency across the company as we strive to meet new targets for reducing per capita consumption. Essex & Suffolk Water has been a leader on water efficiency and we will build on this work and extend to the north east. The major issue for customers in the north east is sewer flooding which affects a relatively small number of customers but is a serious problem when it does occur. Changing weather patterns have increased its incidence; resolving local issues and minimising risks are key parts of the plan going forward. The investment programme will also address outstanding discoloured water issues; mains cleaning is a major part of this.

Customers are at the heart of everything we do. Customer satisfaction is again high as measured by our research alongside that of the Consumer Council for Water. Ofwat has introduced a new Service Incentive Mechanism to measure companies' performance and we are pleased that it takes more account of the quality of our customer response rather than just quantity. Getting it right first time and every time remains our prime commitment to customers.

Customer satisfaction is again high as measured by our research alongside that of the Consumer Council for Water.

The needs of customers are met by an exceptional workforce. Our People Plan is designed to ensure that we develop the skills we need for the future and this year we met our Skills Pledge with 90% of employees reaching NVQ Level 2 standard. Over 70% of our employees responded to our employee survey and our target for our Employee Satisfaction Index, which covers everything from enjoyment of the job to reward, support and care, was met. Employees regard Northumbrian Water as a great company to work for and their pride in working for us is reflected in the service we give to customers.

We continue to support the communities in which we operate. Our community involvement has received widespread acclaim, including the Queen's Award for Enterprise in the category of Sustainable Development which recognises the work of all our employees. Significant achievements include the opening, in September, of Castle View Enterprise Academy in Sunderland, where we are lead sponsor. I was delighted to open the extension to Healthworks, a health centre based on our site in Easington providing important services to that community. We are also working with partners to explore ways of funding education around the Abberton project and have set up a Community Fund to support the local area.

John Cuthbert, Managing Director, retired at the end of March and the Board wishes him well. He led a great deal of successful change in his 19 years with the company creating a business which is well placed to continue to deliver. John also made an outstanding contribution to the UK water industry.

I am delighted to welcome Heidi Mottram as our new Chief Executive Officer from 1 April 2010. She has a reputation for inspirational leadership, working well with customers, employees, communities, regulators and shareholders in a very successful career in the rail industry. The Board looks forward to working with her. She has a clear focus on the needs of our customers and will continue to improve their experience of the company as she leads it through the changes to come. She too recognises the need to work with the communities we serve. We have carefully built partnerships to ensure that our voice is heard at every level. This will be important as discussions about the framework for regulation develop in future months.

I would like to thank Jenny Williams for her six years on the Board and her wise counsel and wish her well as she retires at the end of this year's AGM. I would also like to welcome Margaret Fay who is today appointed as a non-executive director of NWG and NWL. Margaret will shortly step down as Chairman of the regional development agency, One North East, and is a welcome addition to the Board.

Sir Derek Wanless
Chairman
1 June 2010

Sir Derek Wanless with Heidi Mottram, John Cuthbert and Chris Green

Directors' report and business review

The NWG directors are pleased to present their report on the affairs of the Company, along with the audited financial statements and the auditors' report for the year ended 31 March 2010.

Directors

As at 31 March 2010, the directors of the Company were Sir Derek Wanless, Sir Patrick Brown, John Cuthbert, Heidi Mottram, Chris Green, Claude Lamoureux, Martin Nègre, Alex Scott-Barrett and Jenny Williams, who all served throughout the year, except for Heidi Mottram who was appointed on 1 March 2010.

John Cuthbert retired from the Board and as Managing Director on 31 March 2010 and Heidi Mottram took up her position as Chief Executive Officer the next day. Margaret Fay was appointed as a non-executive director of NWG and NWL on 1 June 2010.

In accordance with the Company's Articles of Association (the Articles), Heidi Mottram and Margaret Fay, having been appointed as directors by the Board since the last Annual General Meeting (AGM), will be eligible for election at this year's AGM. All other directors holding office on the day of the notice convening the AGM will retire from office and offer themselves for re-election, with the exception of Jenny Williams who will retire from office at the end of this year's AGM. The directors' biographies are set out on pages 58 and 59.

Activities

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

Hanningfield Reservoir

Business strategy


Heidi Mottram, Chief Executive Officer, at Kielder Water outlets

Strategic direction
Our strategy is to focus on the Group's core competences of water and waste water management and, through that focus, to deliver value to all of our stakeholders. Our activities and priorities continue to be directed to achieving our mission to be the national leader in the provision of sustainable water and waste water services. Our three priorities are:

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

— to ensure a stable financial profile by:
  – optimising cash flow;
  – delivering operational efficiency; and
  – securing low cost long term funds.

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

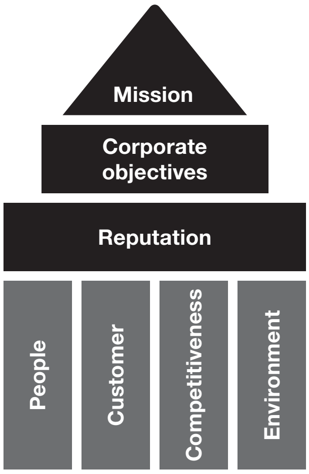
A clear framework
Our core business, NWL, has identified five key strategic themes. Four of these, People, Customer, Competitiveness and Environment, are important individually and also contribute to the fifth, Reputation. These themes underpin our drive for performance and delivery of our corporate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

People
We believe strongly that our people are the key to business success.

Customer
Customers are central to our thinking and our overriding objective is to properly understand and meet their needs.

Competitiveness
To grow our business and meet the challenges of a developing market we strive to be competitive in everything we do.

Environment
Our business is founded on water and environmental engineering and a great deal of what we do influences the environment. We seek to understand our impact on the environment and, also taking into account our impact on, and contribution to, the economy and communities in which we operate, aim always to deliver sustainable outputs from our activities.



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

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

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

Looking to the future
NWL consulted key stakeholders before publishing 'Looking to the future', our long term operational strategy for the next 25 years, in 2007. We published different versions for each of our operational areas and they have been well received by a range of stakeholders. They are available on our websites at www.nwl.co.uk and www.eswater.co.uk

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

Our long term operational strategy was produced to help inform our plans for the period 2010-15. The strategy builds on our achievements of the past 20 years and re-affirms our commitment to long term planning and investment to deliver value to all our stakeholders.

We identified three key challenges for the future:
— sustaining and, where appropriate, improving services while keeping bills affordable;
— maintaining healthy and stable finances to ensure we can continue to borrow money to meet the investment needed in the business; and
— responding to climate change by further reducing greenhouse gas emissions and future-proofing our operations.

Ofwat published a final determination of price limits for the period 2010-15 on 26 November 2009. The NWL board confirmed, on 15 December 2009, that it would not ask Ofwat to refer its decision to the Competition Commission.

Operating environment

Abberton Reservoir

Our external environment

The largest of NWG's businesses, NWL, operates in the north east and south east of England. The two areas have very different economic, demographic and water resource characteristics.

In the north east 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 for at least the next five years with a faster decline in the short term due to the impact of 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.

In contrast, NWL's southern operating area is in 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. NWL is implementing long term plans to ensure the availability of water supplies to meet both current and future demand in a region where water resources are already constrained. After approval from the Environment Agency, 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.

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 the end of 2011.

Regulatory environment

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

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

Customer service is at the heart of the company and all employees have a clear focus on getting things 'right first time every time'.

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

The final determination established a tough settlement for the period 2010-15. However, we are well placed to deliver the required objectives and to meet our commitments to providing safe and secure water supplies and protecting the environment. There is a change in emphasis in the quinquennial £1.2 billion investment programme, from achieving new quality standards to maintaining the high standards already achieved. We will also be working to tackle the challenges posed by climate change, reducing our operational carbon emissions and improving the resilience of our assets.

We welcome the passing of the Flood and Water Management Act 2010 which clarifies responsibilities in relation to flooding and sustainable drainage as well as tidying up and updating other water related legislation. The introduction of a duty on landlords to provide water companies with relevant details so that accurate bills can be issued to tenants is particularly welcome and should assist in collecting income from the private rented sector where bad debts have been relatively high.

The full implementation of Operator Self Monitoring was completed in January 2010. This involves NWL taking on responsibility for sampling and analysing the final effluent at sewage treatment works for compliance purposes. This task was previously undertaken by the EA and the transfer is consistent with the Better Regulation principles.

We are pleased that the final 'River Basin Management Plans' published by the EA for the rivers in our regions proposed an appropriate balance between challenging environmental targets and a clear evidence base for action. We support the emphasis on tackling diffuse pollution at source rather than end of pipe solutions.

NWL intends to increase the emphasis given to catchment management across its operating areas and will increase the number of employees dedicated to promoting catchment management solutions. This will help tackle emerging challenges from water soluble pesticides and also bring a range of other benefits in terms of habitat protection, biodiversity and carbon management.

Putting customers first

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, the quality of our service goes beyond that.

Operating environment continued

For the third year, we only increased our prices by the rate of inflation and did not use the real increase allowed by Ofwat. This decision benefited customers directly.

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 keep customers informed about our activities through leaflets with bills, an annual magazine called 'Source' and our websites at www.nwl.co.uk and 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.

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

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

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

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

CCWater and DWI site visit for the mains cleaning programme in Northumberland

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

Political

During the year, the Group has worked with politicians of all 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 Flood and Water Management Bill, 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 organisations. 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 2009/10 were as follows:

Name of political party	£
Conservative	3,832
Labour	12,855
Liberal Democrats	2,864
Total	19,551

Shareholder authority to permit the Company to continue with these activities until the 2011 AGM will be sought at this year's AGM.

Our investors

Our main communication with shareholders is through the publication of the annual report and financial statements, half-yearly financial report, interim management statements and through information on the Company's website. In addition, the executive directors have regular contact with the Company's large institutional investors, as well as giving presentations to analysts and stockbrokers. During the year, the executive directors met 30 times with a range of institutional investors. Further information on NWG's shareholder relations is contained in the corporate governance report.

Operating environment continued

NWL aims to be recognised as an employer of choice.

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

Equality and diversity
The Group operates 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. NWL monitors its workforce profile against census and sector data and aims to be recognised as an employer of choice within the diverse communities it serves, ensuring it takes full advantage of the rich backgrounds and abilities of current and potential employees.

NWL welcomes 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
Each company engages with its employees through a variety of means appropriate to its working environment. The importance of an inclusive and engaging management style is fully recognised. In 2009, NWL continued to build on its award winning approach by engaging with all employees over some 120 workshops in a dialogue on improvements to our working practices and environment and to seek their views on the areas that should be covered in the 2010-15 People Plan.

Training and development
All Group companies train and develop their employees to benefit both the company and the individual. Annual appraisals are given high priority, as is the identification of training needs, in recognition of the importance of training and development in achieving the Group's goals and policies.

Communication
The Group uses a wide range of communication methods including magazines, newsletters, intranet, notice boards and regular team meetings. 'Unplugged', NWL's magazine, contains articles on activities and news from across the business, focusing on employees and their achievements. NWL issues all employees with a series of information booklets clearly explaining areas such as the company's mission and values, terms, conditions and benefits of employment, occupational health and wellbeing programmes and People Plan objectives.

Disclosure (Whistleblowing)
The Group encourages open feedback and is committed to protecting employees who wish to voice concerns about behaviour or decisions that they believe to be illegal or unethical. The Audit Committee regularly reviews the disclosure policy.

Health and safety
A safe working environment is given high priority across the Group. A health and safety policy is maintained and implemented at each subsidiary. Further details of health and safety can be found in the operational performance section.

Employee Share Incentive Plan (SIP)
The directors believe that employee investment strengthens the ties between the Group and its employees. More than a third of employees participate in the SIP, with an interest in 0.5% 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 of the SIP.

Operating environment
continued

Our aim of balancing economic, social and environmental priorities underpins all of our activities and is an integral part of the way we do business.

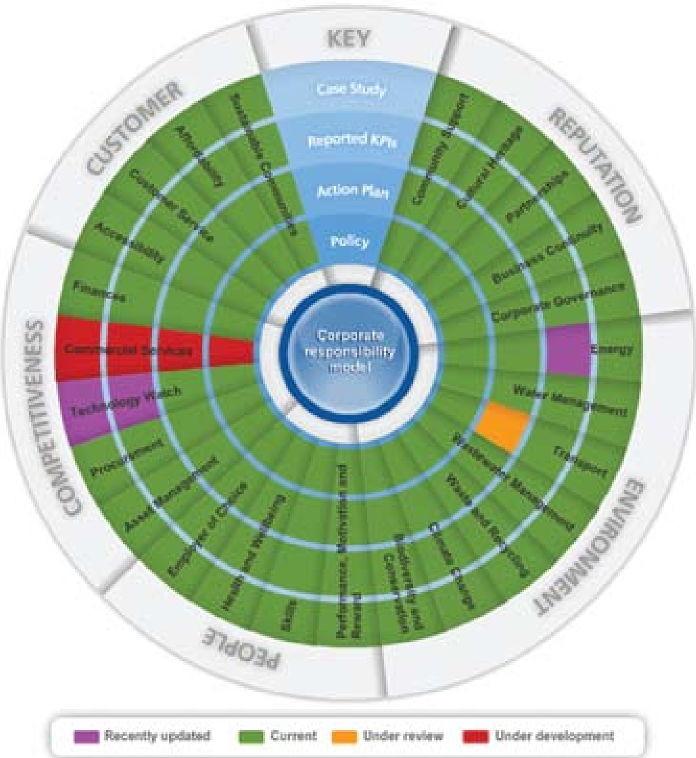
Corporate responsibility
NWL is expected to provide a secure supply of water, a basic necessity for health, and to protect or enhance the environment when we return waste to it. However, our stakeholders also expect us to:
— behave fairly and responsibly;
— use resources wisely;
— improve quality of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

We take our corporate responsibilities seriously. Our aim of balancing economic, social and environmental priorities underpins all of our activities and is an integral part of the way we do business.

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

The Chief Executive Officer is directly accountable to the NWL and NWG boards for both the environment and sustainable development policies.

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



NWL's corporate responsibility model

The Corporate Responsibility Committee (CRC) is a subcommittee of the NWL board and comprises non-executive directors, management team members and senior managers from the business. The CRC maintains a strategic overview of corporate responsibility policies and issues. Within the business, a Corporate Responsibility Management Group (CRMG) drives and manages our corporate responsibility programme both prioritising activity and facilitating reporting and monitoring.

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

The Corporate Responsibility Advisory Group (CRAG) is made up of senior representatives from partner organisations in the key areas of our partnership strategy; environment, community, health, regional support, education and WaterAid. The CRAG acts as a critical friend, helping to validate, guide and challenge NWL's CR strategy and activities.

Sustainable Development – The Queen's Award for Enterprise

Northumbrian Water Limited was awarded the Queen's Award for Enterprise in the category of Sustainable Development. This award recognises our ongoing commitment to best practice and continual improvement in the areas of environmental performance, community investment and sustainability and recognition in this category is rare.

The Queen's Award for Enterprise: Sustainable Development 2009 citation:

"Northumbrian Water Ltd receives The Queen's Award for Enterprise for its ongoing and impressive commitment to sustainability.

It has actively striven to promote best practice within its sector and is committed to ongoing review and continuous improvement.

With a commendable and ever improving environmental performance in place, it is, however, Northumbrian's extremely impressive social and economic initiatives which elevate it to the status of sector leaders.

A diverse suite of programmes have been implemented, encompassing local procurement, strong apprenticeship programmes, individual up skilling and the continuous leverage of their spending power, employment and wider economic presence to ensure maximum benefit for local communities.

Northumbrian's driving commitment to sustainability governance provides an example and benchmark across sectors, demonstrating that strong leadership and ambition can make a tangible difference to communities both local and more widely."

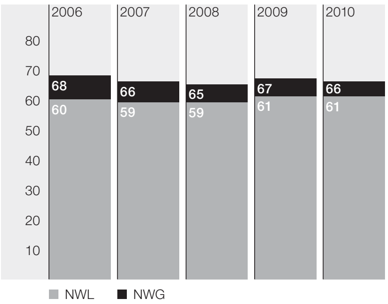
Since the award, work has continued with our long term partnerships; for example, Castle View Enterprise Academy opened to pupils in September 2009 and phase two of Healthworks was opened in November 2009. Further developments in corporate responsibility agenda highlights can be viewed at www.nwl.co.uk/aboutCR.aspx Other examples are outlined below:

Sustainable procurement
Our top suppliers participated in a project called 'Making a Difference Together'. Each was subject to a half a day interview and an in depth corporate responsibility questionnaire. The analysis will be used to further drive sustainable procurement through our supply chain.

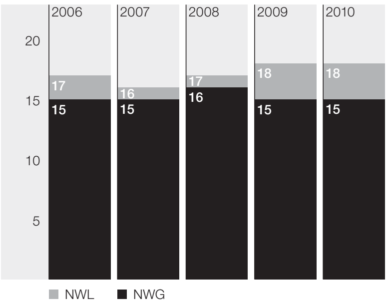
People Plan
During workshops, employees were given the opportunity to influence the development of the 2010-15 People Plan and to respond to the employee survey results. This involved all employees and allowed them to highlight both positive and negative aspects of working for NWL. This was the first time that employees on a large scale have participated in the strategic development of the business and this engagement, at every level in the business, resulted in valuable new ideas which have been incorporated into our forward planning.

Financial performance

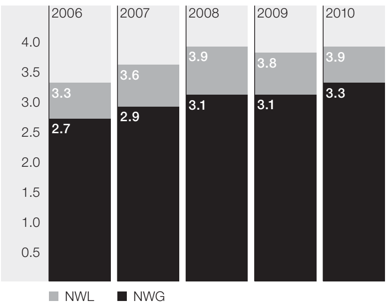
Gearing to RCV %



Cash flow to net debt %



Cash interest cover times



NWG and its subsidiaries use a range of indicators to monitor performance. For NWG, the key performance indicators (KPIs) are all financial. The non-financial KPIs relating to NWL are summarised on page 4. The definition, purpose and source of each KPI are shown on pages 56 and 57.

Performance against the financial KPIs is set out below:

			Performance			
	Target		Current year		Previous year	
KPI	NWG	NWL	NWG	NWL	NWG	NWL
Gearing to RCV (%)	<75	<70[1]	66[3]	61[2]	67	61
Cash interest cover (times)	>2.5	>3.0	3.3	3.9	3.1	3.8
Cash flow to net debt (%)	>13	>13	15	18	15	18

Notes:
1. Less than 65% for the regulated business of NWL.
2. NWL's Regulatory Capital Value (RCV), as advised by Ofwat, at 31 March 2010 was £3,095 million (2009: £2,998 million).
3. NWG's pro forma RCV at 31 March 2010 was £3,420.5 million (2009: £3,324.4 million) (see below).

The pro forma Group RCV includes £218.8 million (2009: £215.6 million) and £106.7 million (2009: £110.8 million) for the Kielder securitisation and PFI contracts, respectively. Adding these to NWL's RCV of £3,095.0 million (2009: £2,998.0 million), results in a pro forma Group RCV of £3,420.5 million (2009: £3,324.4 million).

The Group's gearing on this pro forma basis has decreased from 67% to 66%, with net debt increasing by £32.7 million to £2,262.4 million over the year.

Gearing at NWL, and for the regulated business, is also stable at 61% and 60%, respectively. NWL net debt increased over the period by £52.5 million to £1,896.8 million.

Cash interest cover has improved slightly over the year.

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

Financial results and dividends

	Year to 31.3.2010 £m
Profit for the year	**122.9**
Interim dividend paid (ordinary – 4.39 pence per share)	**22.7**
Final dividend proposed (ordinary – 8.85 pence per share)	**45.8**

NWL has now procured its entire electricity requirement through to March 2015.

Revenue for the year to 31 March 2010 was £704.7 million (2009: £694.1 million). Water and sewerage charges at the Group's principal subsidiary, NWL, were increased by 3% (in line with the November 2008 Retail Price Index) but that increase was partially offset by reductions in non-household revenue as a consequence of the current economic downturn.

Profit on ordinary activities before interest for the year was £275.8 million (2009: £273.6 million). Operating costs increased by £8.4 million (2%) to £428.9 million. At NWL, operating costs have increased from £380.1 million to £388.9 million. This increase principally reflects the impact of increases in salaries, abstraction and rates plus one-off charges for bad debt relating to the closure of a major customer (£1.7 million) and a provision for early retirement and severance costs (£5.4 million). These increases have been partially offset by efficiencies, including the benefit of reduced power prices and the commissioning of the advanced anaerobic digestion plant at Bran Sands on Teesside during the year.

Energy costs at NWL for the year to 31 March 2010 were £36.4 million (2009: £38.8 million) and are expected to reduce by around £4.0 million for the following year. This reflects the full year impact of the Bran Sands advanced anaerobic digestion plant and lower commodity prices. These savings will be sustained as NWL has now procured its entire electricity requirement through to March 2015 at prices below the level funded in the final determination.

Interest charges decreased by £15.2 million within which net cash interest charges increased by £3.1 million. The non-cash elements of the decrease reflect deflation of the principal on the index linked bonds (£29.0 million), a reduction in the expected return on pension assets (£12.7 million), a decrease in the interest cost of pension plan obligations (£2.4 million) and an increase in other non-cash movements of £0.4 million.

Profit on ordinary activities before tax for the year was £170.2 million, 11% higher than the previous year (2009: £152.7 million). The current tax charge of £37.8 million (2009: £32.1 million) principally reflects increased profitability and the timing of relief for prepaid pension contributions.

The deferred tax charge of £9.5 million (2009: £132.5 million) is significantly lower due to the one-off charge of £117.2 million in 2009, following the withdrawal of industrial buildings allowances in the Finance Act 2008.

The effective tax rate for the period was 28% (2009: 31% – excluding the one-off deferred tax charge of £117.2 million).

Financial performance continued

Earnings per share and dividend cover

Basic and diluted earnings per share (EPS) for the year were 23.67 pence and 23.62 pence respectively. In 2009, the basic and diluted loss per share was 2.45 pence. EPS from continuing operations, adjusted for deferred tax, were 25.51 pence (2009: 22.05 pence). From 2009/10, the Group has not adjusted for the credit in respect of the amortisation of debt fair value as this is no longer considered material and has now reached a stable level. The credit for the year ended 31 March 2010 is £5.3 million (2009: £5.6 million) and would have an impact on the adjusted EPS of 1.02 pence per share (2009: 1.08 pence per share).

A final dividend of 8.85 pence per share for the year ended 31 March 2010 will be recommended by the Board to shareholders at the AGM on 29 July 2010 and, if approved, will be paid on 10 September 2010 to shareholders on the Company's Register of Members at the close of business on 13 August 2010. Together with the ordinary interim dividend of 4.39 pence per share, the ordinary dividends paid and proposed for the year will be 13.24 pence per share (2009: 12.79 pence per share). This represents an increase of 3.5%, based on average inflation over the year of 0.5%, on the ordinary dividend for the previous year and is consistent with the Board's decision to maintain a progressive dividend policy with real increases of around 3% per annum. The board of our main subsidiary, NWL, has proposed a dividend policy consistent with the underlying growth assumptions adopted by Ofwat at its price reviews in 2004 and 2009.

The dividend cover for the year, excluding deferred tax, was 2.0x (2009: 1.8x). The cover level has increased principally as a consequence of the application of lower RPI to the index linked bonds.

Northumbrian Water Share Scheme Trustees Limited, which at the date of this report held 914,518 shares to be used in the future to satisfy the vesting and exercise of awards under the Company's Long Term Incentive Plan (LTIP), has waived the right to all dividends on the shares it holds. Further details of the LTIP can be found in the directors' remuneration report.

