

Directors' report and business review

5. Risks and resources



Kevin McNeill, NWL contractor, on site for the mains cleaning programme on Tyneside.

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.

Going concern and treasury risk

The financial ratios, financial results, liquidity position and credit ratings are described in the financial performance section on pages 19 to 22. 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 current pressures within the financial markets have been well documented and the credit crunch has resulted in reduced availability of certain types of finance (such as index linked bonds) and a significant increase in the cost of corporate debt. It is not clear how long current difficult market conditions will persist. However, as the Group has sufficient funding in place to 2011, the effects on the Group are minimal.

The current economic climate is also 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.

As a consequence, 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 key risk for the business is the outcome of the PR09 (periodic review of prices), the process by which Ofwat sets limits on the prices which

NWL can charge customers for the five years from 1 April 2010. Ofwat will publish its draft determination in July 2009 and will consider representations before issuing its final determination in November 2009.

The Government published a consultation paper on the draft Flood and Water Management Bill in April 2009. The Bill includes measures 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 Environment Agency but also have implications for water companies, particularly with regard to how they interact and cooperate with these bodies.

It is intended that the Bill will ultimately incorporate measures in response to the 'Cave Review' (published in April 2009) and the 'Walker Report' on charging and metering (published in June 2009). These measures will be added at a later date and will be subject to separate consultation.

The 'Cave Review' proposes a cautious step-by-step approach to the introduction of competition and envisages the main benefits arising from greater innovation. It proposes a number of regulatory changes including providing Ofwat with a duty to promote innovation and the incorporation of negotiated agreements involving customer representatives (eg CCWater) as part of future price reviews.

The most significant competition proposal, at least in the short term, is the legal separation of retail businesses. This will need to be considered in greater detail as part of a separate consultation. We remain to be convinced of the benefits of this proposal.

The Government has confirmed that it intends to proceed with the transfer of certain private drains and sewers into water company ownership by 2011, which would increase the sewerage network owned and maintained by NWL by about 60%. Further details on

the transfer process are expected later in the year but this will be too late for the costs to be included in the PR09 price review. It is, therefore, likely that all sewerage companies will see an adjustment to price limits post 2010.

Another item of new legislation that will have a significant impact on the business, as and when the provisions are implemented by local authorities, is the Traffic Management Act which came into effect in April 2008.

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. 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 digestion to both reduce sludge volumes and the carbon impact of its activities. NWL will retain a facility to dry sludge and produce pellets as a fuel replacement, as a viable alternative way of using sludge in the medium term.

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 Defra's strategic document 'Future Water' and in the 'Pitt Review' on recent flooding.

Affordability and customer debt

Although our average household bills are relatively low, 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.

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5. Risks and resources continued

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 spring 2008, we published our draft 'Water Resources Management Plan' for consultation and, in January 2009, we produced a Statement of Response to the consultation and provided an updated draft of the plan to Defra. A final plan will be published once approval has been received.

In April 2009, Colchester Borough Council formally approved our application for planning permission for raising Abberton reservoir which will increase its capacity 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. 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



The Right Honourable David Miliband MP, Secretary of State for Foreign and Commonwealth Affairs with residents of Newlands Court, an area where work is underway to protect homes from flooding.

Photo credit: Shields Gazette.

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 British 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.

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. We will continue to do work in this area using the latest projections of the impacts of climate change soon to be published by the UK Climate Impacts Programme.

Employees

People are our key asset and if we are to continue to meet the needs of our customers, and to achieve our regulatory obligations, we need to continue to recruit and retain talented and skilled 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 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 on pages 54 to 63.

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 30 July 2009, was sent to shareholders with this report, together with an explanation of the business to be conducted at the meeting and a form of proxy.

Auditors

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

Directors' declaration

As required under section 234ZA of the Companies Act 1985, 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
 2 June 2009

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