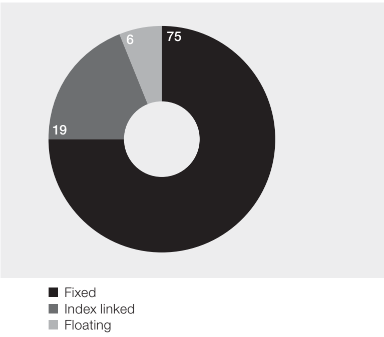
Accounting policies

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2010.

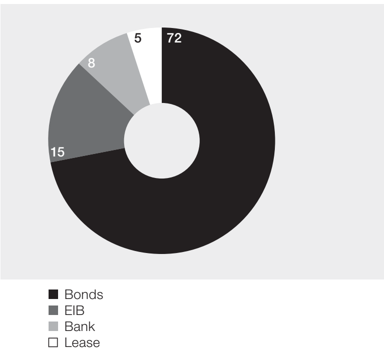
Capital structure and liquidity

The Group has not entered into any new debt facilities during the period and its capital structure and gearing ratios remain largely unchanged.

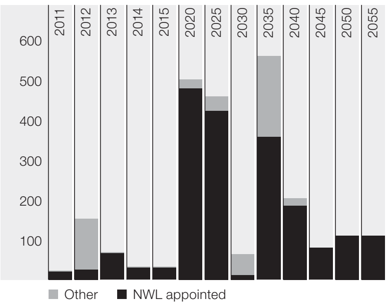
NWG's interest structure %



NWG's funding source %



NWG's gross debt maturity profile £m



The Group and NWL's regulated business debt structure also remain largely unchanged with 75% (NWL: 71%) fixed at an average rate of 5.8% (NWL: 5.96%), 19% (NWL: 22%) index linked at an average real rate of 1.85% (all NWL) and 6% (NWL: 7%) on a variable rate basis. The blended average rate for the Group and NWL's regulated business for the year ended 31 March 2010 was 4.62% and 4.45% (2009: 5.91%, 6.05%), respectively.

Total cash and short term cash deposits available to meet the requirements of the business through to the end of 2011 amounted to £189.1 million at 31 March 2010.

Credit rating

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

Treasury policy

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

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

Pensions

The Group operates both a defined benefit pension scheme, which closed to new entrants on 31 December 2007, and an occupational defined contribution arrangement which began on 1 January 2008.

The deficit (under IAS 19) of the defined benefit scheme of £119.4 million, at 31 March 2009, has increased to £133.1 million at 31 March 2010. This is mainly due to a reduction in the discount rate assumption to 5.5% (2009: 6.1%), partially offset by an increase in the market value of the scheme's assets since March 2009.

The triennial actuarial valuation of the defined benefit scheme as at 31 December 2007 resulted in a surplus of £42.0 million (6%) on an 'ongoing' basis, which took into account the prepaid contributions (in 2006 and 2007) for the period up to 31 December 2010. While the actuarial valuation incorporates longer term forecasts and assumptions than the IAS 19 valuation, the prevailing market conditions are difficult and we will continue to monitor carefully. Furthermore, the final determination to March 2015 reflected NWL's request to fund £6.0 million per annum in respect of the defined benefit pension deficit from 1 January 2012.

Financial performance continued

Creditors
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 2010, was 21 days (2009: 20 days).

Information pursuant to the Takeovers Directive
Structure of the Company's share capital
As at 31 March 2010, the Company had 518,623,845 ordinary 10 pence shares admitted to trading.

Rights and obligations attaching to the shares
The rights attaching to the shares in the Company are set out in the Articles and may be changed with the approval of the shareholders. Subject to the provisions of the Companies Acts, shares may be issued with or have attached thereto such preferred, deferred, qualified or other rights or such restrictions, whether in regard to dividend, voting, return of capital or otherwise, as the Company may by ordinary resolution determine or, if there has not been any such determination, as the Board may determine.

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

Restrictions on the transfer of shares
Any shareholder may transfer a certificated share, as defined in the Articles, by an instrument of transfer in the usual form or in such other form as the Board may approve. However, the transfer of an uncertificated share, as defined in the Articles, need not be in writing and shall comply with any rules adopted by the Board under Article 13.7. The Board may, however, in its absolute discretion and without assigning any reason, decline to register any transfer of any share that is not a fully paid up share or on which the Company has a lien, provided that such discretion may not be exercised in such a way as to prevent dealings in the shares from taking place on an open and proper basis. The Board may also decline to register any transfer unless:
— in the case of a certificated share, the instrument of transfer, duly stamped, is lodged with the Company accompanied by the certificate for the shares to which it relates and such other evidence as the Board may reasonably require to show the right of the transferor to make the transfer;
— in the case of a certificated share, the instrument of transfer is in respect of only one class of share; and
— in the case of a transfer to joint holders of a certificated or uncertificated share, the number of joint holders to whom the share is to be transferred does not exceed four.

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

Additionally, where a member or other person on whom a Disclosure Notice has been served (pursuant to section 793 of the Companies Act 2006) and has not, within the period specified, supplied to the Company the information required in respect of any shares, the Board may impose a sanction declining to register any transfer of shares, other than a sale to a bona fide unconnected third party.

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

	Number of shares at 31.3.2010	**% share capital**	Number of shares at 1.6.2010	% share capital
Ontario Teachers' Pension Plan Board	**138,588,471**	**26.72**	138,588,471	26.72
Amvescap PLC	**80,154,509**	**15.46**	83,064,881	16.01
Pictet Asset Management SA	**31,240,570**	**6.02**	31,719,613	6.12
Legal & General Investment Management Ltd	**15,701,506**	**3.03**	15,114,135	2.91

The holdings include, where applicable, the aggregate of investment management clients' interests within the respective asset management companies and may have since changed without triggering a further notification.

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

Additionally, where a member or other person on whom a Disclosure Notice (pursuant to section 793 of the Companies Act 2006) has been served and has not, within the period specified, supplied to the Company the information required in respect of any shares, the Board may impose a sanction preventing the member from attending and voting at any general meeting.

Financial performance continued

Shares required to fulfil vested awards made under the Northumbrian Water Group plc Employee Trust are acquired through Northumbrian Water Share Scheme Trustees Limited. In line with ABI guidelines, dividends and voting rights are waived on these shares. At 31 March 2010, the Employee Trust held a total of 914,518 shares.

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

Appointment and replacement of directors
The Company may by ordinary resolution appoint any person to be a director. The Board may also appoint directors, either to fill casual vacancies or as an addition to the Board, but any director so appointed shall hold office only until the next following AGM and shall then be eligible for election. Heidi Mottram and Margaret Fay, who were appointed to the Board since the last AGM, will be eligible for election at this year's AGM. Additionally, the Company's Articles provide for the annual re-election of all directors. Details of all the directors seeking re-election at this year's AGM are set out in the Notice of Meeting.

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

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

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

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

— establish local or divisional boards or agencies to manage any of the Company's affairs and appoint any persons to be members of such local or divisional boards, or agents, and fix their remuneration;

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

Allotment of shares

Subject to the provision of the Companies Acts, the Articles and any authorising resolutions passed in general meeting, the shares of the Company shall be at the disposal of the Board, which may offer, allot, grant options over or otherwise dispose of them to such persons, at such times, for such consideration and upon such terms and conditions as the Board may determine. The directors will again be seeking authority from shareholders at this year's AGM for the directors to allot shares during the ensuing year although, at present, the Company has no intention of doing so.

Purchase of own shares

Subject to the provisions of the Companies Acts and the Articles and to any confirmation or consent required by law, the Company may from time to time purchase its own shares. The Company will again be seeking authority from shareholders at this year's AGM to purchase its own shares during the ensuing year although, at present, the Company has no intention of doing so.

Significant agreements

As at 31 March 2010, NWL had £362.4 million of loans provided by the European Investment Bank (EIB) and the applicable terms include change of control clauses. If, after consultation with NWL, the EIB is of the opinion that a change of control has had, or is likely to have, a material adverse effect, then the EIB could give 30 days notice of requesting early repayment of the loans plus, in certain circumstances, a premium depending on prevailing market interest rates.

Carbon management plan

Northumbrian Water Limited published its carbon management plan to meet its target of a reduction of 50% in gross emissions by 2020 from a 2008 base (35% from a reduction in operational emissions and the rest from decarbonisation of the grid).

The carbon management plan includes energy efficiency, renewable energy 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 under way, which will help us to achieve our carbon reduction target, are outlined below:

— investment of £33.0 million in new thermal hydrolysis advanced anaerobic digestion at Bran Sands, which provides 50% (c.4.7 MW) of the energy requirements of the site. This will enable waste 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 increase our use of renewable energy by 20%, as well as reduce our overall energy demand;
— hydroelectric installations at four reservoirs including the UK's largest man-made reservoir, Kielder Water. Work on a new £2.5 million hydroelectric project at our Selset Reservoir has begun and 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 UV 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.

Northumbrian Water Limited has successfully achieved the Carbon Trust Standard for its 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.

Alongside this work, we are continuing to develop our understanding of the potential impacts of a changing climate on the functions of the business. The latest 'UKCP09' projections of the future climate were published by the 'UK Climate Impacts Programme' last summer and provide a valuable resource for understanding the potential impacts on the business.

Operational performance

The level of customers being satisfied or very satisfied remains high

Measuring performance is critical to NWL and it uses a range of KPIs throughout the business to monitor how it is doing. The financial KPIs are shown on page 22 and the operational KPIs are detailed below. These indicators are reviewed by the management team each month and their definition, purpose and source is shown on pages 56 and 57.

Customer satisfaction

NWL measures its 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.

	North (N) South (S)	Target 2009/10	Performance 2009/10
Overall service (%)[1]	N/S	90	88
Value for money (%)[1]	N/S	85	83

Notes:
1. Satisfaction measured on a net basis (see appendix to the directors' report and business review).

Although the performance is slightly below the target, the level of customers being satisfied or very satisfied remains high. This is backed up by the survey carried out by CCWater for the fourth consecutive year, which shows similar high levels of satisfaction, and also concluded, once again, that our customers are the most satisfied in the country in terms of water and sewerage services and also fairness of charges.

Research shows our customers are the most satisfied in the country.

The performance against standards of service is shown below:

Domestic customers

	North (N) South (S)	Target 2009/10	Performance 2009/10
Properties at risk of low pressure	N S	274 126	260 40
Properties subject to unplanned interruption of six hours or more	N S	3,000 2,000	8,671[1] 1,434
Properties subject to hosepipe bans at any time during the year	N/S	0	0
Properties subject to sewer flooding (other causes)	N	150	281
Properties at risk of sewer flooding (once in 10 years or twice in 10 years)	N	76	397
Billing contacts responded to (within five working days) (%)	N S	99.2 99.2	99.4 99.4
Written complaints responded to (within 10 working days) (%)[2]	N S	99.8 99.8	99.9 99.9
Bills based on meter readings (%)	N S	99.95 99.95	99.92 99.93
All telephone lines busy (%)[2]	N S	0.05 0.25	0.17 0.07
Abandoned telephone calls (%)[2]	N S	3.00 2.00	7.43 4.31

Notes:
1. Performance affected by two major bursts in Tyne & Wear and Northumberland.
2. New Service Incentive Mechanism (SIM) measures have been introduced by Ofwat for 2010/11. These are being piloted and monitored during 2010/11, whereupon appropriate targets will be set.

For 2010/11, Ofwat has introduced the Service Incentive Mechanism (SIM) and, amongst other things, this will monitor the quality of our service rather than the quantitative results.

This year, improvements to customer service include a reduction in written complaint numbers by 22%, from 13,050 to 10,185. Our complaint handling and billing query service has been subject to audit by CCWater and they have commented favourably on how we performed; 96% of the 50 cases reviewed in both areas being classed as 'good'.

Debt recovery remains an important area, especially in the current economic climate, where, despite having some of the lowest charges in England and Wales, affordability is becoming an increasing concern for some customers. We continue to be mindful of their circumstances, ensuring our recovery techniques are appropriate and effective. Customers who deliberately avoid paying charges are actively pursued and we continue to work with Ofwat and Defra to seek changes to legislation to assist the industry to impose and collect charges.

Operational performance continued

Kielder Water & Forest Park's Lakeside Way

Business customers

The economic situation has had a significant impact on some business sectors which are important in our operating regions and NWL has been working closely with major customers in those sectors to mitigate the impact where possible. The closures at Corus and Artenius in the Tees Valley have been well publicised. Details of a contract with the new owner of the Artenius site and of a contract extension by one Corus business are given on page 51. Furthermore, with the regional economic agencies, NWL has secured existing and encouraged new business.

Leisure customers

NWL is one of the founding members of Kielder Water & Forest Park Development Trust, which has been accepted by the Charity Commission for registration as a charity. This will replace the existing Kielder Partnership and will seek to promote sustainable development, recreation, access and leisure, education, infrastructure and a range of other charitable purposes at Kielder and in the surrounding area.

The development of Kielder Water & Forest Park is supported by the Northumberland Strategic Partnership, Government Office for the North East and One North East. This year has seen the completion of a 26 mile lakeside multi-user track and water access points as well as the opening of an award winning observatory and a range of mountain biking tracks. The website at www.visitkielder.com provides further details of all facilities.

NWL continues to develop its leisure facilities at all strategic sites, investing in fishing facilities, holiday accommodation and supporting 'Access for All'.

Water

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 2009/10	Performance 2009/10
DWI Mean Zonal Compliance (%)	N	99.90	99.91
	S	99.98	99.82
DWI Operational Performance Index (%)	N	99.65	99.58
	S	99.98	99.97
Distribution Maintenance Index (%)	N	99.70	99.21
	S	99.85	99.94

The DWI will investigate any incidents which could compromise quality and the number of such incidents fell during the year. NWL has appointed catchment management officers to work with farmers and regulators in Essex to help reduce the level of pesticides in the environment and their impact on raw water quality. This work is progressing well and has produced encouraging results.


Work begins at Abberton Reservoir

A long running formal programme, which began just after privatisation, to rehabilitate older parts of the water distribution network has come to an end, contributing to improved water quality results over recent years. 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. More than half of the programme has been completed successfully and work will be completed in 2011, significantly reducing customer complaints of discoloured water.

Water resources
Work started in January 2010 on increasing the capacity of Abberton Reservoir near Colchester by 58%. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke in Norfolk. 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.

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 45% of domestic households in Essex and 58% in Suffolk are now metered. In the north east, where supplies are more plentiful, 22% of households are metered.

In addition, Essex & Suffolk Water have run an award winning water efficiency campaign which, together with the good response from customers, has helped control demand for water. New water efficiency targets have been introduced in 2010/11 to reduce per capita consumption across the company and a number of initiatives have been piloted during the year. A new campaign will also be launched across the company to promote water efficiency ranging from water saving kits to activity in schools and development of our website.

Our assets proved very resilient during the harshest winter for 30 years and we were able to maintain supplies to customers during the period, thanks to the efforts of our employees. The severe freeze, followed by the thaw, did result in a significant increase in burst pipes and leakage which meant we, along with other companies, did not meet our annual targets this year although our three year rolling targets have again been met.

Operational performance continued

NWL agreed, last year, a plan to reduce emissions by 35% by 2020.

Environment

(northern operating area only)	Target 2009/10	Performance 2009/10
Sewage treatment works (%)	99.7	100
Bathing waters Mandatory Standard (%)	100	100
Pollution incidents (category 1, 2 and 3)	89	114

NWL's exceptional performance for sewage treatment works continued with all consented works remaining compliant over the year. Two major schemes, to further improve performance at Sunderland and Darlington sewage treatment works, were completed.

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. Plans to provide a similar plant on Tyneside to process the remainder of the company's sludge, and also replace older technology, are progressing well.

All 34 bathing waters in the north east again passed the required Mandatory Standard and 30 of these met the more demanding Guideline Standard.

Intense summer storms again caused extensive property flooding. Incidents of internal property flooding were the highest ever reported, many due to a single storm over two days in July which affected the whole north east region. Capital schemes to remove 277 properties from flooding registers were successfully completed. Planning to identify schemes for coming years forms a key part of our investment programme and is well advanced, with a further 250 properties to be addressed in 2010/11. The five year programme to improve the visual appearance of discharges from nearly 500 combined sewer overflows was successfully completed, with engineering works taking place at 106 locations in the year.

Climate change

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 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. NWL agreed, last year, a plan to reduce emissions by 35% by 2020, when compared with a 2008 baseline. If the emissions associated with electricity production also fall, in line with Government predictions, this should mean that our emissions will be halved by the 2020 milestone date.

Quality

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

The company also achieved companywide certification to the international occupational health and safety management standard OHSAS 18001 in 2007.

Employees

Throughout the Group we have 3,105 employees, as set out below:

Group business unit	Average number of employees	%
Northumbrian Water Limited	2,930	94
Water and waste water contracts	151	5
Other	24	1
Total employees	**3,105**	**100**

NWG ensures its terms and conditions both attract and retain the best employees in the areas it serves. NWL employee turnover is relatively low at 6.4%, below the UK water industry average of 9.2%.

NWG places great emphasis on health and safety and 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.

NWL's current level of sickness absence is 3.18%, which is the lowest ever achieved and well below the norm for the sector.

	North (N) South (S)	Target 2009/10	Performance 2009/10
Employee turnover (rolling %)[1]	N/S	Industry average 9.2	6.5
Lost time reportable accidents (per 1,000 employees)	N/S	10	5.7
Sickness absence (%)	N/S	2.85	3.18

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

Operational performance continued

Over 80% of employees would recommend working for NWL and 77% believe that NWL is a great organisation to work for.

The active involvement and engagement of everyone across the business is an important part of delivering performance and NWL continues to formally seek the views of employees through an annual employee engagement survey. This year's survey had the largest response rate ever at 71% 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 contributed to the development of departmental action plans. Overall, employee satisfaction levels remain very high with the company achieving its Engagement & Satisfaction Index targets this year. In addition, 80% of respondents told us they are proud to work for the company, 82% would recommend working for the company and 77% believe that NWL is a great organisation to work for.

NWL 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 72% of employees participate in the scheme, up from 62% last year.

Training and development

Our people are the key to our business success. NWL continues to implement its Management Development Framework which is structured (see diagram below) 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 are planning to roll out a new 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 4 management standards, as appropriate, supported by formal development and coaching. Further information on developing our people can be found on page 40.

NWL's Management Development Framework model

Sir Derek Wanless presents Sandra Williams with her health and safety award

Health and safety

Our emphasis on the importance of health and safety within NWL has resulted in major improvements to our safety record in recent years. This year we experienced 10 reportable accidents and incidents per 1,000 employees, which is a continual decline over the previous six 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 reinforce the safety culture in the company.

NWL proactively supports and encourages 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. NWL employees also have on and offsite access to specialist advice and treatment to support recovery from musculoskeletal disorders (MSD). We have reduced sickness absence due to MSD by 22%.

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.

Research and development

NWL run a programme of research and development linked to its 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. This has supported the invention, development, trial and/or implementation of:

— a device for reducing flooding and pollution;
— energy efficiency of waste water aeration systems to determine optimum design and best practice cleaning and replacement cycles;
— microbial fuel cells or electrochemical cells, which generate electricity or hydrogen from waste water respectively;
— beneficial re-uses for water treatment sludge;
— reed-bed based solution for thickening iron rich water treatment sludge and aluminium rich sludge;
— de-watering and thickening water treatment works sludge;
— leak detection technology;
— early warning system for leaks and bursts; and
— remote pipeline condition assessment.

During the year, the Group invested £2.1 million (2009: £1.8 million) in research and development.

Developing our people

NWL introduced an extensive People Plan in 2005/06, as part of a human resources strategy for the following five years. This outlined the organisation's aims up to 2010 and set out a schedule of programmes and matrices in support. Training and development and supporting the performance and aspirations of our people are key elements of the plan.

One of the objectives of the People Plan is to develop leadership skills in current and potential managers and the People Development Framework provides an integrated range of flexible training options and learning ideas.

Everyone who joins NWL receives a personalised induction plan providing their familiarisation and training programme for the first few weeks of their employment. In addition, they are invited to a corporate induction day where they meet senior managers and are introduced to the company and our approach to key areas including health and safety, terms and conditions, pensions and community involvement.

We recognise the vital contribution that training and management development can make to fully realise both organisational and individual potential. Our approach focuses on giving the skills and competencies needed for role and job objectives, to ensure people are working safely and competently with the potential to develop and attain aspirations.

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 day and induction planning, to individual coaching, accreditation of skills through national vocational qualifications, to 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 Level 2 – the equivalent of five GCSEs at grades A to C – by the end of 2010.

An ambitious NVQ programme has been rolled out in our customer and operational areas. Funding has been secured from the Learning and Skills Council's 'Train to Gain' fund and also through Business Link.

NWL's successful four year apprenticeship scheme began in September 2007. We now have three intakes of mechanical and electrical apprentices at different stages in their training with all of the apprentices guaranteed jobs on successful completion of the bespoke programme. In 2009, for the first time, we introduced an information technology/telecoms apprenticeship further developing the range of jobs available to young people in our regions.

Our Graduate Development Programme has been re-launched to provide potential leaders for the future. Candidates undertake a two year programme with three to six month placements in different parts of the business. In addition to a line manager they are also given a senior manager mentor. Employment is also guaranteed on successful completion of the programme. We currently have eight graduates on the programme and plan to recruit an additional three during 2010.

Recognising our employees' academic achievements, the fourth 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.


NORTHUMBRIAN WATER LIMITED
NORTHUMBRIAN WATER LIMITED

Operational performance
continued

Water and waste water contracts

Revenue for the Group's water and waste water contracts was £38.3 million for the year to 31 March 2010 (2009: £39.8 million) and profit on ordinary activities before interest was £10.2 million (2009: £9.1 million). The increase is principally due to decreased power costs and the settlement of outstanding claims offset slightly by a reduction in respect of gas indexation on revenue tariffs at Caledonian Environmental Services. All contracts are performing well and are in line with expectations.

The Group is involved in two projects to deliver long term private finance initiative contracts with Scottish Water for waste water treatment. At Levenmouth, the Group now has a 100% shareholding in both project and operating companies and the benefit of a 40 year contract. Funding was provided through a 37 year fixed interest rate corporate bond with the principal amortising from 2008.

On 12 April 2010, the Group settled the outstanding claim against Caledonian Environmental Services plc with the Design and Construction Consortium, with the costs being capitalised in the year. The Group also, on this date, purchased the remaining 25% minority stake and the outstanding subordinated loan stock in Caledonian Environmental Services for a consideration of £0.4 million.

In Ayrshire, the Group has a 75% shareholding in the project company and a 100% shareholding in the company that operates the three effluent treatment plants that comprise this 30 year contract. Finance was provided through a 27 year loan on a fixed interest basis with the principal amortising from 2003.

In Ireland, the Group is part of a contractual consortium that designed and built a waste water treatment plant for Cork City Council. Under the consortium agreement, the Group has responsibility for a 20 year contract for the operation and maintenance of the plant.

AquaGib Limited, two thirds owned by the Group in a joint venture with the Government of Gibraltar, operates Gibraltar's dual drinking water and sea water distribution systems under its 30 year contract with the Government of Gibraltar.

Other

Agrer

Revenue for the year to 31 March 2010 was £8.5 million (2009: £7.2 million). During the year, Agrer has signed new contracts with a gross margin of €2.16 million, an increase of around 40% over the previous year.

THE QUEEN'S AWARDS FOR ENTERPRISE: SUSTAINABLE DEVELOPMENT 2009

FTSE4Good

Business in the Community CORPORATE RESPONSIBILITY INDEX 2009

The most significant new contracts signed during the year include: economic studies and statistical surveys in Algeria (€1.9 million – 18 months); consolidation of conflict affected populations in Congo, Brazzaville (€0.9 million – 24 months); information systems for rural development and country planning in Chad (€2.5 million – 42 months); water management and irrigation component of the agricultural development programme in Burkina Faso (€3.2 million – 60 months) and a new Framework Contract for Lot 1: Rural Development (48 months).

Corporate responsibility

NWL supports the communities we serve in a number of different ways. As well as providing financial support and facilities, we encourage employees to volunteer their time, skills and expertise through our 'Just an hour' scheme. These activities generally support projects that make the areas we serve better places in which to live, work or invest. The programme focuses on key themes throughout these communities but, increasingly, we are developing initiatives designed to tackle lasting and sustainable change in specific areas.

In April 2009, NWL received the Queen's Award for Enterprise in the category of Sustainable Development. Additionally, we were:

- members of the FTSE4GoodIndex;
- one of only seven companies nationally to achieve the new highest platinum plus ranking in the Business in the Community (BITC) Corporate Responsibility Index. The new platinum plus process evaluated the extent to which our business strategy is underpinned by a focus on long term sustainability. This improves on our platinum status in 2008 as one of the top 100 'Companies for corporate responsibility';
- awarded the BITC Big Tick award for its impact on society, power in partnership and for being a healthy workplace;
- the employee engagement winner at North East of England Chartered Institute of Personnel Development HR&D 2009 awards;
- the category winner of Culture for Success Large Employer Award for employee development, customer service, business growth and the contribution we have made to the community;
- holders of the Payroll Giving Quality Mark Gold Award;
- Beyond Sport Award finalist – best corporate responsibility in sport; and
- winners of the Waterways Renaissance Awards natural environment category for the Trinity Broads Restoration Project.

Over many 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. The Group made charitable donations totalling £156,517.

Operational performance
continued


'Just an hour' employees at Sunningdale School to give the sensory garden a makeover

Over 600 different organisations were given financial and in-kind support during the year through NWL's employee volunteering scheme, 'Just an hour'.

Community support

Employees and volunteering

Currently 26% of employees participate in the 'Just an hour' volunteering scheme and last year gave over 7,890 hours to the community. Over 600 different organisations were given financial and in-kind support during the year.

The 'Care for safety' scheme, which encourages employees to reduce accidents and associated lost time, has triggered payments totalling £49,605 for our nominated charities (Great North Air Ambulance Service, RNLI, Essex Air Ambulance, Myelin Project, Zoe's Place, Macmillan Cancer Support and St Cuthbert's Hospice). Since it began almost £310,000 has been raised for charity.

Education

Further to the launch of the 'Northumbrian Water GLOBE' programme, which saw us link up with the international environmental education initiative set up by Al Gore in 1996, we donated 85 fully automated weather stations and associated training to schools throughout the northern region, to collect weather data in areas where Meteorological Office coverage is poor. This data is now helping to increase understanding of the impact of climate change and is a valuable curriculum tool.

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

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

Work with Colchester Borough Council, Essex County Council, Essex University and the Essex Wildlife Trust is ongoing to use Abberton Reservoir and the enlargement project to further education. A study will look at the need for further education facilities in the vicinity of Abberton Reservoir. Depending on the study's findings, NWL will provide accommodation for use as an education centre.

A wide range of educational materials are available on our websites for children and teachers.

Partnerships

Water for health

NWL continues to promote the health benefits of drinking tap water. To date, over £306,000 has been provided for mains-fed water coolers in schools and around 675 have been supplied in nearly 350 schools. We also continue to promote bottle-free water coolers as a sustainable alternative to bottle-fed coolers.

Sir Derek Wanless at Healthworks phase two launch

Environmental
Key partnerships have been developed with NWL to help the conservation of biodiversity on our sites. Our contribution includes funding project officers and 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).

Sustainable communities
NWL has developed some longer term projects to help build sustainable communities in the areas it serves. These projects are developed with partners to help bring about lasting change and some examples are given below.

Healthworks
NWL granted a 99 year lease to County Durham Primary Care Trust (PCT) on a redundant building at our Easington waterworks and worked in partnership with the PCT, the District of Easington Council, the Neighbourhood Management Pathfinder and other stakeholders to develop services for the local community in an area where census records show one of the worst health records in the country.

Beyond providing the building, we contributed research, marketing and communications support to improve awareness of the centre and helped with events to promote healthy living, targeted at primary and secondary schools and day centres, and linked to our ‘Water for health’ campaign.

We sit on the steering group for Healthworks which achieved almost 10,000 visitors in its first year alone and now provides over 45 health and community support services. 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 the local community. Facilities range from a juice bar to a gym and information kiosks, some of which can be used in a privacy setting with many more planned. Healthworks has been so successful that the plans for phase two were brought forward and this was opened in November by the Chairman, Sir Derek Wanless. Healthworks now includes a GP led walk-in health centre open from 8am to 8pm, 365 days a year, thus securing the future of Healthworks for the community, which is a unique approach to tackling the poor long term health of the residents in Easington.

Operational performance continued

Sporting partnerships

NWL prides itself on being immersed in the community and working with a wide and diverse range of sporting partners is a natural extension of our 'Water for health' campaign, which encourages people to lead a healthy lifestyle. Working with our sporting partners we support a diverse range of sports to get people active as well as educating them on healthy eating and good hydration.

Through our partnerships we have reached over 60,000 children and adults. We provide:

- links and networks to enable sporting partners to get together to share ideas and resources;
- financial support of over £56,000 per annum which then levered over £2.0 million (£1.3 million of this was due to the phase two extension of Healthworks which is on our former site) from other sources;
- advice and marketing support on programme development;
- bottled tap water, sports bottles or mains-fed bottle-free coolers to reinforce the importance of drinking tap water to re-hydrate during sporting activities; and
- help with fundraising and raising the profile to attract additional investment.

We can generate wider support for projects by adding our name and commitment to them and by encouraging others to get involved thus generating additional funding sources for projects. Our involvement acts as a key catalyst to raise confidence that projects present real opportunities for the private sector.

Education

NWL is lead sponsor of Castle View Enterprise Academy, a new and exciting independent school for 11-16 year olds serving the areas of Castletown, Town End Farm and Hylton Castle in Sunderland. The area contains some of the most deprived wards in the region and 61-80% of the school catchment population is categorised as 'struggling families'.

The Academy opened in September 2009 and offers a new approach to education. It is one of three academies created in Sunderland with the City Council as co-sponsor using a unique model under the 'Building Schools for the Future' programme. Our aim as lead sponsor is to create a centre of excellence with a clear focus on raising standards of academic performance and enabling every student to achieve their personal best in all areas of academy life within a safe, secure and stable environment. The project has been almost four years from planning to opening and our employees have helped in the design, build and management arrangements. The company will use its business networks to complement the Academy's specialism which is business and enterprise.

Castle View Academy, Sunderland

NWL prides itself on being immersed in the community.

Economy

North East Enterprise Bond

Our investment in the bond is a five year interest free loan, which helped fund the purchase and running of a number of 'Launch Pads' – mobile vehicles that tour the region to help trigger and encourage enterprise start-ups. Working with creative enterprise promoters such as Big Ideas, People into Enterprise and Newcastle Education Business Partnership, the bond serves as a catalyst to encourage people to set up their own business or social enterprise.

NEL Growth Fund

Our investment in the fund is to provide start up capital in eligible high growth businesses based in the north east of England. The fund is managed by NEL Capital the specialist venture capital division of NEL Fund Managers.

Affordable housing

NWL has been working for the last five years with Hastoe housing on an affordable rural housing project as part of our 'Good Moves' programme. Planning permission has been granted for 12 affordable rural houses on a piece of land that is no longer required by NWL close to the company's Hanningfield water treatment works in Essex. The homes will be located in a rural area where a significant need for affordable housing has been identified.

WaterAid

NWL has continued to raise funds and awareness for the work of WaterAid which brings sustainable water and sanitation solutions as well as hygiene education to the poorest parts of Africa and Asia. The employee fundraising committee has raised more than £3.0 million, since 1997, with the help of the company and last year focused its fundraising support on specific projects in Tanzania.

Community Foundations

Community Foundations covering our areas of supply hold endowment funds totalling nearly £1.0 million contributed by NWL over the last 18 years. These are long term investments with the income from the funds used to support community initiatives. Recipients are chosen by committees of our own employees (39 groups this year).

Kielder Partnership

Kielder Water & Forest Park includes the largest man-made reservoir in the UK and is surrounded by Kielder Forest, the largest man-made woodland in Europe. We have worked with partners in the Kielder Partnership to develop and regenerate the economy of this rural area through tourism development.

The Kielder Partnership is continuing to benefit from the impact of the £5.4 million capital investment at Kielder Water & Forest Park between 2007 and 2010. Key developments include the Kielder Observatory, Lakeside Way trail, six new art installations and five flagship mountain bike trails. As a result:

— five direct jobs have been created;
— tourism days have increased by 62,000 (26%) to 300,000 with 60% of these from outside the north east region; and
— direct and indirect spend has increased by £3,169,000 (33%) contributing £12.6 million to the local economy.

The visitor economy is pivotal for a sustainable future as it is the key source of employment and income generation in an area with few opportunities due to the decline in traditional economic sectors such as agriculture and mining.

The partners have established the Kielder Water & Forest Park brand and the Big Picture Development Plan provides a long term vision for the area, including a range of sustainable solutions to attract new audiences.

It builds on the strengths of Kielder to create a destination which adds critical mass to other iconic attractions in the north east, as part of One North East's promotion of the region. Work is well under way and examples of significant recent achievements are provided below.

Affordable rural housing
There is a need for affordable rural housing to meet local employment needs and we supported this development by the Home Housing Group in Kielder village. Four of our employees live in these houses which are fully sustainable too, thanks to a pilot project which uses wood chip technologies to heat the home.

Artwork and observatory
The art and architecture programme has been developed over 15 years and there are now more than 20 innovative contemporary landscape art and architecture pieces to see, or interact with, making Kielder Water & Forest Park the largest outdoor public art gallery in the UK. Kielder also has the darkest night skies in England with minimal light pollution and the Kielder Observatory, which was designed to rise like the deck of a ship sailing above the landscape, offers exciting opportunities to those with an interest in learning more about the night sky.

Lakeside Way
This year has seen the completion of a 26 mile lakeside multi-user trail, with water access points that encircles the shoreline of Kielder Water.

Britain's most beautiful marathon
In February, we launched the Kielder Marathon which will take place this autumn and is billed as Britain's most beautiful marathon. It will use the Lakeside Way and, with over 1,500 runners, it will help to promote the profile of the area.

Ospreys
In 2009, a long term project to encourage Ospreys to return to the region was rewarded when a pair of first time parent birds nested on a specially erected platform and successfully reared a brood of three chicks; the first born in Northumberland for at least 200 years. Controlled access encouraged visitors to the site and this will be developed now that the birds have returned this year.

Risks and resources

Waste water storm tank, South Shields, part of our £3.0 million flood alleviation scheme

The NWG Board requires all subsidiaries within the Group to identify and assess the impact of risks to their business. For each risk, the likelihood and consequences are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed. Apart from NWL, none of the subsidiaries has risks considered to be significant to the Group's short and long term value.

For NWL, the management team reviews the approach to risk management in detail every year and the Audit Committee considers the outcome. The NWL management team review the significant risks every month and summary reports on these reviews are submitted to the NWL board. This year, the Audit Committee commissioned an additional risk and assurance mapping report from Ernst & Young, to provide NWL's management and the Audit Committee with a view of the different assurance functions and the extent to which they provide assurance that the control activities mitigating the key business risks are working properly. In performing the review, Ernst & Young interviewed several of the managers most involved in the management of risk and, having done so:

— identified the main risks in NWL's existing risk register and additional risks that they would typically expect to be included based on their knowledge of the water sector;
— identified the main audit and assurance activities; and
— mapped the sources of assurance against the control activities and risks checking for gaps and duplication.

The main conclusions, which were reported by Ernst & Young to the NWL board, were:

— the mechanics of the risk assessment and the format of the risk register are typical of what Ernst & Young would expect to see within an effective risk management process;
— much of the content of the risk register is very typical of what they see within other companies operating within this sector; and
— there are many different sources of assurance across the business and the assurance coverage of key risks is reasonable.

Having received Ernst & Young's assessment of the current approach to risk and assurance, the board considered the documentation of risk appetite and the manner in which assurance is received. The board agreed that as well as ensuring that an effective 'bottom up' risk management programme is in place, they should also consider risks of a more strategic nature regularly. Subject to addressing Ernst & Young's points, the board considered the current approach to general business risk to be acceptable, although board papers could usefully make more explicit reference to how risks have been evaluated. However, a draft register of strategic risks will also be produced for discussion. As well as helping to identify these risks this should also help the board agree whether its appetite for risk should be documented formally.

Going concern and treasury risk
The financial ratios, financial results, liquidity position and credit ratings are described in the financial performance section on pages 22 to 25. In addition, note 20 to the financial statements includes details on the Group's strategy and treasury operations for managing its capital; its exposures to liquidity risk, interest rate risk, foreign currency risk and counterparty risk; and details of its financial instruments.

The Group has sufficient funding in place to finance all of its operations until the end of 2011, leaving it well placed to deal with continued volatility in capital markets.

The current economic climate is having an impact on revenues, particularly those from industrial and commercial customers and those associated with the housing market. We continue to monitor the uncertain situation very carefully and, in particular, the recovery of domestic revenue. We welcome the passing of the Flood and Water Management Act 2010, which will require landlords to disclose details of their tenants which will help improve debt collection.

Overall, industrial revenues are currently expected to be close to those assumed by Ofwat when setting prices for 2010-15. Our largest single customer, Artenius UK Limited, ceased production in 2009 and Ofwat assumed this plant would remain closed. However, in February 2010, it was bought by a Korean company, KP Chemicals, whose subsidiary Lotte Chemical UK Limited brought the plant back into operation in April 2010 (although NWL revenue will be slightly lower than under the previous Artenius contract). By contrast, a number of plants have closed which Ofwat had assumed would remain open. The most significant is Corus Cast Products where the blast furnace was mothballed in January 2010, although Corus has also announced that the South Bank Coke Ovens, which was also under threat of closure, will remain open for at least a further three years.

The directors believe that the Group 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.

Regulatory risk
The fact that NWL has been able to accept the outcome of PR09 reduces the main source of regulatory risk.

The Flood and Water Management Act 2010 also includes provisions to implement the recommendations of the 'Pitt Review' on flooding as well as a range of other measures to tidy up aspects of water related legislation. The flooding measures primarily relate to local authorities and the EA but also have implications for water companies, particularly with regard to how they interact and cooperate with those bodies.

Risks and resources
continued

The Labour Government signalled its intention to proceed with the transfer of certain private drains and sewers into water company ownership, increasing the network owned and maintained by NWL by about 70%. The timetable is slipping and we have still not seen the implementing regulations. The earliest practical date of transfer is now October 2011, but further delay in issuing the regulations will result in a delay in the transfer date. The costs associated with the transfer were not included in the PR09 price review. It is, therefore, likely that all sewerage companies will see an adjustment to price limits in light of the transfer.

The full impact of another item of legislation, the Traffic Management Act 2004, is not yet clear, but the Labour Government indicated its desire to increase charges for disruptive roadworks.

The General Election has delayed Government measures in response to the 'Cave Review' (on competition) and the 'Walker Review' (on charges and metering). The new coalition Government has made some early statements about its desire to consider the Cave, Walker and Pitt reviews. We expect this to provide greater clarity to the future direction of the industry. If and when changes are proposed, NWL will work constructively to ensure that new legislation takes account of the practical needs of the industry.

Through 2007 to 2009, the company detected pesticides, metaldehyde and clopyralid, in its treated water at a number of sites, primarily in the Essex area. Whilst these pesticides are not of concern to human health, they were detected at levels in excess of the regulatory standard. As a result of this we agreed an undertaking with the DWI to carry out certain actions to mitigate the situation. This has predominantly involved proactive catchment management with the appointment of two catchment officers who have been working with farmers and regulators to advise on better use of such pesticides. Whilst this is likely to be a long term project, the early signs are very encouraging with the results detected this autumn and winter being significantly lower than the previous two years. This is also a much more sustainable solution than the alternative, which would be to construct major new treatment processes to remove any residual pesticides.

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

The first relates to the use of sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, the sector would need to find or develop alternative ways to re-use or dispose of its sewage sludge.

We will continue to play a leading role in the industry on water efficiency measures and to encourage customers to use water wisely.

This could mean higher capital and revenue costs to provide additional sludge processing facilities. The development of the 'Safe Sludge Matrix' and the proposed revision of the Sludge (Use in Agriculture) Regulations have reduced the immediate risk in this area. NWL is introducing advanced anaerobic digestion to both reduce sludge volumes and the carbon impact of its activities and provide a sustainable outlet for sludge. Advanced anaerobic digestion is already in operation at our Bran Sands site and plans to develop this at our Howdon site are well advanced.

The second is the potential for sewer flooding. As rainfall patterns become more variable and intense storms more frequent, localised heavy rainfall can result in sewers becoming overloaded. We welcome the focus on integrated flood management in the Flood and Water Management Act 2010.

Affordability and customer debt

Affordability is an issue for NWL with income deprivation levels in the northern area the highest of all water and sewerage companies and in the southern area, close to the national average.

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

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

Water resources

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

In our Essex and Suffolk areas, however, water resource availability is a key issue. We have been successful over many years in encouraging our customers to use less water and in keeping leakage at or below the economic level. Nonetheless, we need to continue to invest to achieve our aim of ensuring our customers have a safe, secure and reliable supply of water well into the future. In January 2010, we published our final 'Water Resources Management Plan' having received approval from the Secretary of State.

Risks and resources
continued

Weather radar at High Moorsley, near Durham City, with David Chapman NWL, Graham Butler Met Office, and Phil Marshall EA

Work is progressing on increasing the capacity of our Abberton Reservoir near Colchester by 58%. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke in Norfolk. We are working closely with the EA on progressing this. Once this scheme is in operation in 2014, it is unlikely we will need to develop major resources in Essex for the next 25 years.

We will continue to play a leading role in the industry on water efficiency measures and to encourage customers to use water wisely. We will work with other stakeholders to develop a coordinated strategy for reducing water use to sustainable levels.

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

Changing weather patterns

The water cycle and the changing weather has a direct influence on the provision of water and waste water services. NWL's employees are experienced in managing the effects of too much or too little rainfall, but changing weather patterns will 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 last year by the UK Climate Impacts Programme.

Over the course of the year we will be doing more work in this area as we respond to the new adaptation reporting power granted to the Government by the 2008 Climate Change Act. This will set out in the public domain the extent to which the changing climate is likely to impact on the business and what actions we are taking to meet the challenge it represents.

Employees

If we are to continue to optimise our assets, offer an excellent service to our customers, and achieve our regulatory obligations, we need to continue to recruit, retain and develop talented people as a leading employer in our regions. We will continue to offer all our employees terms and conditions at least commensurate with other major employers as well as appropriate training and development to support their ongoing performance and career progression. This includes the comprehensive management development framework, graduate and apprentice programmes, as well as initiatives such as the NVQ programme which reach many employees.

Directors' remuneration and interests
Information about directors' remuneration and their interests in the shares of the Company is contained in the directors' remuneration report.

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

Annual general meeting
The notice convening the AGM, to be held on 29 July 2010, was sent to shareholders together with an explanation of the business to be conducted at the meeting and a form of proxy.

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

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.

By order of the Board

Martin Parker
General Counsel and Company Secretary
1 June 2010

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

Appendix to the directors' report and business review

Group financial KPIs

Gearing to RCV

Definition and calculation: The ratio of Group net debt to NWL's Regulatory Capital Value (RCV) plus a pro forma RCV for the Kielder securitisation and the PFI contracts (at the level of associated debt included in the Group's net debt relating to those assets). The NWL RCV represents the total capital value of the appointed water and sewerage business on which The Water Services Regulation Authority (Ofwat) allows a rate of return at price reviews based on its view of the cost of capital.

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

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

Cash interest cover

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

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

Source of underlying data: Audited financial statements.

Cash flow to net debt

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

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

Source of underlying data: Audited financial statements.

NWL financial KPIs

Regulatory gearing

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

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

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

NWL non-financial KPIs

Water

Drinking water quality

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

Purpose: To monitor drinking water quality.

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

Environment

Sewage treatment works

Definition and calculation: Percentage of population equivalent served by non-compliant works failing Look Up Tables' consents.

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

Source of underlying data: Information recorded by NWL and the Environment Agency (EA) and reported on by the latter.

Bathing waters Mandatory Standard

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

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

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

Pollution incidents

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

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

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

Customer

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.

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.

Employee

Lost time reportable accidents

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

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

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

Sickness absence

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

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

Source of underlying data: Statement of Fitness for Work (fit note), return to work interviews and weekly returns by managers.

Employee turnover

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

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

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

Board directors' biographies

Sir Derek Wanless
Chairman
Sir Derek Wanless was appointed to the Board as an independent non-executive director in December 2003. He joined the board of NWL in January 2006, and, in July 2006 became Chairman of NWG and NWL. Sir Derek chairs the Nomination Committee and is a member of the Remuneration Committee. He became a director of National Westminster Bank in 1991 and its Group Chief Executive in 1992. He retired from this position in 1999. Sir Derek is currently Chairman of Legal and General plc's Longevity Science Advisory Panel and a member of the Board for Actuarial Standards at the Financial Reporting Council.

John Cuthbert
Managing Director (until 31 March 2010)
John Cuthbert was appointed to the Board in May 2003. John joined the water industry in 1991 and was appointed Managing Director of North East Water plc in 1993. Following the acquisition of the former Northumbrian Water Group plc by Lyonnaise des Eaux in 1995, he transferred within the Group to become Managing Director of Essex & Suffolk Water plc. John took over as Managing Director of the former Northumbrian Water Group plc, and also of NWL, in 2001 and up until 31 March 2010, was a member of the Nomination Committee. John retired from the Group on 31 March 2010.

Heidi Mottram OBE
Chief Executive Officer (from 1 April 2010)
Heidi Mottram was appointed to the NWG and NWL boards, as an Executive Director, on 1 March 2010, and became Chief Executive Officer and a member of the Nomination Committee on 1 April. Heidi began her career with British Rail as a General Management Trainee in the mid 1980s. Her first senior position was that of Station Manager in Harrogate in 1986 and she then held a number of roles before joining Midland Mainline in 1999 as Operations Director. Heidi was Commercial Director for Arriva Trains Northern from January 2004, before joining Serco-NedRailways in November 2004 as Managing Director, Northern Rail Limited. Heidi was named Rail Business Manager of the Year in 2009 and was awarded an OBE this year, for services to the rail industry.

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

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

Margaret Fay CBE
Independent Non-executive Director (from 1 June 2010)
Margaret Fay was appointed to the boards of NWG and NWL on 1 June 2010. Margaret was formerly Managing Director of Tyne Tees Television until she took early retirement in December 2003 in order to take up her current position as Chairman of One North East, the Regional Development Agency. She is a Board Member of the new Homes and Communities Agency, Patron of Tees Valley Community Foundation and the Prince of Wales' Ambassador for the North East of England. Margaret was awarded an OBE for services to broadcasting in 2004 and, in 2010, a CBE for services to regional development.

Claude Lamoureux
Non-executive Director
Claude Lamoureux was appointed to the boards of NWG and NWL on 1 December 2006. Claude was, until 1 December 2007, President and CEO of the Ontario Teachers' Pension Plan Board (OTPP). Previously, he spent 25 years as a financial executive with Metropolitan Life in Canada and the US. He is Chairman of Cordiant Capital and is also a director of Xstrata plc, Industrial Alliance Insurance and Financial Services Inc, Maple Leaf Foods Inc, Atrium Innovations Inc, The Learning Partnership and the York University Foundation. OTPP holds 27% of the issued share capital of Northumbrian Water Group plc and Claude is, therefore, not regarded as an independent director.

Martin Nègre
Independent Non-executive Director
Martin Nègre was appointed to the Board in May 2003 and to the board of NWL in January 2006. Martin is a member of the Audit, Remuneration and Nomination Committees. He was, between April 2000 and April 2001, the CEO of the former Northumbrian Water Group plc and the chief corporate representative of its parent company, Suez, in the UK. He currently chairs Ecofin Global Utilities Hedge Fund Limited, Ecofin Special Situations Utilities Fund and Ecofin North American Hedge Fund. His other directorships include Ecofin Water & Power Opportunities plc, Bolux Utilities (Sicav Luxembourg), Mercurius Utilities (Liechtenstein), EFMI Global Utilities and Infrastructure Funds plc and EFMI UBAM Global Utilities 130/130 Fund. All the above funds are focused on utilities. In 2005, he became a director of Promethean plc, an AIM-listed investment company and he sits on the supervisory board of Jean-Philippe Hottinguer & Cie.

Alex Scott-Barrett
Independent Non-executive Director
Alex Scott-Barrett was appointed to the Board of NWG in September 2006, having previously joined the board of NWL in November 2005. Alex chairs the Remuneration Committee and is a member of the Audit and Nomination Committees. Alex qualified as a chartered accountant in 1981 and joined Cazenove in 1982. He worked initially as an analyst and transferred to the corporate finance department in 1986, becoming a partner in 1988. In 1996, he became a director of the firm's fund management division and, from 2000 to 2003, was the Chief Operating Officer of that division. Alex left Cazenove in 2003. He is a non-executive director of Lighthouse Group plc and is a Trustee of L'Arche and Help for Heroes.

Jenny Williams
Independent Non-executive Director
Jenny Williams joined the Board in May 2004, and the board of NWL in January 2006 and is a member of the Audit and Nomination Committees. She is a Commissioner and Chief Executive of the Gambling Commission and a Trustee of the charity, Connections at St Martins. She was Head of Water Finance and Flotation at the time of water privatisation, and has held various directorships in Government departments, including the Home Office, the Department of the Environment, Transport and the Regions and the Inland Revenue. She was a Director-General of the Lord Chancellor's Department (now the Department for Justice). Jenny will retire from the boards of NWG and NWL on 29 July 2010.

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

Corporate governance report

Introduction and corporate governance statement

The Board believes best practice in corporate governance is an important tool in helping it meet its responsibilities. The Board considers that, during the year and up to the date of this report, it has complied with the main principles and provisions of the Combined Code 2008 (the Code). The Code is available to download from the Financial Reporting Council's website at www.frc.org.uk/corporate/combinedcode.cfm or, alternatively, printed copies can be obtained free of charge from FRC publications, tel: 020 8247 1264, email: customer.services@cch.co.uk

This report, together with the directors' remuneration report, describes how the Company has applied the principles of the Code during the year. The Group has provided the information required under Disclosure and Transparency Rule 7.2.6 within the section headed 'Information pursuant to the Takeovers Directive' in the directors' report and business review.

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

The Board also ensures that business is conducted in accordance with the Group's Code of Conduct, which addresses the Group's responsibilities to a range of stakeholders and for the environment. This Code of Conduct is on the Company's website.

The Board

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

Board agendas are proposed by the Chief Executive Officer and Company Secretary, with input from NWL's management team, for approval by the Chairman.

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

The following table sets out the attendance of directors at Board and committee meetings during 2009/10:

	Board	Board (by telephone)	Nomination	Remuneration	Audit
Number of meetings	6	1	5	3	3
Sir Derek Wanless	6	1	5	3	3[1]
Sir Patrick Brown	6	1	5	3	3
John Cuthbert	6	1	2	3[1]	3[1]
Chris Green	6	1	–	–	3[1]
Claude Lamoureux	6	1	4[1]	–	–
Heidi Mottram[2]	1	–	1	1[1]	–
Martin Nègre	6	1	5	3	–
Alex Scott-Barrett	6	–	5	3	3
Jenny Williams	6	–	4	–	3

Notes:
1. Not a member, but attended at the invitation of the Committee chairman.
2. Appointed to the Board on 1 March 2010.

A Board meeting, called at short notice and held by telephone conference, took place on 11 December 2009 to discuss the final determination.

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

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

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

Authorisation of directors' conflicts of interest
Directors have a statutory duty, under section 175 of the Companies Act 2006, to avoid a situation in which they have, or can have, a conflict of interest with the Company's interests. However, there is no breach of this duty if the Board has authorised the matter in question. The Articles permit directors (other than the director having the interest in question) to authorise any situation giving rise to a known or potential conflict. A register of the interests which have been authorised is maintained by the Company Secretary and is available at every Board meeting. The Company will follow emerging best practice in line with the General Counsel 100's guidance paper.

Board balance and independence
Eight directors served throughout the year – the Chairman, two executive directors, the senior independent non-executive director and four other non-executive directors. Sir Derek Wanless is the non-executive Chairman. The executive directors were John Cuthbert (Managing Director) and Chris Green (Finance Director). Sir Patrick Brown is the senior independent non-executive director and the other independent non-executive directors are Martin Nègre, Alex Scott-Barrett and Jenny Williams. Claude Lamoureux is also a non-executive director but is not independent as he was, until 1 December 2007, President and CEO of OTPP, which holds 27% of the issued share capital of the Company.

Heidi Mottram was appointed as an executive director on 1 March 2010 and took up her position as Chief Executive Officer on 1 April 2010, immediately following John Cuthbert's retirement. Margaret Fay was appointed as a non-executive director of NWG and NWL on 1 June 2010.

The Company complies with the Code's requirement that half of the directors, excluding the Chairman, are independent non-executive directors. The Chairman was independent on appointment. Biographical details of the directors appear on pages 58 and 59 and details of their service contracts are in the directors' remuneration report.

The Chairman and Chief Executive Officer have clearly defined written responsibilities which have been agreed by the Board. The Chairman leads the Board and creates the conditions for overall Board and individual director effectiveness, both inside and outside the boardroom. The Chief Executive Officer is responsible for running the Company's business on a day to day basis.

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

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

Corporate governance report continued

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

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

The Company Secretary ensures that directors are kept informed and that information flows effectively within the Group by:
— keeping in regular contact with directors;
— sending Board papers to directors before each Board meeting;
— sending briefing packs to directors in the months when Board meetings are not held; and
— providing a directors' team room intranet site containing Board and committee papers, minutes, analysts' reports and reference and regulatory documents, to which all directors have access.

Performance evaluation
A full evaluation of the performance of the Board, its committees and of individual directors was conducted during the year. Having engaged an external consultant to conduct last year's evaluation, the exercise was conducted internally this year. Each director completed a detailed questionnaire prior to a one-to-one meeting with the Chairman. The questionnaire was prepared by the Chairman and Company Secretary and was designed to address strategic issues and succession planning, as well as the approach of the Board to operational and financial matters, the role of the non-executive directors and the quality of information received by the Board. The performance of NWL's board, committees and individual directors was evaluated at the same time. Except in relation to Heidi Mottram and Margaret Fay, who have been appointed directors since the last AGM and will seek election as directors for the first time at this year's AGM, the Chairman's comments on the evaluation of the directors seeking annual re-election at the AGM are provided in the Notice of Meeting. The comments of the Senior Independent non-executive director on the evaluation of the Chairman are also provided in the Notice.

External appointments
Executive directors have generally only accepted non-executive positions outside the Group where this would benefit either the Group or the local community. These positions have tended to be with educational institutions, economic regeneration groups or similar bodies. The Board has agreed that executive directors of the Company who are appointed to non-executive directorships of a more commercial nature may retain the fees, subject to obtaining the Chairman's consent before an appointment is accepted. Only one such external appointment per director will generally be permitted. On 1 November 2009, John Cuthbert was appointed as a non-executive director of Bellway plc. This appointment was made following John's decision to retire from the Group earlier in the year.

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

Remuneration Committee

The work of the Remuneration Committee and details of the directors' remuneration are set out in the directors' remuneration report.

Nomination Committee

The main duty of the Nomination Committee is to identify and nominate candidates to fill Board vacancies for approval by the Board. The Committee also reviews succession planning for the Board, NWL board and senior appointments and will make recommendations to the Board when appropriate. The Committee's usual policy is to use external recruitment consultants or to advertise in order to identify suitable candidates.

Following the announcement of John Cuthbert's retirement, the Committee initiated a search for a successor. Heidi Mottram was identified as a suitable candidate by recruitment consultants and then interviewed by a specially authorised sub-committee of the Nomination Committee. She then had discussions with the Finance Director before her appointment was recommended to the full Nomination Committee and then the boards of NWG and NWL.

In addition to the appointment of Heidi Mottram, the Committee also recommended to the NWG and NWL boards the appointment of Margaret Fay, as an additional independent non-executive director. The Committee felt that an additional non-executive with strong business and political contacts, especially in the north east, would be a valuable addition to the boards. Margaret Fay was regarded by the Committee as an ideal candidate for this role and she was, therefore, approached by the Company to discuss the opportunity.

The Committee also considered extensions to the appointments of non-executive directors on the NWG and NWL boards whose contracts for services expired during the year. An extension to the appointment of Sir Derek Wanless took him into his seventh year as a non-executive director of the NWG Board and, having been subject to a rigorous review as required by the Combined Code, the Committee remains satisfied with his performance. Non-executive directors are appointed for a term of one year and all directors are now subject to annual re-election at the AGM.

The members of the Nomination Committee are now Sir Derek Wanless (chairman), Sir Patrick Brown, Heidi Mottram, Martin Nègre, Alex Scott-Barrett and Jenny Williams, and the membership is compliant with the Code.

Accountability and audit

Audit Committee

The Audit Committee members during the year were Sir Patrick Brown (chairman), Alex Scott-Barrett and Jenny Williams. Alex Scott-Barrett is a chartered accountant and the Board is satisfied that he has recent and relevant financial experience. On 1 April 2010, Martin Nègre was appointed as an additional member of the Committee.

The Committee's membership complies with the Code. The Chairman and executive directors are invited to Audit Committee meetings with the permission of its chairman but have no right of attendance. Managers from within the Group are invited to Audit Committee meetings to discuss issues relating to their areas of the business. During the year, the Committee met with both the external Audit Partner and Internal Audit Manager to discuss audit business, without the executive directors being present. The Committee remains satisfied that the internal audit function is able to operate with independence and is not under any pressure from the executive management of the Company to produce particular results.

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

Corporate governance report continued

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

During the year its work included:
— monitoring the integrity of the financial statements of the Company;
— reviewing the Company's internal controls (both financial and IT) by considering reports of both the internal and external auditors, directing questions to management and reviewing the financial risks and controls information provided to them on an annual basis, as detailed on pages 65 and 66;
— monitoring and reviewing the effectiveness of the internal audit function by reviewing the scope of the annual audit plan, the results of those audits and monitoring the completion of actions identified during the audit;
— monitoring and reviewing the performance and effectiveness of the external auditors, in particular, by reviewing the scope and costs of the audit process;
— reviewing the external auditors' independence by monitoring the extent of the provision of non-audit services and receiving reports from the external auditors;
— monitoring the potential impact and management of significant risks to the business using a risk methodology (meeting the recommendations of the 2005 Turnbull Review Group guidance) which sets out and rates all identified risks, including operational, external, financial, environmental, social and governance risks;
— reviewing the Committee's terms of reference;
— reviewing the Group's financial approval rules;
— reviewing the Group's tax strategy;
— reviewing NWL's contract terms;
— reviewing the Group's accounting and treasury policies; and
— reviewing the Company's interim management statements, half-yearly and preliminary results' announcements and final published annual report and financial statements.

Given the importance of NWL to the Group's business, the Committee works closely with the Audit Committee of NWL. In particular, both committees review significant regulatory reports for Ofwat and regularly review NWL's debt recovery strategy and performance. In addition, meetings were held with the Ofwat Reporter during the year to discuss the June Return process.

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

External auditors
Ernst & Young LLP have been the Group's auditors since 2003. The audit engagement partner is subject to change every five years and was last changed in 2008.

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

On 26 May 2010, Ernst & Young confirmed to the Audit Committee, in accordance with ISA 260 (Communication of audit matters to those charged with governance), that they have considered their relationship with the Company and that, in their professional judgement, the objectivity of the audit engagement partner and audit staff is not impaired.

Review of internal control

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

The Board has overall responsibility for maintaining a sound system of internal control and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives. Regular reviews of the effectiveness of the internal control system are carried out in accordance with the 2005 Turnbull Review Group guidance. The actions necessary to address weaknesses and otherwise improve the system of internal control are communicated to management. Internal audit monitors implementation of these actions and reports back to the Audit Committee. This process has been in place throughout the year and up to the date of approval of the 2009/10 annual report and financial statements. There are inherent limitations in any system of internal control and even the most effective system can only provide a reasonable, and not absolute, assurance against material misstatement or loss.

The use of our standard accounting manual by finance teams throughout the Group ensures that transactions and balances are recognised and measured in accordance with prescribed accounting policies and that information is appropriately reviewed and reconciled as part of the reporting process. The use of a standard reporting pack by all entities in the Group ensures that information is gathered and presented in a consistent way that facilitates the production of the consolidated financial statements.

The Board has reviewed the effectiveness of the Group's system of internal control, as follows, during the year. The internal audit team manages a process whereby all of the financial controls within the Group are identified and certified by the relevant manager as having operated for the full year. As part of a programme of work (which is agreed with the Audit Committee), these controls are tested throughout the year. A report detailing any areas of concern is produced after each audit. As part of the same process all of the key business risks are identified. Each risk is assessed on an unmanaged basis, the controls in place to mitigate the risks are detailed and the risk is then re-assessed after these controls. An additional risk-mapping exercise undertaken during the year is described on page 50.

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

Organisational structure

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

The NWL management team manages the major business of the Group and, during the year, consisted of John Cuthbert (Managing Director), Chris Green (Finance Director), Graham Neave (Operations Director and on NWL board), Ceri Jones (Regulation & Scientific Services Director and on NWL board), John Devall (Water & Networks (South) Director), Ian Donald (Customer Services Director), Diane Morton (HR Director), Colin Price (Technical Director) and Henry Wilson (Waste water & Networks (North) Director). Heidi Mottram (Chief Executive Officer) joined the management team on 1 April 2010, following John Cuthbert's retirement. The NWL management team meets monthly to consider and discuss progress against annual and monthly financial and operational targets. It prepares an annual budget and business plan for consideration and approval by the NWL board. NWL operates a balanced scorecard system which monitors progress against KPIs and which covers all areas of operation of the business.

Corporate governance report
continued

The Board is able to monitor the impact of environmental, social and governance matters on the Group's business, to assess the impact of significant risks on the business and to evaluate methods of managing these risks through reports it receives from the Subsidiary Boards and the Audit Committee. The environmental risks considered to be significant by the Board are described on pages 52 and 53, together with a summary of how NWL is managing these risks.

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

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

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

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

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

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

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

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

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

Martin Parker
General Counsel and Company Secretary
1 June 2010

Directors' remuneration report

In this report, which will be submitted for approval at the AGM on 29 July 2010, we describe how the executive directors are remunerated. Those parts of the remuneration report which are subject to audit by Ernst & Young are marked 'audited'.

The Remuneration Committee

The role of the Remuneration Committee

The Remuneration Committee of the Board (the Committee) determines the remuneration and terms of employment of the Chairman of the Company, executive directors of NWG and NWL and a further seven senior managers, in accordance with a remuneration policy approved by the Board. The terms of reference for the Committee are published on our website at www.nwg.co.uk (in the 'about us: corporate governance' section) or a copy can be requested from the Company Secretary.

The Committee is always available to engage with major shareholders and their representatives to discuss remuneration matters. During 2009, the Remuneration Committee did consult with its larger shareholders, the Association of British Insurers and RiskMetrics on the change that has been made to the LTIP performance measures. This is described below.

Remuneration Committee members

The Committee members are Martin Nègre (chairman until 31 March 2010), Sir Patrick Brown, Anita Frew, Alex Scott-Barrett (chairman from 1 April 2010), who are all considered by the Company to be independent, and Sir Derek Wanless. The membership of the Committee was, therefore, compliant with the Combined Code throughout the year. Martin Parker, the Company Secretary, is secretary to the Committee.

External advice

The Committee continued to receive advice during the year from its appointed advisers, Hewitt New Bridge Street (HNBS), and also from the Managing Director (although never about his own remuneration). HNBS was paid £41,616 for these services in 2009/10 and continues to assist the Committee in maintaining best practice in relation to remuneration. HNBS did not provide any other services to the Company during the year.

The Committee's work in 2009/10

The Committee met three times during the year with 100% attendance by all members, to:
— set the remuneration package for the new Chief Executive Officer;
— discuss and approve the new policy on LTIP performance measures;
— agree bonus payments for 2008/09;
— set performance targets for executive directors and senior managers;
— agree salaries for 2010/11;
— determine the vesting percentage to be applied to the LTIP awards made on 21 December 2006 which vested on 21 December 2009; and
— grant LTIP awards on 4 January 2010 (to vest on 4 January 2013).

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

Remuneration policy

The Committee considers the principles and provisions of the Combined Code when setting its policy and believes it is fully compliant. The policy of the Company is to provide remuneration that is sufficient to attract, retain and motivate directors of the quality required to run the Company successfully, while paying fairly. Although HNBS provides the Committee with detailed comparative data on other companies in the sector, the Committee is aware of, and avoids the risk of, remuneration being ratcheted up as a result of benchmarking exercises.

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

The remuneration policy of the Committee is:

— that the setting of base salaries is largely influenced by individual contributions and internal relativities rather than external comparators (although for 2009/10 the Committee was influenced by general economic conditions);
— that the annual bonus plan recognises the interests of all of the Company's stakeholders (shareholders, customers and employees) rather than being focused solely on profit; and
— that management shares in the longer term value created for the Company's investors and the serviceability of the Company's regulated assets.

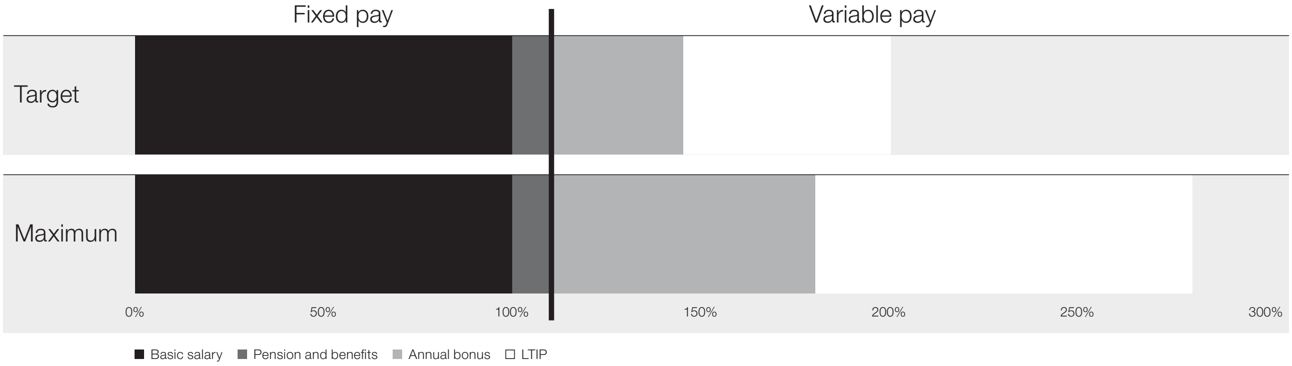
Elements of remuneration

The remuneration of the executive directors comprises:

— basic salary;
— benefits (including pension and participation in the Company's 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 new 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.

Chief Executive Officer's remuneration



Directors' remuneration report
continued

Basic salary and benefits
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.

Current basic salaries, together with the previous year's salaries, are set out below:

	As at 1.4.2010	As at 1.4.2009	As at 1.4.2008
John Cuthbert	**n/a**	£295,000	£295,000
Chris Green	**£228,000**	£225,000	£225,000
Heidi Mottram	**£320,000**	n/a	n/a

The basic salaries of the executive directors were not increased for 2009/10. For 2010/11 salaries for senior executives have been increased by 1.3% (except for John Cuthbert who retired on 31 March 2010 and for Heidi Mottram who was appointed on 1 March 2010). This is the same as for all other employees.

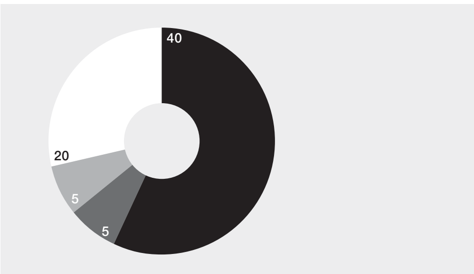
Benefits provided to the executive directors comprise membership of pension schemes (as detailed below), car allowance and healthcare.

Pensions
The main features of the Northumbrian Water Pension Scheme are set out in note 24 to the financial statements. Basic salary is the only pensionable element of the executive directors' remuneration packages.

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

Annual bonus
The annual bonus plan has been designed to reflect the interests of all of the Company's stakeholders. Consistent with prior years, maximum annual bonus potential for the executive directors for 2010/11 is 70% of salary, which is apportioned as follows:

Annual bonus %



■ Shareholders – profit before tax (PBT)
■ Customers – Ofwat's Overall Performance Assessment (OPA)
■ Employees – percentage lost time through sickness
□ Bespoke personal targets

Actual performance against the 2009/10 targets was as follows:

Bonus metric	Maximum bonus (% of salary)	John Cuthbert Actual bonus (% of salary)	Chris Green Actual bonus (% of salary)
PBT	40	19.5	19.5
OPA rating	5	1.0	1.0
Percentage lost time through sickness	5	–	–
Bespoke personal targets	20	18.0	18.0
Total	**70**	**38.5**	**38.5**
		£113,575	**£86,625**

Notes:
1. The PBT bonus is based on actual PBT performance compared to the budget PBT set by the Board at the beginning of the year. PBT has been chosen because it is a primary financial measure for the Company, for which the executive directors are accountable. The calculation of PBT performance is adjusted to exclude (i) the impact of any variance between the actual and budget interest charge on index linked bonds issued by Northumbrian Water Finance plc, which depends entirely on RPI in July of each year and is, therefore, outside of management control; and (ii) the impact of restructuring costs.
2. NWL's estimated OPA score for 2009/10 is 363, against a range for bonus purposes of 343 to 428, being the published range of performance across the 10 water and sewerage companies in 2008/09. NWL's score was adversely affected by sewer flooding.
3. The year end percentage of time lost through sickness was 3.18%, against a range for bonus purposes of 2.7% to 2.99%.
4. In 2009/10, John Cuthbert's personal targets related principally to managing the PR09 process, maintaining key financial ratios and measures, ensuring that good relationships were maintained with major investors and analysts, implementing the agreed approach to succession planning, ensuring that investment needs were properly quantified and that the investment programme was delivered with regulatory outputs met and identifying further opportunities to impact the cost base of NWL and improve its efficiency ranking. Chris Green's personal targets were focused mainly on managing the PR09 process, maintaining key financial ratios and measures, relationships with major investors and analysts, positioning NWL to respond to Ofwat's proposals on accounting separation and competition, ensuring that investment needs were properly quantified and that the investment programme was delivered with regulatory outputs met, identifying further opportunities to impact the cost base of NWL and improve its efficiency ranking and ensuring an appropriate balance of risk and reward in the management of the Group treasury.

In accordance with the terms agreed on her appointment, Heidi Mottram was awarded a bonus in respect of March 2010 equal to 38.5% of her salary for that month. This was the average percentage of the bonuses awarded to John Cuthbert and Chris Green for the year.

For 2010/11, the same bonus metrics will continue to be used with the same weightings as described above.

LTIP

Under the LTIP, executive directors and senior managers may receive, at the discretion of the Remuneration Committee, annual conditional awards of shares in the Company worth up to 100% of annual salary at grant, although only the executive directors participate at the 100% level. All awards have three year pre-vesting performance conditions.

For the three annual awards granted from December 2006 to December 2008 the vesting of up to half of an award is subject to relative total shareholder return (TSR) performance against the FTSE 250 (excluding investment trusts) and the other half is subject to a relative return on capital employed (ROCE) target as monitored by Ofwat.

In the latter half of 2009, the Committee reviewed its policy on the pre-vesting performance conditions that should apply to LTIP awards. The Committee, with advice from HNBS, came to two conclusions that led to changes being made to its policy on performance conditions, namely:

— the volatility in the share prices of companies in the Financials and Oil & Gas FTSE sectors had increased dramatically and this was no longer correlated with NWG's share price movements. This means that these companies are not the best comparators in a relative TSR performance condition; statistically they are more likely to be grouped at the top or the bottom of the list. Accordingly, for LTIP awards made in 2009/10 and future years, the TSR comparator group will exclude companies from these defined FTSE sectors; and
— the work undertaken on drawing up the business plan for 2010-15 showed that there were other long term performance measures, in addition to ROCE, that should be measured and potentially rewarded. These are performance against Ofwat's serviceability targets and customer satisfaction levels. As such, they have been incorporated as LTIP performance metrics.

Directors' remuneration report continued

These changes were discussed with the Company's top shareholders and received their support. The Committee thanks them for their constructive engagement in this exercise. This consultation did result in the LTIP award date slipping from early December to 4 January 2010. However, this was still within the six week grant window as permitted by the LTIP rules.

The details of this award to Chris Green are:

	Number of conditional awards granted	Face value of awards granted as a % of salary†
Chris Green	83,240	100%

† Based on a closing share price on 31 December 2009 of 270.3 pence.

Details of the pre-vesting performance condition for these awards are:

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.	For the 2009/10 awards, 30% of this part of an award (i.e. 6% of the total award) will vest for average three year ROCE of 6.3%, 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.	For the 2009/10 awards, 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 advantages of using these targets include:
- the continued use of TSR provides consistency with past awards, alignment with investors and, as a result of the less correlated and volatile sectors now being excluded, provides an improved line of sight for executives;
- the use of an absolute ROCE target ensures that reward is directly linked to the management's delivery of the business plan;
- they recognise that the maintenance of NWL's regulated assets (through the serviceability targets) is critical to the longer term returns for shareholders; and
- customer satisfaction is a key objective for NWL and customers are important stakeholders.

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 21 December 2006, became available to vest on 21 December 2009. The Committee instructed PricewaterhouseCoopers (PwC) to assess the level of vesting of this award. PwC reported that 33.2% of the award was available to vest (being 66.5% 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 Table 3.

Full details of award levels and performance conditions are shown in Table 2.

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

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

Fees payable during 2009/10 and the Company's policy from 1 April 2010 (in line with the approach taken in respect of the salaries of NWG executives) are:

	2010/11 £	2009/10 £
Chairman	159,516	157,500
Non-executive director base fee	37,220	36,750
Audit Committee chairing fee	10,634	10,500
Remuneration Committee chairing fee	5,317	5,250

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

Directors' interests in LTIP awards
The directors' conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP as at 31 March 2010, are set out in Table 3.

Directors' remuneration report continued

Ordinary 10 pence shares required to fulfil LTIP awards which have vested may be provided by the Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited. The Trustees are Sir Patrick Brown, Martin Nègre, John Cuthbert (until 31 March 2010), Anita Frew, Alastair Balls and Kate Alsop. At 31 March 2010, the Trust held a total of 914,518 ordinary 10 pence shares. This represents 0.2% of the Company's total issued share capital, so is materially less than the 5% limit on shares that can be held in trust. In line with the ABI Guidelines, dividends are waived on these shares and the voting rights attached to these shares will not be exercised at the AGM.

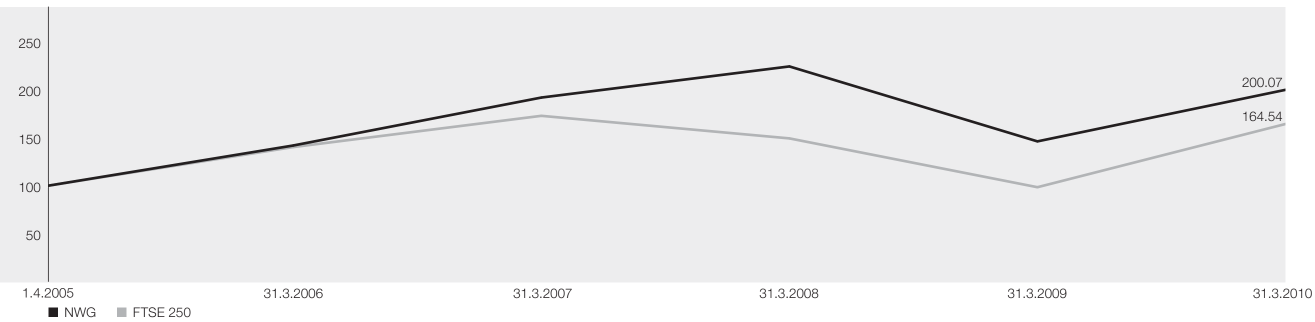
Share dilution

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

Performance graph

The graph below shows a comparison between the TSR for the Company's shares for the five year period to 31 March 2010, and the TSR for the companies comprising the FTSE 250 Index (excluding investment trusts) over the same period. This index has been selected as the Company is a constituent of the FTSE 250.

Performance graph £



Note:
This graph shows the value, by 31 March 2010, of £100 invested in Northumbrian Water Group plc on 1 April 2005 compared with the value of £100 invested in the FTSE 250 Index (excluding investment trusts) over the same period.

Service contracts

All non-executive directors are appointed for a term of 12 months with a six month notice period for the Company and the director. The executive directors have service contracts with 12 months notice periods and which expire when the directors reach normal retirement age. The contracts do not contain any liquidated damages clauses. Details of the contracts of the executive and non-executive directors who served during the year are shown in Table 4.

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

Retirement of John Cuthbert and recruitment of Heidi Mottram
John Cuthbert retired on 31 March 2010 and Heidi Mottram was appointed as an executive director on 1 March 2010, giving the Company the benefit of John Cuthbert's expertise and experience in a one month handover process to Heidi Mottram. Heidi Mottram took up her position as Chief Executive Officer on 1 April 2010.

As explained above, Heidi Mottram has been employed on a salary of £320,000. She will not participate in the Company's final salary pension scheme (now closed), and instead, the Company will make an employer's contribution of 8% of salary into the Company's money purchase scheme for her benefit. She will participate in the annual bonus plan and LTIP as described above. No other compensation was paid to her in connection with her recruitment.

External appointments of executive directors
The Board's position on external appointments is described in full in the corporate governance report but, in summary, the Board has agreed that executive directors of the Company who are appointed to non-executive directorships which pay a fee may retain the fees, subject to obtaining the Chairman's consent before an appointment is accepted. Only one such external appointment per director will generally be permitted. On 1 November 2009, John Cuthbert was appointed as a non-executive director of Bellway plc. This appointment was made following John's decision to retire from the Group earlier in the year. John Cuthbert retained the director's fee received from Bellway plc, which is an annual amount of £46,380. Heidi Mottram is a Board member of Yorkshire Forward for which she is paid and retains an annual fee of £8,666.

Directors' interests in shares
The directors' beneficial interests in the ordinary 10 pence shares of the Company, as at 31 March 2010, are set out in Table 6. The NWG Board has agreed to introduce a guideline requesting NWG directors to build up (over a maximum of five years) shares in the Company with a value equal to one year's basic salary (in the case of the executive directors) or one year's fees (in the case of non-executive directors).

Directors' interests in shares under the SIP
The Company SIP is open to UK employees with more than three months' service. Further details of the SIP are set out in the directors' report and business review. During the year, the executive directors had the opportunity to participate in the SIP and their interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP, are set out in Table 7.

This directors' remuneration report has been produced in accordance with the Companies Act 2006 and Schedule 8 of the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008. It was approved by the Board and signed on its behalf by the chairman of the Remuneration Committee. It will be put to the shareholders for approval at the Company's AGM.

Alex Scott-Barrett
Chairman of Remuneration Committee
1 June 2010

Directors' remuneration report continued

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

Table 1
Directors' emoluments (audited)
The emoluments of the directors of the Company for their services as directors of the Company and (where relevant) its subsidiaries, are set out below, rounded to the nearest thousand pounds:

	Fees £000	Basic salary £000	Benefits[1] £000	Bonus[2] £000	**Total for the year ended 31.3.2010 £000**	Total for the year ended 31.3.2009 £000
Executive directors						
John Cuthbert	–	295	20	114	**429**	335
Heidi Mottram	–	27	1	10	**38**	–
Chris Green	–	225	12	86	**323**	273
Non-executive directors						
Sir Derek Wanless	158	–	–	–	**158**	158
Sir Patrick Brown[3]	47	–	–	–	**47**	47
Claude Lamoureux	37	–	–	–	**37**	37
Martin Nègre[4]	42	–	–	–	**42**	42
Alex Scott-Barrett	37	–	–	–	**37**	37
Jenny Williams	37	–	–	–	**37**	37
Total remuneration	358	547	33	210	**1,148**	966

Notes:
1. The remuneration of each executive director includes non-cash benefits comprising the provision of car allowances and healthcare.
2. The annual bonus is payable in June 2010, for performance during the year ended 31 March 2010.
3. Includes additional fee paid as chairman of Audit Committee.
4. Includes additional fee paid as chairman of Remuneration Committee.

Table 2
Summary of LTIP performance conditions (unaudited)

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

LTIP award made 13 December 2007 and 15 December 2008	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth 100% of salary.
Performance conditions and vesting schedules	As per LTIP award made 21 December 2006.

LTIP award made 4 January 2010	
Maximum award	100% of salary permitted and actual grants to executive directors related to shares worth 100% of salary.
Performance conditions and vesting schedules	Please refer back to the remuneration report for new performance conditions.

Directors' remuneration report
continued

Table 3
Directors' interests in LTIP awards (audited)

As at 31 March 2010, the directors had the following conditional interests in the ordinary 10 pence shares of the Company, awarded in accordance with the terms of the LTIP:

	Award date	Awards held at the start of the year	Awarded during the year	Awards lapsed during the year	Awards vested during the year	**Awards held as at 31.3.2010**
John Cuthbert	21.12.2006[1]	66,721	–	44,521	22,200[2]	**–**
	13.12.2007[3]	79,230	–	–	–	**79,230**
	15.12.2008[4]	103,100	–	–	–	**103,100**
Totals		249,051	–	44,521	22,200	**182,330**
Chris Green	21.12.2006[1]	49,423	–	32,978	16,445[2]	**–**
	13.12.2007[3]	61,620	–	–	–	**61,620**
	15.12.2008[4]	78,650	–	–	–	**78,650**
	4.1.2010[5]	–	83,240	–	–	**83,240**
Totals		189,693	83,240	32,978	16,445	**223,510**

Notes:
1. The market value of the shares on the date of the award was 302.75 pence per share. The three year performance period runs from 1 October 2006 to 30 September 2009.
2. Shares vested on 21 December 2009 and the closing price on that date was 269.00 pence per share.
3. The market value of the shares on the date of the award was 334.00 pence per share. The three year performance period runs from 1 October 2007 to 30 September 2010.
4. 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.
5. 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.
6. The cost of conditional awards is charged to the income statement over the three year performance period to which they relate after taking account of the probability of performance criteria being met. In the year, £0.4 million was charged to the income statement (2009: £0.5 million).
7. Details of the performance conditions are shown at Table 2.
8. The market price of the shares on 31 March 2010 was 283.10 pence per share. During the year, the highest market price was 295.70 pence per share and the lowest market price was 203.00 pence per share.
9. Aggregate gross gains made by directors on exercise of awards at date of vesting was £103,955 (2009: £92,336).

Table 4
Directors' service contracts (unaudited)

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

	Initial appointment	Current contract start date	Unexpired term[1]	Notice period by either party	Current contract end date
Executive directors[2]					
John Cuthbert[3]	23.5.2003	23.5.2003	Not fixed term	12 months	Normal retirement age (65)
Heidi Mottram	1.3.2010	1.3.2010	Not fixed term	12 months	Normal retirement age (65)
Chris Green	23.5.2003	23.5.2003	Not fixed term	12 months	Normal retirement age (65)
Non-executive directors[4]					
Sir Derek Wanless	1.12.2003	1.12.2008	6 months	6 months	30.11.2010
Sir Patrick Brown	12.5.2003	12.5.2009	11 months	6 months	11.5.2011
Claude Lamoureux	1.12.2006	1.12.2008	6 months	6 months	30.11.2010
Martin Nègre	12.5.2003	12.5.2009	11 months	6 months	11.5.2011
Alex Scott-Barrett	26.9.2006	26.9.2008	4 months	6 months	25.9.2010
Jenny Williams	27.5.2004	27.5.2009	2 months	6 months	29.7.2010

Notes:
1. Calculated as at 1 June 2010 and rounded to nearest whole month.
2. The service contracts of the executive directors do not contain provisions relating to compensation for termination. In the event of termination by the Company, the Remuneration Committee would make recommendations to the Board on what payments, if any, should be made to the director, depending on the circumstances of the termination, taking into account the Combined Code which discourages payment for failure. The Company would also expect directors to seek to mitigate their loss.
3. John Cuthbert took early retirement on 31 March 2010.
4. Contracts do not provide for compensation for loss of office in excess of fees accrued.

Table 5
Directors' pensions and pension benefits (audited)

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

	Accrued pension at 31.3.2009 £000	**Accrued pension at 31.3.2010 £000**	Increase in accrued pension £000	Increase in accrued pension net of inflation £000	Transfer value of net increase in accrued pension less directors' contributions £000	Transfer value of accrued pension at 1.4.2009 £000	**Transfer value of accrued pension at 31.3.2010 £000**	Total change in transfer value less directors' contributions £000
John Cuthbert	163.4	**172.0**	8.6	1.3	24.1	3,119.0	**3,580.9**	461.9
Chris Green	99.3	**104.3**	5.0	0.6	9.3	1,838.4	**2,111.4**	273.0

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

Table 6
Directors' interests in shares (audited)

The directors had the following beneficial or family interests in the ordinary 10 pence shares of the Company as at 31 March 2010:

	Number of shares held at the start of the year	**Number of shares held as at 31.3.2010**	Number of shares held as at 1.6.2010
Sir Derek Wanless	30,000	**65,000**	65,000
John Cuthbert	232,436[1]	**232,436**	n/a[2]
Chris Green	152,894[3]	**169,339[4]**	169,339
Sir Patrick Brown	43,000	**43,000[5]**	43,000
Claude Lamoureux	25,000	**25,000**	25,000
Martin Nègre	70,000	**70,000**	70,000
Alex Scott-Barrett	10,000	**20,000**	20,000
Jenny Williams	6,000	**6,000**	6,000

Notes:
1. At 1 April 2009, 69,436 of these shares were beneficially owned by Mrs L Cuthbert, 4,000 were beneficially owned by Mr I M Cuthbert and 9,000 were beneficially owned by Miss S L Cuthbert.
2. Mr Cuthbert retired from the Company on 31 March 2010.
3. At 1 April 2009, 137,894 of these shares were beneficially owned by Mrs G Green, and 5,000 were beneficially owned by each of Miss P J Green, Mr M F Green and Mr J M Green.
4. At 31 March 2010, 139,339 of these shares were beneficially owned by Mrs G Green, and 10,000 were beneficially owned by each of Miss P J Green, Mr M F Green and Mr J M Green.
5. On 11 March 2010, Sir Patrick Brown transferred 43,000 shares to Lady Brown.

Directors' remuneration report continued

Table 7
Directors' interests in shares under the SIP (audited)
The directors who held office as at 31 March 2010 had the following interests in the ordinary 10 pence shares of the Company, purchased and held in accordance with the terms of the SIP:

	Number of SIP shares held at the start of the year[1]	**Number of SIP shares held as at 31.3.2010[1]**	Number of SIP shares held as at 1.6.2010[1]
John Cuthbert	4,785	**5,653**	–[2]
Chris Green	4,785	**5,653**	6,372

Notes:
1. These figures include the shares paid for by the participant and the free shares granted by the Company.
2. Mr Cuthbert's shares were released from the SIP on 1 April 2010, following his retirement on 31 March 2010.
3. A summary of the SIP can be found in the directors' report and business review.

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

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

The directors are required to prepare Group financial statements for each financial year. Under Company Law, the directors must not approve the financial statements unless they are satisfied that they present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those Group financial statements the directors are required to:

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

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Group's transactions and disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that the Group financial statements comply with the Companies Act 2006 and Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and, hence, for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Responsibility statements
We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with IFRS as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Company and the undertakings included in the consolidation taken as a whole; and
- the directors' report and business review includes a fair review of the development and performance of the business and the position of the Company and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board

Sir Derek Wanless
Chairman

Heidi Mottram
Chief Executive Officer

Report of the Auditors on the Group financial statements

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

We have audited the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2010 which comprise the Consolidated income statement, the Consolidated statement of comprehensive income, the Consolidated statement of changes in equity, the Consolidated balance sheet, the Consolidated cash flow statement and the related notes 1 to 28. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union.

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 auditors

As explained more fully in the Statement of directors' responsibilities set out on page 81, the directors are responsible for the preparation of the Group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the Group 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 Group'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.

Opinion on financial statements

In our opinion the Group financial statements:

— give a true and fair view of the state of the Group's affairs as at 31 March 2010 and of its profit for the year then ended;
— have been properly prepared in accordance with IFRS as adopted by the European Union; and
— have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

— the information given in the Directors' report and business review for the financial year for which the financial statements are prepared is consistent with the Group financial statements; and
— the information given in the Corporate governance report with respect to internal control and risk management systems in relation to financial reporting processes and about share capital structures 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:

Under the Companies Act 2006 we are required to report to you if, in our opinion:
— certain disclosures of directors' remuneration specified by law are not made;
— we have not received all the information and explanations we require for our audit; or
— a corporate governance statement has not been prepared by the Company.

Under the Listing Rules we are required to review:
— the directors' statement, set out on page 51, in relation to going concern; and
— the part of the Corporate governance report relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review.

Other matters
We have reported separately on the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2010 and on the information in the Directors' remuneration report that is described as having been audited.

Debbie O'Hanlon (Senior statutory auditor)
For and on behalf of Ernst & Young LLP
Statutory Auditor
Newcastle upon Tyne
1 June 2010

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Consolidated income statement

For the year ended 31 March 2010

	Notes	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Continuing operations			
Revenue	2	**704.7**	694.1
Operating costs	3	**(428.9)**	(420.5)
Profit on ordinary activities before interest	2	**275.8**	273.6
Finance costs payable	6	**(143.7)**	(183.5)
Finance income receivable	6	**37.2**	61.8
Share of profit after tax of jointly controlled entities		**0.9**	0.8
Profit on ordinary activities before taxation	2	**170.2**	152.7
– current taxation	7	**(37.8)**	(32.1)
– deferred taxation	7	**(9.5)**	(132.5)
Profit/(loss) for the year		**122.9**	(11.9)
Attributable to:			
Equity shareholders of the parent Company		**122.5**	(12.7)
Minority interests		**0.4**	0.8
		122.9	(11.9)
Basic earnings/(loss) per share attributable to ordinary equity holders of the parent Company	8	**23.67p**	(2.45p)
Diluted earnings/(loss) per share attributable to ordinary equity holders of the parent Company	8	**23.62p**	(2.45p)
Adjusted earnings per share for profit from continuing operations attributable to ordinary equity holders of the parent Company (excluding deferred tax)	8	**25.51p**	22.05p
Ordinary final dividend proposed per share	9	**8.85p**	8.50p
Dividend paid per share	9	**12.89p**	12.36p

Consolidated statement of comprehensive income

For the year ended 31 March 2010

	Notes	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Profit/(loss) for the year		**122.9**	(11.9)
Other comprehensive income			
Actuarial gains/(losses)	24	**1.1**	(207.8)
Losses on cash flow hedges taken to equity		**(0.8)**	(11.7)
Translation differences		**(0.3)**	0.9
Transferred to the income statement on cash flow hedges		**–**	(0.1)
Tax on items charged or credited to equity		**(0.1)**	61.5
Total other comprehensive loss		**(0.1)**	(157.2)
Total comprehensive income/(loss) for the year		**122.8**	(169.1)
Attributable to:			
Equity shareholders of the parent Company		**122.4**	(169.9)
Minority interests		**0.4**	0.8
		122.8	(169.1)

Consolidated statement of changes in equity

For the year ended 31 March 2010

	Equity share capital £m	Share premium reserve £m	Cash flow hedge reserve £m	Treasury shares £m	Currency translation £m	Retained earnings £m	Total equity £m	Minority interests £m	Total £m
At 1 April 2008	51.9	446.5	1.0	(0.8)	0.1	(8.6)	490.1	1.7	491.8
Loss for the year	–	–	–	–	–	(12.7)	(12.7)	0.8	(11.9)
Other comprehensive income	–	–	(8.6)	–	0.9	(149.5)	(157.2)	–	(157.2)
Total comprehensive income and expense for the year	–	–	(8.6)	–	0.9	(162.2)	(169.9)	0.8	(169.1)
Shares purchased	–	–	–	(1.7)	–	–	(1.7)	–	(1.7)
Share-based payment	–	–	–	–	–	0.5	0.5	–	0.5
Exercise of LTIP awards	–	–	–	0.2	–	(0.2)	–	–	–
Equity dividends paid	–	–	–	–	–	(64.0)	(64.0)	(0.1)	(64.1)
At 1 April 2009	51.9	446.5	(7.6)	(2.3)	1.0	(234.5)	255.0	2.4	257.4
Profit for the year	–	–	–	–	–	122.5	122.5	0.4	122.9
Other comprehensive income	–	–	(0.6)	–	(0.3)	0.8	(0.1)	–	(0.1)
Total comprehensive income and expense for the year	–	–	(0.6)	–	(0.3)	123.3	122.4	0.4	122.8
Share-based payment	–	–	–	–	–	0.4	0.4	–	0.4
Exercise of LTIP awards	–	–	–	0.3	–	(0.3)	–	–	–
Equity dividends paid	–	–	–	–	–	(66.7)	(66.7)	–	(66.7)
At 31 March 2010	**51.9**	**446.5**	**(8.2)**	**(2.0)**	**0.7**	**(177.8)**	**311.1**	**2.8**	**313.9**

Consolidated balance sheet

As at 31 March 2010

	Notes	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Non-current assets			
Goodwill	10	**3.6**	3.6
Other intangible assets	10	**64.2**	64.2
Property, plant and equipment	11	**3,504.9**	3,388.2
Investments in jointly controlled entities	12	**4.1**	3.8
Financial assets		**12.9**	14.0
Amounts receivable relating to consortium relief		**1.7**	1.7
		3,591.4	3,475.5
Current assets			
Inventories	13	**3.3**	3.2
Trade and other receivables	14	**136.4**	131.7
Short term cash deposits	15	**15.8**	160.6
Cash and cash equivalents	15	**174.8**	108.8
		330.3	404.3
Total assets		**3,921.7**	3,879.8
Non-current liabilities			
Interest bearing loans and borrowings	17	**2,433.9**	2,465.3
Provisions	19	**2.2**	2.5
Deferred income tax liabilities	7	**606.1**	596.5
Pension liability	24	**133.1**	119.4
Other payables		**7.8**	8.1
Grants and deferred income		**219.5**	215.6
		3,402.6	3,407.4
Current liabilities			
Interest bearing loans and borrowings	17	**33.1**	49.2
Provisions	19	**0.2**	0.2
Trade and other payables	16	**151.2**	147.8
Interest rate swaps	20	**12.5**	11.7
Income tax payable		**8.2**	6.1
		205.2	215.0
Total liabilities		**3,607.8**	3,622.4
Net assets		**313.9**	257.4
Capital and reserves			
Issued capital	21	**51.9**	51.9
Share premium reserve		**446.5**	446.5
Cash flow hedge reserve		**(8.2)**	(7.6)
Treasury shares		**(2.0)**	(2.3)
Currency translation		**0.7**	1.0
Retained earnings		**(177.8)**	(234.5)
Equity shareholders' funds		**311.1**	255.0
Minority interests		**2.8**	2.4
Total capital and reserves		**313.9**	257.4

Approved by the Board on 1 June 2010 and signed on its behalf by:

Sir Derek Wanless
Chairman

Heidi Mottram
Chief Executive Officer

Consolidated cash flow statement

For the year ended 31 March 2010

	Notes	**Year to 31.3.2010 £m**	Year to 31.3.2009 £m
Operating activities			
Reconciliation of profit before interest to net cash flows from operating activities			
Profit on ordinary activities before interest		**275.8**	273.6
Depreciation		**105.5**	100.7
Other non-cash charges and credits		**(5.7)**	(4.3)
Net credit for provisions, less payments		**(0.3)**	(0.3)
Difference between pension contributions paid and amounts recognised in the income statement		**10.3**	7.9
(Increase)/decrease in inventories		**(0.1)**	0.2
Increase in trade and other receivables		**(5.0)**	(8.6)
Increase/(decrease) in trade and other payables		**0.4**	(0.3)
Cash generated from operations		**380.9**	368.9
Interest paid		**(114.8)**	(120.6)
Income taxes paid		**(35.7)**	(29.6)
Net cash flows from operating activities		**230.4**	218.7
Investing activities			
Interest received		**8.8**	12.0
Capital grants received		**10.1**	11.2
Proceeds on disposal of property, plant and equipment		**0.3**	1.2
Dividends received from jointly controlled entities		**0.6**	0.8
Short term cash deposits		**144.8**	(160.6)
Maturity of investments		**1.4**	1.7
Purchase of property, plant and equipment		**(220.6)**	(231.8)
Net cash flows from investing activities		**(54.6)**	(365.5)
Financing activities			
New borrowings		**–**	141.4
Purchase of treasury shares		**–**	(1.7)
Dividends paid to minority interests		**–**	(0.1)
Dividends paid to equity shareholders		**(66.7)**	(64.0)
Repayment of borrowings		**(20.9)**	(95.9)
Payment of principal under hire purchase contracts and finance leases		**(7.2)**	(7.0)
Net cash flows from financing activities		**(94.8)**	(27.3)
Increase/(decrease) in cash and cash equivalents		**81.0**	(174.1)
Cash and cash equivalents at start of year	15	**92.3**	266.4
Cash and cash equivalents at end of year	15	**173.3**	92.3
Cash and cash equivalents at end of year	15	**173.3**	92.3
Short term cash deposits	15	**15.8**	160.6
Total cash and cash equivalents and short term cash deposits		**189.1**	252.9

Notes to the consolidated financial statements

1. Accounting policies

(a) Statement of compliance

The consolidated financial statements have been prepared in accordance with IFRS as adopted by the European Union as it applies to the financial statements of the Group for the year ended 31 March 2010 and in accordance with the Companies Act 2006.

The directors consider the following accounting policies to be relevant in relation to the Group's financial statements. The financial statements of the Group for the year ended 31 March 2010 were authorised for issue by the Board of directors on 1 June 2010 and the balance sheet was signed on the Board's behalf by Sir Derek Wanless (Chairman) and Heidi Mottram (Chief Executive Officer).

The Group has adopted the following standards and interpretations during the year:

— IAS 1 Presentation of Financial Statements (Revised)
— IAS 32 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation
— IAS 23 Borrowing Costs (Revised)
— Improvements to IFRS May 2008
— IFRS 2 Share-based Payments – Vesting Conditions and Cancellations
— IFRS 8 Operating Segments
— IFRIC 15 Agreements for the Construction of Real Estate

The adoption of IAS 1 Presentation of Financial Statements (Revised) has required the 'Reconciliation of movements in equity', previously disclosed in note 22 to the annual report and financial statements for the year ended 31 March 2009, to be presented as a primary statement entitled 'consolidated statement of changes in equity'. In addition, the 'consolidated statement of recognised income and expense' has been replaced with the 'consolidated statement of comprehensive income'.

In adopting IFRS 8 Operating Segments, the Group concluded that the operating segments and the measures of revenue, segment profit, segment assets and liabilities were the same as the business segments determined in accordance with IAS 14 Segment Reporting.

In adopting IAS 23 Borrowing Costs (Revised), the Group has amended its accounting policy and, from 1 April 2009, capitalises borrowing costs on qualifying assets. The Group has capitalised £1.2 million for the year to 31 March 2010.

IFRIC 18 Transfers of Assets from Customers has not been applied in the financial statements as it is effective for accounting periods beginning on or after 31 October 2009. The Group will, therefore, apply IFRIC 18 in preparing the annual report and financial statements for the year ending 31 March 2011.

The adoption of IAS 32 Presentation of Financial Statements, Improvements to IFRS May 2008, IFRS 2 Share-based Payments and IFRIC 15 Agreements for the Construction of Real Estate do not have a material impact on the Group.

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

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

(b) Basis of consolidation

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

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

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

(c) Associates and jointly controlled entities

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

(d) Goodwill

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

1. Accounting policies continued

(e) Intangible assets other than goodwill

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

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

(f) Property, plant and equipment

Property, plant and equipment and depreciation

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

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

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

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

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

Infrastructure assets

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

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

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

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

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

(g) Financial assets

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

(h) Foreign currencies and foreign currency transactions

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

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

(i) Inventories

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

(j) Revenues

Provision of services

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

1. **Accounting policies** continued

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

Dividends

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

(k) Grants and contributions

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

(l) Leases

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

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

(m) Pensions and other post-employment benefits

Defined benefit scheme

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

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

The service cost is disclosed in employment costs and the expected interest income and interest cost on obligations are disclosed within finance costs payable/(income receivable).

Notes to the consolidated financial statements continued

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

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

(n) Share-based payments
The cost of equity-settled transactions with employees is measured by reference to the fair value at the date at which they are granted and is recognised as an expense over the vesting period, which ends on the date on which the relevant employees become fully entitled to the award. Fair value is determined by an external valuer using the Monte-Carlo simulation model. In valuing equity-settled transactions, no account is taken of any vesting conditions, other than conditions linked to the price of the shares of the Company (market conditions) or those not related to performance or service (non-vesting conditions).

No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon a market or non-vesting condition, which are treated as vesting irrespective of whether or not the market or non-vesting 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 vesting conditions and the number of equity instruments that will ultimately vest or, in the case of an instrument subject to a market or non-vesting condition, be treated as vesting as described above. This includes any award where non-vesting conditions within the control of the Group or the employee are not met. The movement in cumulative expense since the previous balance sheet date is recognised in the income statement, with a corresponding entry in equity.

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

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

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

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

1. Accounting policies continued

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

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

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

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

Deferred tax is recognised in the income statement unless it relates to items accounted for outside profit or loss, in which case it is recognised in correlation with the underlying transaction either in other comprehensive income or directly in equity.

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

Value added tax

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

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

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

(p) Derivative financial instruments

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

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

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

Notes to the consolidated financial statements continued

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

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

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

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

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

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

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

(q) Interest bearing loans and borrowings
All loans and borrowings are initially stated at the amount of the net proceeds, being fair value of the consideration received net of issue costs associated with the borrowing. Finance costs (including issue costs) are taken to the income statement over the term of the debt at a constant rate on the balance sheet carrying amount. The carrying amount is increased by the finance charges amortised and reduced by payments made in respect of the accounting period. The carrying amount of index linked borrowings increases annually in line with the July RPI, with the accretion being charged to the income statement as finance costs payable. Other borrowing costs are recognised as an expense when incurred.

Loans and borrowings acquired at acquisition are restated to fair value. The adjustment arising on acquisition is amortised to the income statement on the basis of the maturity profile of each instrument. Realised gains and losses that occur from the early termination of loans and borrowings are taken to the income statement in that period.

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

1. Accounting policies continued

(r) Borrowing costs

Borrowing costs are generally expensed as incurred. Borrowing costs that are directly attributable to the acquisition or construction of an asset that necessarily takes a substantial time to prepare for its intended use are capitalised while the asset is being constructed as part of the cost of that asset.

Capitalisation ceases when the asset is substantially ready for its intended use or sale. If active development is interrupted for an extended period, capitalisation is suspended. When construction occurs piecemeal and use of each part ceases upon substantial completion of that part. A weighted average cost of borrowings is used.

The Group capitalises borrowing costs for all eligible assets when construction was commenced on or after 1 April 2009. The Group continues to expense borrowing costs relating to construction projects that commenced prior to 1 April 2009.

(s) Loans and receivables

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

(t) Cash and cash equivalents and short term cash deposits

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

Short term cash deposits disclosed in the balance sheet comprise cash deposited with a remaining maturity of greater than three months, a fixed interest rate and which do not constitute cash equivalents under IAS 7 'Statement of Cash Flows'.

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

(u) Trade and other receivables

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

(v) Investments

Investments are initially recorded at the fair value of the consideration given including the acquisition charges associated with the investment. Subsequent to initial recognition, they are valued at original cost less any impairment.

(w) Provisions

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

Notes to the consolidated financial statements continued

1. Accounting policies continued

(x) Impairment of assets

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

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

(y) De-recognition of financial assets and liabilities

A financial asset or liability is generally de-recognised when the contract that gives rise to it is settled, sold, cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a de-recognition of the original liability and the recognition of a new liability, such that the difference in the respective carrying amounts together with any costs or fees incurred are recognised in the income statement.

1. Accounting policies continued

(z) Accounting standards

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

International Accounting Standards (IAS/IFRS)	Effective for accounting periods beginning on or after:
IFRS 1: First Time Adoption of International Reporting Standards	1.7.2009[1]
IFRS 1: Amendment to IFRS 1 – Additional Exemptions for First-time Adopters	1.1.2010
IFRS 1: Amendment to IFRS 1 – Limited Exemption from Comparative IFRS 7 Disclosures	1.7.2010
IFRS 2: Amendment to IFRS 2 – Group Cash-settled Share-based Payment Transactions	1.1.2010
IFRS 3: Business Combinations (Revised)	1.7.2009
IFRS 9: Financial Instruments: Classification and Measurement	1.1.2013
IAS 24: Related Party Disclosures (Revised)	1.1.2011
IAS 27: Consolidated and Separate Financial Statements (Revised)	1.7.2009
IAS 32: Amendment to IAS 32: Classification of Rights Issues	1.1.2010[2]
Amendment to IAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items	1.7.2009
Improvements to IFRS April 2009	1.7.2009, 1.1.2010[3]

International Financial Reporting Interpretation Committee (IFRIC)	Effective for accounting periods beginning on or after:
IFRIC 14: Amendment: Prepayments of a Minimum Funding Requirement	1.1.2011
IFRIC 17: Distributions of Non-cash Assets to Owners	1.7.2009[4]
IFRIC 18: Transfers of Assets from Customers	1.7.2009[5]
IFRIC 19: Extinguishing Financial Liabilities with Equity Instruments	1.1.2010

1. Effective in EU at the latest, financial years starting after 31 January 2010.
2. Effective in EU at the latest, financial years starting after 31 January 2010.
3. Effective in EU at the latest, financial years starting after 31 December 2009.
4. Effective in EU at the latest, financial years starting after 31 October 2009.
5. Effective in EU at the latest, financial years starting after 31 October 2009.

The directors do not anticipate that the adoption of these standards and interpretations will have a material impact on the Group's financial statements in the period of initial application.

(aa) Key assumptions

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

— those assumptions used in arriving at the pension asset/liability under IAS 19. These key assumptions and their possible impact are disclosed in note 24, 'Pensions and other post-retirement benefits';
— the bad debt provision which is calculated by applying a range of percentages to debt of different ages. These percentages also vary between different categories of debt. Higher percentages are applied to those categories of debt which are considered to be of greater risk and also to debt of greater age. The value of the bad debt provision is sensitive to the specific percentages applied; and
— the asset lives assigned to property, plant and equipment, details of which can be found in note 1(f).

Notes to the consolidated financial statements continued

2. Segmental analysis

For management purposes, the Group is organised into business units according to the nature of the products and services and has three reportable operating segments. Profit is measured at profit on ordinary activities before interest.

Northumbrian Water Limited

NWL is one of the 10 regulated water and sewerage businesses in England and Wales. NWL operates in the north east of England, where it trades as Northumbrian Water, and in the south east of England, where it trades as Essex & Suffolk Water. NWL also has non-regulated activities closely related to its principal regulated activity.

Water and waste water contracts

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

Other

Agrer provides overseas aid funded project work in developing countries through a number of funding agencies. Central unallocated costs and provisions are also included.

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

Revenue

	Northumbrian Water Limited £m	Water and waste water contracts £m	Other £m	Total £m
Year ended 31 March 2010				
Segment revenue	**657.8**	**38.3**	**14.8**	**710.9**
Inter segment revenue	**–**	**–**	**(6.2)**	**(6.2)**
Revenue to external customers	**657.8**	**38.3**	**8.6**	**704.7**
Year ended 31 March 2009				
Segment revenue	647.0	39.8	13.0	699.8
Inter segment revenue	–	–	(5.7)	(5.7)
Revenue to external customers	647.0	39.8	7.3	694.1

All revenue above represents services provided.

2. Segmental analysis continued

Profit on ordinary activities before interest

	Northumbrian Water Limited £m	Water and waste water contracts £m	Other £m	Total £m
Year ended 31 March 2010				
Segment profit on ordinary activities before interest	**268.9**	**10.2**	**(3.3)**	**275.8**
Net finance costs				**(106.5)**
Share of profit from jointly controlled entities				**0.9**
Profit on ordinary activities before taxation				**170.2**
Taxation				**(47.3)**
Profit for the year from continuing operations				**122.9**
Year ended 31 March 2009				
Segment profit on ordinary activities before interest	266.9	9.1	(2.4)	273.6
Net finance costs				(121.7)
Share of profit from jointly controlled entities				0.8
Profit on ordinary activities before taxation				152.7
Taxation				(164.6)
Loss for the year from continuing operations				(11.9)

Assets and liabilities

	Northumbrian Water Limited		Water and waste water contracts		Other		Total	
	31.3.2010 £m	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m
Segment assets	**3,503.6**	3,446.1	**130.6**	131.7	**287.5**	302.0	**3,921.7**	3,879.8
Segment liabilities	**444.5**	431.9	**22.9**	20.8	**3,140.4**	3,169.7	**3,607.8**	3,622.4

Other comprises taxation, interest and net debt.

	Northumbrian Water Limited		Water and waste water contracts		Total	
	31.3.2010 £m	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m
Property, plant and equipment additions	**216.9**	229.6	**5.4**	3.0	**222.3**	232.6
Depreciation	**99.5**	95.0	**6.0**	5.7	**105.5**	100.7

3. Operating costs

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Materials and consumables	**23.7**	23.3
Manpower costs (see note 5)	**111.4**	103.0
Own work capitalised	**(27.0)**	(27.0)
Depreciation of property, plant and equipment	**105.5**	100.7
Profit on disposal of property, plant and equipment	**(0.2)**	(1.2)
Amortisation of capital grants	**(5.0)**	(4.8)
Costs of research and development	**2.1**	1.8
Operating lease payments	**1.2**	1.6
Bad debt charge	**19.6**	17.5
Other operating costs	**197.6**	205.6
Operating costs	**428.9**	420.5

Notes to the consolidated financial statements continued

4. Auditors' remuneration

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Audit of the financial statements†	**0.3**	0.3
Other fees to auditors:		
Taxation services	**–**	0.1

† £95,000 of this relates to the Company (2009: £97,000).

5. Employee information

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

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Wages and salaries	**87.1**	85.2
Restructuring cost – wages and salaries	**0.9**	–
Restructuring cost – defined benefit pension service cost (see note 24)	**4.8**	–
Social security costs	**7.3**	7.1
Defined benefit pension service cost (see note 24)	**9.7**	9.9
Other pension costs	**1.6**	0.8
Total employment costs	**111.4**	103.0
Total employment costs were charged as follows:		
Capital schemes and infrastructure renewals	**23.1**	23.3
Manpower costs	**88.3**	79.7
	111.4	103.0

Included in wages and salaries is a total expense of shared-based payments of £0.7 million (2009: £0.9 million) which arises from transactions accounted for as equity-settled share-based payments.

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

	Year to 31.3.2010 Number	Year to 31.3.2009 Number
Northumbrian Water Limited	**2,930**	2,966
Water and waste water contracts	**151**	156
Other	**24**	25
	3,105	3,147

The information required by Schedule 5 of the Large and Medium-sized Companies and Group (Accounts and Reports) Regulations 2008 is contained in the directors' remuneration report under directors' emoluments, directors' pensions and pension benefits, directors' interests in shares and debentures, directors' interests in LTIP awards and directors' interests in shares under the Share Incentive Plan.

6. Finance costs payable/(income receivable)

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Finance costs payable on debentures, bank and other loans and overdrafts	**114.7**	122.8
Amortisation of discount, fees, loan issue costs and other financing items	**(4.5)**	(4.9)
Accretion on index linked bonds	**(6.6)**	22.4
Interest cost on pension plan obligations	**36.1**	38.5
Finance costs payable on hire purchase contracts and finance leases	**4.0**	4.7
Total finance costs payable	**143.7**	183.5
Expected return on pension plan assets	**(31.6)**	(44.3)
Finance income receivable	**(5.6)**	(17.5)
Net finance costs payable	**106.5**	121.7

7. Taxation

(a) Tax on profit on ordinary activities

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Current tax:		
Current income tax charge at 28%	**38.9**	33.0
Income tax reported in equity on cash flow hedges	**–**	0.1
Adjustment in respect of prior periods	**(1.3)**	(1.1)
UK corporation tax	**37.6**	32.0
Overseas tax	**0.2**	0.1
Total current tax	**37.8**	32.1
Deferred tax:		
Origination and reversal of temporary differences in the year at 28%	**9.2**	13.8
Effect of changes in tax rates and laws:		
– Impact of Industrial Buildings Allowances abolition	**–**	117.2
Income tax reported in equity on cash flow hedges	**–**	(0.1)
Adjustment in respect of prior periods	**0.3**	1.6
Total deferred tax	**9.5**	132.5
Tax charge in the income statement	**47.3**	164.6

(b) Tax relating to items charged or credited outside of profit or loss

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Current tax:		
Current tax recycled to income statement on cash flow hedges	**–**	(0.1)
Deferred tax:		
Actuarial gains and losses on pension schemes	**0.3**	(58.2)
Deferred tax recycled to income statement on cash flow hedges	**–**	0.1
Interest rate swaps	**(0.2)**	(3.3)
Tax charge/(credit) in the statement of comprehensive income	**0.1**	(61.5)

Notes to the consolidated financial statements continued

7. Taxation continued

(c) Reconciliation of the total tax charge

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Accounting profit before tax	**170.2**	152.7
Accounting profit multiplied by standard rate of corporation tax (28%)	**47.7**	42.8
Effects of:		
Expenses not deductible for tax purposes	**1.8**	3.6
Depreciation in respect of non-qualifying items	**0.9**	0.9
Non-taxable income and enhanced tax reliefs	**(0.5)**	(0.1)
Non-taxable amortisation of financing items	**(1.5)**	(1.6)
Refinancing of infrastructure assets	**–**	1.6
Adjustment to tax charge in respect of prior periods	**(1.0)**	0.5
Other	**(0.1)**	(0.3)
	47.3	47.4
Effect of changes in tax rates and laws:		
– Impact of Industrial Buildings Allowances abolition	**–**	117.2
Total tax expense reported in the income statement	**47.3**	164.6

The effective tax rate for the year to 31 March 2010 was 27.8% (2009: 107.8%). The decrease of 80% is mainly due to the impact of the abolition of industrial building allowances in 2009. In the absence of the industrial building allowances adjustment in 2009, the effective rate would have been 31%.

(d) Unrecognised tax losses

The Group has tax losses of £7.1 million (2009: £8.2 million) which have arisen in AquaGib Limited for which a deferred tax asset has not been recognised as they may not be used to offset taxable profits elsewhere in the Group and it is not expected that the subsidiary will utilise significant amounts in the foreseeable future. The losses are, however, available for offset against future taxable profits arising in the subsidiary without time limit.

(e) Temporary differences associated with Group investments

No deferred tax liability was recognised in the Group's 2009 financial statements in respect of the unremitted earnings of the Group's overseas subsidiaries on the basis that none of the undistributed profits were expected to be distributed in the foreseeable future. As a result of changes in UK tax legislation which largely exempt from UK tax overseas dividends received on or after 1 July 2009, no temporary differences (and therefore no deferred tax liabilities) arise at 31 March 2010 as the Group does not expect to suffer a tax charge on any future distributions.

7. Taxation continued

(f) Deferred tax

The movements in deferred tax liabilities/(assets) are as follows:

	Accelerated tax depreciation £m	Deferred income £m	Tax losses £m	Retirement benefit obligations £m	Fair values interest rate swaps £m	Business combinations £m	Other £m	Total £m
At 1 April 2008	537.1	(57.2)	(4.8)	23.5	–	11.5	15.3	525.4
Charge/(credit) in the income statement	134.3	(1.7)	(0.3)	0.5	–	(0.2)	(0.1)	132.5
Other comprehensive income	–	–	–	(58.2)	(3.3)	–	–	(61.5)
Reported in equity on cash flow hedges	–	–	–	–	–	–	0.1	0.1
At 1 April 2009	671.4	(58.9)	(5.1)	(34.2)	(3.3)	11.3	15.3	596.5
Charge/(credit) in the income statement	15.5	(1.3)	(0.6)	(4.2)	–	(0.4)	0.5	9.5
Other comprehensive income	–	–	–	0.3	(0.2)	–	–	0.1
At 31 March 2010	**686.9**	**(60.2)**	**(5.7)**	**(38.1)**	**(3.5)**	**10.9**	**15.8**	**606.1**

(g) Factors that may affect future tax charges

The Group expects to continue to incur high levels of capital expenditure during NWL's 2010-15 regulatory period and, under current tax legislation, be able to claim tax reliefs in excess of depreciation.

In addition to the phased abolition of industrial building allowances by 2011, capital allowances are now being claimed at the revised rates introduced by the Finance Act 2008 – the main changes being a reduction in the rate of allowance for items of general plant and machinery from 25% to 20% per annum and an increase in the rate for long life assets from 6% to 10% per annum with effect from 1 April 2008.

8. Earnings per share

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

	Profit 31.3.2010 £m	**Weighted average number of shares 31.3.2010 million**	**Earnings per share 31.3.2010 pence**	Loss 31.3.2009 £m	Weighted average number of shares 31.3.2009 million	Loss per share 31.3.2009 pence
Basic EPS	**122.5**	**517.6**	**23.67**	(12.7)	518.0	(2.45)

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

Notes to the consolidated financial statements continued

8. Earnings per share continued

	Profit 31.3.2010 £m	Weighted average number of shares 31.3.2010 million	Earnings per share 31.3.2010 pence	Loss 31.3.2009 £m	Weighted average number of shares 31.3.2009 million	Loss per share 31.3.2009 pence
Diluted EPS	**122.5**	**518.6**	**23.62**	(12.7)	518.6	(2.45)

Adjusted EPS is considered by the directors to give a better indication of the Group's underlying performance due to the volatile and non-cash nature of deferred tax. From 2009/10, the Group has not adjusted for the credit in respect of the amortisation of debt fair value as this is no longer considered material and has now reached a stable level. The credit for the year ended 31 March 2010 is £5.3 million (2009: £5.6 million) and would have an impact on the adjusted EPS of 1.02 pence per share (2009: 1.08 pence per share).

	Profit 31.3.2010 £m	Weighted average number of shares 31.3.2010 million	Earnings per share 31.3.2010 pence	(Loss)/ profit 31.3.2009 £m	Weighted average number of shares 31.3.2009 million	(Loss)/ earnings per share 31.3.2009 pence
Basic EPS	**122.5**	**517.6**	**23.67**	(12.7)	518.0	(2.45)
Deferred tax	**9.5**		**1.84**	132.5		25.58
Amortisation of debt fair value	**–**		**–**	(5.6)		(1.08)
Adjusted EPS	**132.0**	**517.6**	**25.51**	114.2	518.0	22.05

9. Dividends paid and proposed

	Year to 31.3.2010 £m	Year to 31.3.2009 £m
Declared and paid during the year:		
Equity dividends on ordinary shares:		
Final dividend for 2008/09: 8.50 pence (2007/08: 8.07 pence)	**44.0**	41.8
Interim dividend for 2009/10: 4.39 pence (2008/09: 4.29 pence)	**22.7**	22.2
Dividends paid	**66.7**	64.0
Proposed for approval by shareholders at the AGM:		
Final dividend for 2009/10: 8.85 pence (2008/09: 8.50 pence)	**45.8**	44.0

10. Intangible assets

	Goodwill £m	Other £m	Total £m
Cost:			
At 1 April 2008, 1 April 2009 and 31 March 2010	**3.8**	**64.2**	**68.0**
Impairment:			
At 1 April 2008, 1 April 2009 and 31 March 2010	**(0.2)**	**–**	**(0.2)**
Net book value at 31 March 2010	**3.6**	**64.2**	**67.8**
Net book value at 1 April 2008 and 31 March 2009	3.6	64.2	67.8

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

10. Intangible assets continued

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

The other intangible asset represents the right in perpetuity to receive income under the operating agreement with the Environment Agency in respect of the Kielder Water transfer scheme and, therefore, the directors consider the asset has an indefinite life. Accordingly, future cash flows, which increase in line with inflation, have been discounted at a rate of 6.44% in perpetuity. This represents a long term nominal gilt yield and an assumed credit spread. This calculation satisfied the Group that the carrying value at 31 March 2010 had not been impaired. Furthermore, it is improbable that the discount rate would increase to such a level that the carrying value would be impaired.

11. Property, plant and equipment

	Freehold land and buildings £m	Infrastructure assets £m	Operational structures, plant and machinery £m	Fixtures, fittings, tools and equipment £m	Assets in the course of construction £m	Total £m
Cost:						
At 1 April 2008	93.3	1,609.2	2,036.9	175.2	146.5	4,061.1
Additions	–	0.1	2.7	0.2	229.6	232.6
Schemes commissioned	2.0	101.5	96.6	5.5	(205.6)	–
Disposals	–	(7.9)	(11.2)	–	–	(19.1)
At 1 April 2009	95.3	1,702.9	2,125.0	180.9	170.5	4,274.6
Additions	–	4.7	1.6	0.3	215.7	222.3
Schemes commissioned	6.9	96.7	132.9	38.3	(274.8)	–
Reclassifications	13.4	–	(2.0)	(11.4)	–	–
Disposals	–	(6.6)	(3.2)	–	–	(9.8)
At 31 March 2010	**115.6**	**1,797.7**	**2,254.3**	**208.1**	**111.4**	**4,487.1**
Depreciation:						
At 1 April 2008	32.1	70.0	584.1	118.6	–	804.8
Charge for the year	1.9	21.6	67.8	9.4	–	100.7
Disposals	–	(7.9)	(11.2)	–	–	(19.1)
At 1 April 2009	34.0	83.7	640.7	128.0	–	886.4
Charge for the year	1.9	22.8	71.8	9.0	–	105.5
Reclassifications	0.1	–	–	(0.1)	–	–
Disposals	–	(6.6)	(3.1)	–	–	(9.7)
At 31 March 2010	**36.0**	**99.9**	**709.4**	**136.9**	**–**	**982.2**
Net book value at 31 March 2010	**79.6**	**1,697.8**	**1,544.9**	**71.2**	**111.4**	**3,504.9**
Net book value at 31 March 2009	61.3	1,619.2	1,484.3	52.9	170.5	3,388.2
Net book value at 1 April 2008	61.2	1,539.2	1,452.8	56.6	146.5	3,256.3

Operational structures, plant and machinery include an element of land and buildings dedicated to those assets. The Group has applied IAS 23 Borrowing Costs (Revised) in the year and has capitalised £1.2 million for the year to 31 March 2010 (2009: £nil). The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation was 5.96%.

Notes to the consolidated financial statements continued

11. Property, plant and equipment continued

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

	31.3.2010 £m	31.3.2009 £m
Infrastructure assets	**47.8**	48.3
Operational structures, plant and machinery	**23.6**	24.1
	71.4	72.4

12. Investments

	31.3.2010 £m	31.3.2009 £m
Investments in jointly controlled entities	**4.1**	3.8

(a) Investments in jointly controlled entities

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

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

	VLS 31.3.2010 £m	Agreco 31.3.2010 £m	VLS 31.3.2009 £m	Agreco 31.3.2009 £m
Revenue	**6.9**	**3.1**	6.5	2.5
Operating costs	**(5.9)**	**(2.5)**	(5.7)	(2.0)
Profit on ordinary activities before interest	**1.0**	**0.6**	0.8	0.5
Finance costs payable	**(0.6)**	**–**	(0.4)	–
Profit on ordinary activities before taxation	**0.4**	**0.6**	0.4	0.5
Current taxation	**(0.1)**	**–**	(0.1)	–
Profit for the year	**0.3**	**0.6**	0.3	0.5
Non-current assets	**7.9**	**–**	7.2	–
Current assets	**7.9**	**3.6**	6.5	2.9
Share of gross assets	**15.8**	**3.6**	13.7	2.9
Current liabilities	**(4.6)**	**(2.8)**	(3.9)	(2.4)
Non-current liabilities	**(7.9)**	**–**	(6.5)	–
Share of gross liabilities	**(12.5)**	**(2.8)**	(10.4)	(2.4)
Share of net assets	**3.3**	**0.8**	3.3	0.5

12. Investments continued

(b) The Group's interests in principal subsidiaries at 31 March 2009 and 31 March 2010 were as follows:

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

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

13. Inventories

	31.3.2010 £m	31.3.2009 £m
Stores	**3.3**	3.2

14. Trade and other receivables

	31.3.2010 £m	31.3.2009 £m
Trade receivables	**72.2**	68.7
Amounts owed by jointly controlled entities	**0.5**	0.5
Prepayments and accrued income	**53.4**	51.7
Financial assets	**1.1**	1.4
Other receivables	**9.2**	9.4
	136.4	131.7

Notes to the consolidated financial statements continued

14. Trade and other receivables continued

As at 31 March 2010, trade receivables at nominal value of £37.1 million (2009: £31.7 million) were impaired. Movements in the provision for impairment of trade receivables were as follows:

	£m
At 1 April 2008	27.3
Charge for the year	17.5
Utilised	(13.1)
At 1 April 2009	31.7
Charge for the year	19.6
Utilised	(14.2)
At 31 March 2010	**37.1**

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

	0-3 months £m	3-12 months £m	12-24 months £m	24-36 months £m	36-48 months £m	>48 months £m	Total £m
2010	**0.5**	**24.9**	**11.8**	**5.8**	**2.7**	**0.6**	**46.3**
2009	0.5	23.9	10.3	5.3	2.6	0.4	43.0

15. Cash and cash equivalents and short term deposits

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

	31.3.2010 £m	31.3.2009 £m
Cash at bank and in hand	**66.1**	40.0
Short term deposits	**108.7**	68.8
	174.8	108.8
Bank overdrafts	**(1.5)**	(16.5)
Cash and cash equivalents	**173.3**	92.3

	31.3.2010 £m	31.3.2009 £m
Short term cash deposits >3 months	**1.1**	120.8
Short term cash deposits <3 months	**14.7**	39.8
Short term cash deposits	**15.8**	160.6

Short term cash deposits of £14.7 million (2009: £39.8 million), with a maturity of less than three months, represent amounts on deposit at fixed rates with the Northumbrian Water Pension Scheme.

16. Trade and other payables

	31.3.2010 £m	31.3.2009 £m
Trade payables	**11.0**	10.4
Other payables	**19.4**	19.2
Interest payable	**39.7**	35.9
Accruals and deferred income	**81.1**	82.3
	151.2	147.8

17. Interest bearing loans and borrowings

	31.3.2010 £m	31.3.2009 £m
Current:		
Bank overdrafts	**1.5**	16.5
Current instalments due on borrowings (principal £19.7 million, 2009: £20.6 million)	**24.6**	25.8
Current obligations under finance leases and hire purchase contracts (see note 18)	**7.0**	6.9
	33.1	49.2
Non-current:		
Non-current obligations under finance leases and hire purchase contracts (principal £104.1 million, 2009: £104.8 million) (see note 18)	**104.1**	104.8
Non-current instalments on borrowings (principal £2,300.2 million, 2009: £2,326.6 million)	**2,329.8**	2,360.5
	2,433.9	2,465.3
Borrowings comprise the following:		
Loans (principal £546.6 million, 2009: £567.4 million)	**550.5**	572.6
Subordinated loan stock	**6.8**	6.6
Eurobonds – due 11 October 2017 bearing interest rate of 6.0% (principal £300.0 million, 2009: £300.0 million)	**308.6**	309.8
Eurobonds – due 6 February 2023 bearing interest rate of 6.875% (principal £350.0 million, 2009: £350.0 million)	**386.8**	389.7
Eurobonds – due 29 April 2033 bearing interest rate of 5.625% (principal £350.0 million, 2009: £350.0 million)	**346.3**	346.0
Eurobonds – due 23 January 2034 bearing interest rate of 5.87526% (principal £248.0 million, 2009: £248.0 million)	**241.1**	240.7
Eurobonds – due 31 March 2037 bearing interest rate of 6.627% (principal £61.6 million, 2009: £61.6 million)	**58.9**	58.9
Index linked Eurobonds – due 15 July 2036 bearing interest rate of 2.033% (principal £169.5 million, 2009: £171.9 million)	**168.5**	170.9
Index linked Eurobonds – due 30 January 2041 bearing interest rate of 1.6274% (principal £66.6 million, 2009: £67.7 million)	**66.5**	67.5
Index linked Eurobonds – due 16 July 2049 bearing interest rate of 1.7118% (principal £110.4 million, 2009: £112.0 million)	**110.2**	111.8
Index linked Eurobonds – due 16 July 2053 bearing interest rate of 1.7484% (principal £110.4 million, 2009: £112.0 million)	**110.2**	111.8
	2,354.4	2,386.3
Less current instalments due on bank loans (principal £19.7 million, 2009: £20.6 million)	**(24.6)**	(25.8)
	2,329.8	2,360.5

The difference between the principal value of £2,300.2 million (2009: £2,326.6 million) and the carrying value of £2,329.8 million (2009: £2,360.5 million) are unamortised issue costs of £14.7 million (2009: £15.4 million) and a credit of £44.3 million (2009: £49.3 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

The value of the capital and interest elements of the index linked Eurobonds are linked to movements in the UK Retail Price Index (see note 1(q)).

Notes to the consolidated financial statements continued

18. Obligations under hire purchase contracts and finance leases

	31.3.2010 £m	31.3.2009 £m
Amounts due:		
Not later than one year	**7.0**	6.9
After one year but not more than five years	**23.5**	23.2
Later than five years	**154.6**	160.0
	185.1	190.1
Less finance charges allocated to future periods	**(74.0)**	(78.4)
Present value of minimum lease payments	**111.1**	111.7
Disclosed as due:		
Not later than one year	**7.0**	6.9
After more than one year	**104.1**	104.8
	111.1	111.7

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

	31.3.2010 £m	31.3.2009 £m
Not later than one year	**0.8**	0.9
After one year but not more than five years	**2.6**	3.1
After five years	**26.7**	26.8
	30.1	30.8

19. Provisions

	£m
At 1 April 2009	
Current	0.2
Non-current	2.5
At 1 April 2009	2.7
Utilised	(0.3)
At 31 March 2010	**2.4**
Analysed as:	
Current	0.2
Non-current	2.2
	2.4

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

20. Financial instruments

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

20. Financial instruments continued

(b) Treasury operations

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

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

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

(d) Liquidity risk

As regards day to day liquidity, the Group's policy is to have available standby committed bank borrowing facilities with a value of no less than £50.0 million and with a bank agreement availability period of no less than three months. At 31 March 2010, the Group had £75.0 million of undrawn committed bank facilities (2009: £75.0 million). These facilities matured in May 2010 and have not been renewed. However, given the level of surplus cash available to fund the Group's operations, the Board have agreed to allow the current facilities to lapse, and to review the position in March 2011.

(e) Interest rate risk

The Group finances its operations through a mixture of retained profits and bank borrowings. It borrows at both fixed and floating rates of interest and, accordingly, uses interest rate swaps to generate the desired interest profile and to manage the Group's exposure to interest rate fluctuations. The Group's policy is to keep a minimum 60% of its borrowings at fixed rates of interest. At 31 March 2010, 75% (2009: 75%) of the Group's borrowings were at fixed rates of interest. Index linked borrowings are treated as variable rate debt.

(f) Foreign currency risk

The Group's policy is that any foreign currency exposure in excess of £100,000 sterling equivalent of a transactional nature, or £3.0 million sterling equivalent of a translation nature, should be covered immediately on identification. Any exposures are covered through the use of forward foreign exchange contracts.

(g) Market price risk

The Group's exposure to market price risk principally comprises interest rate exposures. The Group's policy is to accept a degree of interest rate risk. The following table shows the impact on profit and equity of an increase in the variable cost of borrowing. The range is considered reasonable based on the forecast variable rates of borrowing and all other elements being consistent for the next 12 months and highlights this is not material to the Group:

Increase in basis points	Effect on profit/equity £m
2010	
+50	**0.9**
+100	**1.9**
+150	**2.8**
2009	
+50	0.8
+100	1.5
+150	2.3

Notes to the consolidated financial statements continued

20. Financial instruments continued

(h) Credit risk

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

(i) Counterparty risk

The treasury strategy, which is approved by the Board, requires that investments are limited to certain money market and treasury instruments, and that the Group's exposure to any single bank, building society or market is controlled, with maximum deposits allowed with any single counterparty. The investment criteria cover credit rating and asset size, including sovereign and political risk. Current market conditions have resulted in closer monitoring of counterparties and cancellation or suspension of deposits.

(j) Capital risk

The primary objective of the Group's capital management is to ensure that it maintains a strong credit rating and healthy capital ratios in order to support its business and maximise shareholder value.

The Group monitors capital using gearing ratios for the Group and NWL. For NWL, this is net debt divided by the RCV as determined and published by Ofwat, and for the Group, RCV plus a pro forma RCV for the Kielder securitisation and the PFI contracts (at the level of associated debt included in the Group's net debt relating to those assets). The Group's policy is to keep the gearing ratio less than 75% and 70% for the Group and NWL, respectively.

(k) Contractual maturity of financial liabilities (principal and future interest payments)

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

Year ended 31 March 2010

	On demand £m	Less than 3 months £m	3-12 months £m	1-5 years £m	More than 5 years £m	Total £m
Interest bearing loans and borrowings	1.5	40.3	118.0	824.4	4,381.8	5,366.0
Trade and other payables	0.1	10.8	0.1	–	–	11.0
	1.6	**51.1**	**118.1**	**824.4**	**4,381.8**	**5,377.0**

Year ended 31 March 2009

	On demand £m	Less than 3 months £m	3-12 months £m	1-5 years £m	More than 5 years £m	Total £m
Interest bearing loans and borrowings	16.5	40.7	113.9	671.6	4,632.9	5,475.6
Trade and other payables	–	63.0	27.6	0.2	–	90.8
	16.5	103.7	141.5	671.8	4,632.9	5,566.4

20. Financial instruments continued

(l) Maturity profile of financial assets and liabilities (carrying value)

Year ended 31 March 2010

	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
Fixed rate:							
Eurobonds	(4.0)	(4.1)	(4.2)	(4.1)	(4.3)	(1,321.0)	(1,341.7)
Subordinated loan stock	–	–	–	–	–	(6.8)	(6.8)
Bank loans	(17.7)	(24.5)	(21.1)	(21.2)	(21.2)	(168.0)	(273.7)
Obligations under finance leases and hire purchase contracts	(2.7)	(2.3)	(1.7)	(1.1)	(0.5)	(0.4)	(8.7)
Other loans	(0.4)	(0.3)	(0.3)	(0.3)	(0.3)	(1.0)	(2.6)
Fixed rate at 31 March 2010	**(24.8)**	**(31.2)**	**(27.3)**	**(26.7)**	**(26.3)**	**(1,497.2)**	**(1,633.5)**
Variable rate:							
Cash and cash equivalents	174.8	–	–	–	–	–	174.8
Short term cash deposits	15.8	–	–	–	–	–	15.8
Financial investments	1.1	0.9	0.5	0.2	–	11.3	14.0
Eurobonds	–	–	–	–	–	(455.4)	(455.4)
Bank loans	(2.5)	(171.7)	(10.0)	(10.0)	(10.0)	(70.0)	(274.2)
Overdrafts	(1.5)	–	–	–	–	–	(1.5)
Obligations under finance leases and hire purchase contracts	(4.3)	(4.4)	(4.5)	(4.5)	(4.5)	(80.2)	(102.4)
Variable rate at 31 March 2010	**183.4**	**(175.2)**	**(14.0)**	**(14.3)**	**(14.5)**	**(594.3)**	**(628.9)**
Net borrowings at 31 March 2010							**(2,262.4)**

Year ended 31 March 2009

	Within 1 year £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m	Total £m
Fixed rate:							
Eurobonds	(3.9)	(4.0)	(4.1)	(4.1)	(4.1)	(1,324.9)	(1,345.1)
Subordinated loan stock	–	–	–	–	–	(6.6)	(6.6)
Bank loans	(19.3)	(17.8)	(24.5)	(21.0)	(21.1)	(189.4)	(293.1)
Obligations under finance leases and hire purchase contracts	(2.7)	(2.1)	(1.8)	(1.1)	(0.5)	(0.3)	(8.5)
Other loans	–	(0.4)	(0.3)	(0.3)	(0.3)	(1.5)	(2.8)
Fixed rate at 31 March 2009	(25.9)	(24.3)	(30.7)	(26.5)	(26.0)	(1,522.7)	(1,656.1)
Variable rate:							
Cash and cash equivalents	108.8	–	–	–	–	–	108.8
Short term cash deposits	160.6	–	–	–	–	–	160.6
Financial investments	1.4	1.2	0.9	0.6	0.2	11.1	15.4
Eurobonds	–	–	–	–	–	(462.0)	(462.0)
Bank loans	(2.5)	(2.5)	(171.7)	(10.0)	(10.0)	(80.0)	(276.7)
Overdrafts	(16.5)	–	–	–	–	–	(16.5)
Obligations under finance leases and hire purchase contracts	(4.2)	(4.3)	(4.4)	(4.5)	(4.5)	(81.3)	(103.2)
Variable rate at 31 March 2009	247.6	(5.6)	(175.2)	(13.9)	(14.3)	(612.2)	(573.6)
Net borrowings at 31 March 2009							(2,229.7)

The variable rate net borrowings comprise sterling denominated bank borrowings and deposits that bear interest at rates based upon up to 12 months LIBOR.

Notes to the consolidated financial statements continued

20. Financial instruments continued

(m) Currency exposures

At 31 March 2010, after taking into account the effects of forward foreign exchange contracts, the Group had no currency exposures (2009: £nil).

(n) Borrowing facilities

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

	31.3.2010 £m	31.3.2009 £m
Expiring in less than one year	**75.0**	–
Expiring in more than one year but not more than two years	**–**	75.0
	75.0	75.0

(o) Fair values of financial assets and financial liabilities

A comparison by category of book values, which are all recognised at amortised cost, and fair values of the Group's financial assets and liabilities as at 31 March is set out below:

	Book value		Fair value	
	31.3.2010 £m	31.3.2009 £m	**31.3.2010 £m**	31.3.2009 £m
Financial assets:				
Cash and cash equivalents	**174.8**	108.8	**174.8**	108.8
Short term cash deposits	**15.8**	160.6	**15.8**	163.0
Financial investments	**14.0**	15.4	**14.0**	15.4
Trade and other receivables	**136.4**	131.7	**136.4**	131.7
Financial liabilities:				
Overdraft	**(1.5)**	(16.5)	**(1.5)**	(16.5)
Bank loans (principal of £546.6 million, 2009: £567.4 million)	**(550.5)**	(572.6)	**(559.5)**	(589.0)
Subordinated loan stock	**(6.8)**	(6.6)	**(6.8)**	(6.6)
Eurobonds (principal of £1,766.4 million, 2009: £1,773.2 million)	**(1,797.1)**	(1,807.1)	**(1,804.0)**	(1,578.9)
Obligations under finance leases and hire purchase contracts (principal of £111.1 million, 2009: £111.6 million)	**(111.1)**	(111.7)	**(111.1)**	(111.7)
Interest rate swaps	**–**	–	**(12.5)**	(11.7)
Trade and other payables	**(151.2)**	147.8	**(151.2)**	147.8
	(2,277.2)	(1,950.2)	**(2,305.6)**	(1,747.7)

The fair values of the interest rate swaps and sterling denominated long term fixed rate and index linked debt with a book value of £1,797.1 million (2009: £1,807.1 million), have been determined by reference to prices available from the markets on which the instruments involved are traded. All the other fair values shown above have been calculated by discounting cash flows at prevailing interest rates.

In the absence of an openly traded market value for the index linked bonds with a book value of £455.4 million (2009: £462.0 million), the fair value at the balance sheet date has been calculated by considering the remaining debt maturity, the relevant UK index linked gilt rate and an appropriate credit spread by reference to market evidence for conventional bonds.

The difference between the principal value of £2,424.1 million (2009: £2,452.2 million) and the carrying value of £2,458.7 million (2009: £2,491.4 million) are unamortised issue costs of £14.7 million (2009: £15.4 million) and a credit of £49.3 million (2009: £54.6 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

20. Financial instruments continued

(p) Hedges

Cash flow hedges – currency forward contracts

At 31 March 2010, the Group held no forward exchange contracts (2009: nil).

Cash flow hedges – interest rate swap

At 31 March 2010, the Group held three interest rate swaps, designated as a hedge of future interest cash flows, for which the Group has firm commitments. The swap is used to convert variable rate interest payments to a fixed rate basis. The terms of these swaps are as follows:

Notional amount	Start date	Termination date	Fixed rate%
GBP 100 million	**15.9.2008**	**15.3.2022**	**4.79**
GBP 62.5 million	**29.1.2009**	**31.5.2011**	**2.345**
GBP 62.5 million	**29.1.2009**	**31.5.2011**	**2.435**

These hedges were designated as highly effective.

At 31 March 2009, the Group held three interest rate swaps, designated as a hedge of future interest cash flows, for which the Group had firm commitments. The swaps were used to convert variable rate interest payments to a fixed rate basis. The terms of these swaps were as follows:

Notional amount	Start date	Termination date	Fixed rate%
GBP 100 million	15.9.2008	15.3.2022	4.79
GBP 62.5 million	29.1.2009	31.5.2011	2.345
GBP 62.5 million	29.1.2009	31.5.2011	2.435

These hedges were designated as highly effective.

(q) Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:
- level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
- level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and
- level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data.

All other financial assets and liabilities are carried at amortised cost.

Liabilities measured at fair value

	31.3.2010 £m	Level 1 £m	Level 2 £m	Level 3 £m
Interest rate swap	**(12.5)**	**–**	**(12.5)**	**–**

During the year to 31 March 2010, there were no transfers between level 1 and level 2 fair value measurements, and no transfers into and out of level 3 fair value measurements.

Notes to the consolidated financial statements continued

21. Authorised and issued share capital

	31.3.2010 £m	31.3.2009 £m
Authorised:		
700 million ordinary shares of 10 pence each	**70.0**	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence each	**51.9**	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 914,518 (2009: 1,038,252) ordinary 10 pence shares in the Company for use under the Company's LTIP. All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 71 to 77. As at 31 March 2010, the share price of the ordinary 10 pence shares in the Company was 283.1 pence (2009: 218.25 pence).

22. Additional cash flow information

Analysis of net debt as at 31 March 2010

	As at 1.4.2009 £m	Cash flow £m	Other non-cash movements £m	As at 31.3.2010 £m
Cash and cash equivalents	92.3	81.0	–	**173.3**
Short term cash deposits	160.6	(144.8)	–	**15.8**
Financial investments	15.4	(1.4)	–	**14.0**
Loans (principal of £2,319.8 million, 2009: £2,347.2 million)	(2,386.3)	20.9	11.0	**(2,354.4)**
Finance leases (principal of £111.1 million, 2009: £111.6 million)	(111.7)	7.2	(6.6)	**(111.1)**
	(2,229.7)	(37.1)	4.4	**(2,262.4)**

The difference between the principal value of £2,430.9 million (2009: £2,458.8 million) and the carrying value of £2,465.5 million (2009: £2,498.0 million) are unamortised issue costs of £14.7 million (2009: £15.4 million) and a credit of £49.3 million (2009: £54.6 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

Analysis of net debt as at 31 March 2009

	As at 1.4.2008 £m	Cash flow £m	Other non-cash movements £m	As at 31.3.2009 £m
Cash and cash equivalents	266.4	(174.1)	–	92.3
Short term cash deposits	–	160.6	–	160.6
Financial investments	17.1	(1.7)	–	15.4
Loans (principal of £2,347.2 million, 2008: £2,299.9 million)	(2,344.1)	(24.7)	(17.5)	(2,386.3)
Finance leases (principal of £111.6 million, 2008: £89.7 million)	(89.8)	(13.8)	(8.1)	(111.7)
	(2,150.4)	(53.7)	(25.6)	(2,229.7)

22. Additional cash flow information continued

The difference between the principal value of £2,458.8 million (2008: £2,389.6 million) and the carrying value of £2,498.0 million (2008: £2,433.9 million) are unamortised issue costs of £15.4 million (2008: £15.9 million) and a credit of £54.6 million (2008: £60.2 million) in excess of the original loan proceeds to reflect the fair value of loans owed by subsidiaries acquired in 2003.

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

23. Financial commitments

	31.3.2010 £m	31.3.2009 £m
Expenditure contracted for	**85.3**	168.8

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

24. Pensions and other post-retirement benefits

The Group operates a defined benefit pension scheme, Northumbrian Water Pension Scheme (NWPS or the scheme), providing benefits based on final pensionable remuneration to 2,033 active members at 31 March 2010 (2009: 2,169).

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

The most recent actuarial valuation of the scheme was at 31 December 2007. At that date the value of assets amounted to £732.3 million 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.

The scheme also has a defined contribution section which had 389 active members at 31 March 2010 (2009: 310). 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 Group in the year totalled £0.6 million (2009: £0.4 million).

Notes to the consolidated financial statements continued

24. Pension and other post-retirement benefits continued
The additional disclosures regarding the Group's defined benefit scheme as required under IAS 19 'Employee Benefits', and the relevant impact on the Group's financial statements are set out below.

A qualified actuary, using revised assumptions that are consistent with the requirements of IAS 19, has updated the actuarial valuation described above as at 31 March 2010. Investments have been valued, for this purpose, at fair value.

	31.3.2010	31.3.2009
Pay increases[1]	**4.7%**	4.0%
Pension increases	**3.7%**	3.0%
Price inflation	**3.7%**	3.0%
Discount rate	**5.5%**	6.1%
Mortality assumptions[2,3]	**PCMA/PCFA00**	PCMA/PCFA00
– Life expectancy for a member aged 65 – female (years)	**23.0**	22.9
– Life expectancy for a member aged 65 – male (years)	**20.7**	20.6

Notes:
1. Including promotional salary scale.
2. 115% of PCMA/PCFA00.
3. PCMA/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 31.3.2010 %	**31.3.2010 £m**	Long term expected rate of return 31.3.2009 %	31.3.2009 £m
Equities	**7.5**	**499.3**	7.2	369.0
Corporate bonds	**5.5**	**70.7**	6.1	38.9
Government bonds	**4.5**	**27.2**	4.2	50.0
Property	**6.0**	**66.6**	5.7	58.7
Cash	**3.9**	**14.3**	4.0	1.8
Loan to scheme from Company	**0.5**	**(14.7)**	2.0	(39.8)
Total fair value of assets		**663.4**		478.6
Present value of liabilities		**(796.5)**		(598.0)
Deficit		**(133.1)**		(119.4)

The discount rate at 31 March 2010 has been set by reference to the yield on AA corporate bonds (AA over 15 years) at that date, extrapolated forward to a duration of 18 years which reflect the duration of the expected benefit payments. The expected rate of return on equities represents a 3% premium of the yield on long term Government bonds at 31 March 2010. The gross redemption yield on index linked UK Government stocks was 0.7%. The long term inflation rate implied by these yields is 3.8% which has been reduced by 0.1% to allow for an inflation risk premium. Mortality rates have been based on the PA00 tables, applying medium cohort adjustment of 115% loading to mortality rates based on the year of birth of membership.

24. Pension and other post-retirement benefits continued

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

	31.3.2010 £m	31.3.2009 £m
Recognised in the income statement:		
Current service cost	**9.9**	9.6
Past service cost	**4.6**	0.3
Recognised in operating costs in arriving at profit on ordinary activities before interest	**14.5**	9.9
Interest cost on plan obligations	**36.1**	38.5
Expected return on plan assets	**(31.6)**	(44.3)
Recognised in finance costs payable/(income receivable)	**4.5**	(5.8)
Recognised in the statement of comprehensive income:		
Actual return on scheme assets	**209.0**	(161.0)
Less expected return on scheme assets	**(31.6)**	(44.3)
	177.4	(205.3)
Other actuarial gains and losses	**(176.3)**	(2.5)
Net actuarial gains/(losses)	**1.1**	(207.8)
Cumulative amounts recognised since adopting the standard	**(80.5)**	(81.6)

History of experience gains and losses:

	31.3.2010 £m	31.3.2009 £m	31.3.2008 £m	31.3.2007 £m	31.3.2006 £m
Fair value of assets	**663.4**	478.6	666.7	710.8	659.8
Present value of defined benefit obligation	**(796.5)**	(598.0)	(576.2)	(668.1)	(663.5)
Deficit/(surplus)	**(133.1)**	(119.4)	90.5	42.7	(3.7)
Experience adjustments arising on plan assets	**177.4**	(205.3)	(93.4)	0.6	87.1
Experience adjustments arising on plan liabilities	**–**	18.7	0.6	1.7	34.0

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

	31.3.2010 £m	31.3.2009 £m
At 1 April	**598.0**	576.2
Current service cost	**9.9**	9.6
Past service cost	**4.6**	0.3
Interest cost on plan obligations	**36.1**	38.5
Contributions by plan participants	**0.1**	0.1
Actuarial loss on obligations	**176.3**	2.5
Benefits paid	**(28.5)**	(29.2)
At 31 March	**796.5**	598.0
Present value of funded defined benefit obligations	**796.5**	598.0

Notes to the consolidated financial statements continued

24. Pension and other post-retirement benefits continued

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

	31.3.2010 £m	31.3.2009 £m
At 1 April	**478.6**	666.7
Expected return on plan assets	**31.6**	44.3
Actuarial gain/(loss) on plan assets	**177.4**	(205.3)
Contributions by employer	**4.2**	2.0
Contributions by plan participants	**0.1**	0.1
Benefits paid	**(28.5)**	(29.2)
At 31 March	**663.4**	478.6

The Group through its subsidiary, AquaGib, also operates a non-contributory defined benefit scheme. The deficit at 31 March 2010, under local GAAP, was £2.8 million (2009: surplus of £0.3 million). The Group made contributions amounting to £0.8 million (2009: £0.5 million) to the defined benefit pension scheme.

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

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

A reduction in the net discount rate will increase the assessed value of liabilities, as a higher value is placed on benefits paid in the future. A rise in the net discount rate will have an opposite effect of similar magnitude. The overall effect of a change in the net discount rate of 0.1% would change the liabilities by around £14.4 million.

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

The disclosures have been prepared using the 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 2010 of 20.7 years (2009: 20.6 years) for males and 23.0 years (2009: 22.9 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%.

25. Long Term Incentive Plan (LTIP)

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

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

	31.3.2010 Number	31.3.2009 Number
Outstanding at 1 April	**1,190,034**	1,103,069
Granted during the year	**414,679**	462,700
Forfeited/lapsed during the year	**(238,686)**	(270,480)
Exercised	**(123,734)**	(105,255)
Outstanding at 31 March	**1,242,293**	1,190,034
Exercisable at 31 March	**4,724**	9,023

The weighted average exercise price throughout the year was £nil (2009: £nil). The fair value of conditional share awards granted during the year was £0.1 million (2009: £0.1 million).

The weighted average share price at the date of exercise for the conditional share awards is 268.71 pence (2009: 248.08 pence).

For the conditional awards outstanding as at 31 March 2010, the weighted average remaining contractual life is 1.8 years (2009: 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:

	31.3.2010	31.3.2009
Dividend yield	**4.7%**	4.9%
Expected share price volatility	**29%**	28%
Share price at award	**272.50p**	251.50p
Expected FTSE 250 Index volatility	**24%**	23%
Risk free interest rate	**2.1%**	2.6%
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.

Notes to the consolidated financial statements continued

25. Long Term Incentive Plan (LTIP) continued

Share Incentive Plan (SIP)

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

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

	31.3.2010 Number	31.3.2009 Number
Outstanding at 1 April	**117,687**	97,876
Granted during the year	**134,397**	119,922
Forfeited during the year	**(1,805)**	(2,861)
Exercised	**(107,078)**	(97,250)
Outstanding at 31 March	**143,201**	117,687

26. Special purpose entities

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

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

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

	31.3.2010 £m	31.3.2009 £m
Income statement:		
Finance costs receivable	**14.9**	15.0
Finance costs payable	**(14.9)**	(15.0)
Balance sheet:		
Investments	**241.0**	240.7
Current assets	**4.7**	4.7
Non-current liabilities	**(242.9)**	(242.6)
Current liabilities	**(2.7)**	(2.7)
Net assets	**0.1**	0.1

27. Related parties

During the year, the Group entered into transactions, in the ordinary course of business, with other related parties. Those transactions with directors of the Company are disclosed in the directors' remuneration report on pages 68 to 80. In accordance with IAS 24, the directors consider that there are no further disclosures in respect of key management. Transactions entered into, and trading balances outstanding at 31 March with other related parties, are as follows:

	Sales to related party £m	Purchases from related party £m	Amounts owed by related party £m	Amounts owed to related party £m
Related party:				
Jointly controlled entities				
2010	**0.1**	**10.2**	**0.5**	**8.7**
2009	0.1	10.7	0.5	8.4

Purchases from jointly controlled entities include £3.3 million (2009: £3.9 million) in respect of capital purchases under finance leases, £0.1 million (2009: £0.2 million) in respect of operating leases, £6.2 million (2009: £6.0 million) in respect of costs payable under finance leases and £0.6 million (2009: £0.6 million) in respect of other purchases.

At 31 March 2010, the Group had a short term cash deposit with the Northumbrian Water Pension Scheme of £14.7 million (2009: £39.8 million).

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

28. Post balance sheet event

On 12 April 2010, the Group settled the outstanding claim against Caledonian Environmental Services plc with the Design and Construction Consortium, with the costs being capitalised in the year. The Group also, on this date, purchased the remaining 25% minority stake and the outstanding subordinated loan stock in Caledonian Environmental Services for a consideration of £0.4 million. The subordinated loan stock was acquired at a gain compared to book value and the Group will book a £4.6 million gain in 2010/11.

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

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

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). 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 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 United Kingdom 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 adequate accounting records that 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.

Report of the Auditors on the Company financial statements

Independent auditors' report to the members of Northumbrian Water Group plc
We have audited the parent Company financial statements of Northumbrian Water Group plc for the year ended 31 March 2010 which comprise the parent Company balance sheet and the related notes 1 to 10. 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 auditors
As explained more fully in the Statement of directors' responsibilities set out on page 126, the directors are responsible for the preparation of the parent Company financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the parent Company 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 parent 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.

Opinion on financial statements
In our opinion the parent Company financial statements:
— give a true and fair view of the state of the Company's affairs as at 31 March 2010;
— 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 matters prescribed by the Companies Act 2006
In our opinion:
— the part of the Directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006; and
— the information given in the Directors' report and business review for the financial year for which the financial statements are prepared is consistent with the parent Company financial statements.

Report of the Auditors on the Company financial statements continued

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 by the parent Company, or returns adequate for our audit have not been received from branches not visited by us;
— the parent Company financial statements and the part of the Directors' remuneration report to be audited are not in agreement with the accounting records and returns;
— 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.

Other matters
We have reported separately on the Group financial statements of Northumbrian Water Group plc for the year ended 31 March 2010.

Debbie O'Hanlon (Senior statutory auditor)
For and on behalf of Ernst & Young LLP
Statutory Auditor
Newcastle upon Tyne
1 June 2010

Company balance sheet
As at 31 March 2010

	Notes	31.3.2010 £m	31.3.2009 £m
Fixed assets			
Investments in subsidiary undertakings	4	**1,022.6**	1,022.6
		1,022.6	1,022.6
Current assets			
Debtors: receivable within one year	5	**4.3**	6.8
Cash at bank		**12.0**	11.4
		16.3	18.2
Creditors: amounts falling due within one year	6	**(2.8)**	(7.7)
Net current assets		**13.5**	10.5
Total assets less current liabilities		**1,036.1**	1,033.1
Creditors: amounts falling due after more than one year	7	**(491.9)**	(490.0)
Net assets		**544.2**	543.1
Capital and reserves			
Called up share capital	8	**51.9**	51.9
Share premium account	9	**446.5**	446.5
Treasury shares	9	**(2.0)**	(2.3)
Profit and loss account	9	**47.8**	47.0
Equity shareholders' funds		**544.2**	543.1

Approved by the Board on 1 June 2010 and signed on its behalf by:

Sir Derek Wanless
Chairman

Heidi Mottram
Chief Executive Officer

Notes to the Company financial statements

1. Accounting policies

(a) Basis of accounting

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

(b) Fixed asset investments

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

(c) Taxation

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

(d) Interest bearing loans and borrowings

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

2. Auditors' remuneration

Auditors' remuneration for the year ended 31 March 2010 was £95,000 (2009: £97,000).

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

3. Profit attributable to members of the parent Company

The profit dealt with in the financial statements of the parent Company is £67.7 million (2009: £64.9 million).

4. Investments in subsidiary undertakings

	£m
At 1 April 2009 and 31 March 2010	1,022.6

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

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

5. Debtors

	31.3.2010 £m	31.3.2009 £m
Amounts owed by subsidiary undertakings	**4.0**	6.5
Prepayments and accrued income	**–**	0.1
Other	**0.3**	0.2
	4.3	6.8

Amounts owed by subsidiary undertakings include amounts receivable for the provisional surrender of tax losses amounting to £2.3 million (2009: £4.7 million).

Notes to the Company financial statements continued

6. Creditors: amounts falling due within one year

	31.3.2010 £m	31.3.2009 £m
Amounts owed to subsidiary undertakings	**2.6**	7.3
Accruals and deferred income	**0.2**	0.4
	2.8	7.7

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

	31.3.2010 £m	31.3.2009 £m
Amounts owed to subsidiary undertakings	**491.9**	490.0

	31.3.2010 £m	31.3.2009 £m
Loans are repayable as follows:		
Not wholly repayable within five years	**491.9**	490.0

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

8. Authorised and issued share capital

	31.3.2010 £m	31.3.2009 £m
Authorised:		
700 million ordinary shares of 10 pence	**70.0**	70.0
Allotted, called up and fully paid:		
518.6 million ordinary shares of 10 pence	**51.9**	51.9

The Northumbrian Water Group plc Employee Trust, through Northumbrian Water Share Scheme Trustees Limited, currently holds 914,518 (2009: 1,038,252) ordinary 10 pence shares in the Company for use under the Company's LTIP. All of these shares have been conditionally awarded under the LTIP. Details of the main features of the LTIP and the conditions for vesting can be found in the directors' remuneration report on pages 71 to 77. As at 31 March 2010, the share price of the ordinary 10 pence shares in the Company was 283.1 pence (2009: 218.25 pence).

9. Reserves

	Treasury shares £m	Share premium account £m	Profit and loss account £m
At 1 April 2008	(0.8)	446.5	46.2
Profit for the year	–	–	64.9
Purchase of own shares for the LTIP	(1.7)	–	–
Share-based payment	–	–	0.1
Exercise of LTIP awards	0.2	–	(0.2)
Dividends	–	–	(64.0)
At 31 March 2009	(2.3)	446.5	47.0
Profit for the year	–	–	67.7
Share-based payment	–	–	0.1
Exercise of LTIP awards	0.3	–	(0.3)
Dividends paid	–	–	(66.7)
At 31 March 2010	**(2.0)**	**446.5**	**47.8**

10. Commitments

The Company has issued letters of continuing support to subsidiary companies with net liabilities amounting to £8.3 million (2009: £7.1 million) and net current liabilities of £nil (2009: £nil). These subsidiary companies are expected to meet their working capital requirements from operating cash flows.

The Company is guarantor to the EIB in respect of borrowings by Northumbrian Water Limited. The loan principal outstanding at 31 March 2010 amounted to £362.4 million (2009: £381.5 million).

The Company is party to a cross guarantee arrangement with other Group companies in respect of bank facilities. Overdrafts outstanding at 31 March 2010 in respect of the arrangement amounted to £0.9 million (2009: £17.5 million). The directors do not expect any loss to arise as a result of this arrangement.

Shareholder information

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

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

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

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

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

To use any of these facilities, please log on to Capita Registrars' website at www.capitashareportal.com

If you have any queries about the above facilities, please contact the Capita share portal helpline on 0871 664 0391 (calls cost 10 pence per minute plus network extras) overseas +44 (0)20 8639 3367, or by email at shareportal@capita.co.uk

Capita share dealing services
Capita Registrars provides a low cost share dealing service. Further information is available at www.capitadeal.com, or by telephoning 0871 664 0364 (calls cost up to 10 pence per minute plus network extras). This enables you to deal in the shares of the Company and other companies for which Capita acts as registrar, provided you are already a shareholder in the relevant company, and it offers the share deal facility to its shareholders.

International payment services
Capita Registrars has partnered with Travelex, the world's largest specialist provider of commercial international payment services, to provide a service that will convert your sterling dividends into your local currency at a competitive rate. They can either arrange for these funds to be sent to you by currency draft or can pay them direct into your bank account. For further information telephone +44 (0)20 8639 3405 (from outside the UK) or 0871 664 0385 (from within the UK) between 9.00 am and 5.30 pm in the UK. Calls cost 10 pence per minute plus network extras.

ShareGift
You may donate your shares to charity free of charge through ShareGift. Further details are available at www.sharegift.org.uk or by telephoning +44 (0)20 7930 3737.

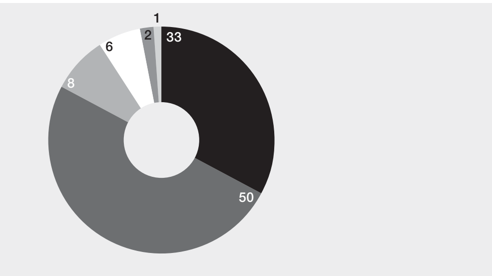
Dividend re-investment plan
The Company receives occasional requests from shareholders wishing to receive their dividends in the form of shares instead of cash. There are costs involved in providing this service, and at present it would not be cost effective. This issue is kept under regular review.

Beneficial owners of shares with ‘information rights’

Please note that beneficial owners of shares who have been nominated by the registered holder of those shares to receive information rights under section 146 of the Companies Act 2006 are required to direct all communications to the registered holder of their shares rather than to the Company’s registrar, Capita Registrars, or the Company.

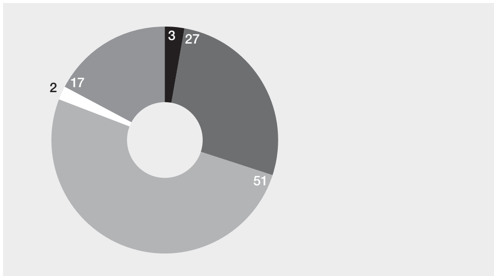
Shareholder analysis

Number of shareholders by size of holding as at 31 March 2010 %



■ Shareholders with 1–1,000 shares
■ Shareholders with 1,001–5,000 shares
■ Shareholders with 5,001–10,000 shares
□ Shareholders with 10,001–100,000 shares
■ Shareholders with 100,001–1,000,000 shares
■ Shareholders with over 1,000,000 shares

Number of shareholdings by type as at 31 March 2010 %



■ Individuals
■ Ontario Teacher’s Pension Plan Board
■ Nomiee accounts
□ Investment trusts, pensions funds and other institutions
■ Banks and bank nomineess

Disability Discrimination Act

If you wish to receive a copy of our report on audio tape, in braille or in a large text version, please telephone us on +44 (0)191 301 6701, or email us at shareholders@nwl.co.uk

For general queries about your shares, please contact Capita Registrars:
Northern House
Woodsome Park
Fenay Bridge
Huddersfield
HD1 9UT
Tel: 0871 664 0300 (calls cost 10 pence per minute plus network extras)
From overseas: +44 (0)20 8639 3399
Fax: +44 (0)1484 600 911
Email: ssd@capitaregistrars.com
Web: www.capitaregistrars.com

For general shareholder queries please contact Secretariat:
Tel: +44 (0)191 301 6701
Fax: +44 (0)191 301 6705
Email: shareholders@nwl.co.uk

To request financial statements and other Company literature please contact Communications:
Tel: +44 (0)191 301 6734
Email: shareholders@nwl.co.uk

Shareholder information continued

Annual General Meeting

The Notice of Meeting, information about the AGM to be held on 29 July 2010 and the proxy voting card are enclosed with these financial statements. Shareholder questions and special needs requests should be addressed to Secretariat at our registered office address, raised by telephone on +44 (0)191 301 6701, or sent by email to shareholders@nwl.co.uk

Warning to shareholders – boiler room scams

Over the last year, many companies have become aware that their shareholders have received unsolicited phone calls or correspondence concerning investment matters. These are typically from overseas based 'brokers' who target UK shareholders, offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. These operations are commonly known as 'boiler rooms'. These 'brokers' can be very persistent and extremely persuasive, and a 2006 survey by the Financial Services Authority (FSA) has reported that the average amount lost by investors is around £20,000.

It is not just the novice investor that has been duped in this way; many of the victims had been successfully investing for several years. Shareholders are advised to be very wary of any unsolicited advice, offers to buy shares at a discount or offers of free company reports. If you receive any unsolicited investment advice:

— make sure you get the correct name of the person and organisation;
— check that they are properly authorised by the FSA before getting involved by visiting www.fsa.gov.uk/register/
— report the matter to the FSA either by calling 0845 606 1234 or visiting www.moneymadeclear.fsa.gov.uk
— if the calls persist, hang up.

General Counsel and Company Secretary

Martin Parker

Registered office
Northumbrian Water Group plc
Northumbria House
Abbey Road
Pity Me
Durham, DH1 5FJ
Tel: 0870 608 4820

Financial calendar

2010

29 July	AGM
29 July	Interim Management Statement
11 August	Ex-dividend date
13 August	Record date
10 September	Final dividend payment
30 November	Half-yearly announcement
15 December	Ex-dividend date
17 December	Record date

2011

28 January	Interim dividend payment

Group websites
www.nwg.co.uk
www.nwl.co.uk
www.eswater.co.uk
www.nw-ss.co.uk
www.agrer.com

Northumbrian Water main switchboard
Tel: 0870 608 4820

Northumbrian Water customer queries
Customer services:
0845 717 1100
Customer accounts:
0845 733 5566

Essex & Suffolk Water customer queries
Customer services:
0845 782 0999
Customer accounts:
0845 782 0111

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