

2. Group Accounting Policies

(A) Basis of preparation

Basis of accounting

The restated financial information for the year to 31 March 2005, the opening balance sheet at 1 April 2005 and the financial statements for the year ending 31 March 2006 have been prepared in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board adopted for use in the European Union.

The financial statements of the Group are prepared under the historical cost convention except for certain derivative financial instruments that have been measured at fair value. The date of transition from accounting under UK GAAP to accounting under IFRS is 1 April 2004.

First time adoption of IFRS

In general the Group is required to apply its accounting policies determined under IFRS fully retrospectively to determine the opening IFRS balance sheet. In order to ease the transition to IFRS the accounting standard IFRS1 'First-time Adoption of International Financial Reporting Standards' includes several exceptions to this principle, some of which are mandatory and some permissive. In preparing these initial statements the Group has applied the following exemptions to the restatement of historical data:

- (a) Business combinations: The Group has chosen not to restate business combinations prior to the transition date on an IFRS basis.
- (b) Employee benefits: All cumulative actuarial gains and losses have been recognised in equity at the transition date.
- (c) Cumulative translation differences: One of the requirements of IAS21 The Effects of Changes in Foreign Exchange Rates is that on disposal of an operation, the cumulative amount of exchange differences previously recognised directly in equity for that foreign operation are to be transferred to the income statement as part of the profit or loss on disposal. The Group has adopted the exemption allowing these cumulative translation differences to be reset to zero at the transition date.
- (d) Share-based payments: The Group has chosen to adopt the exemption to apply IFRS2 Share-based Payment only to equity settled awards granted after 7 November 2002 and not fully vested before 1 January 2005.
- (e) Infrastructure assets: The Group has adopted the option to restate infrastructure assets to use the fair value as the deemed historic cost in the balance sheet.

To enhance comparability, the Group has chosen to adopt IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' with effect from 1 April 2004 and has not elected to defer application of these standards to 1 April 2005.

Basis of consolidation

The Group financial statements consolidate the financial statements of Kelda Group plc, its subsidiaries, associates and joint ventures. The results of undertakings acquired or sold are consolidated for the periods from the date of acquisition or up to the date of disposal. Acquisitions are accounted for under the purchase method of accounting.

(B) Accounting policies

A summary of the principal accounting policies, which have been consistently applied throughout the year and the preceding year, is set out below.

Foreign currencies

In the accounts of the Group's companies, individual transactions denominated in foreign currencies are translated into local currency at the actual exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into local currency at the rates ruling at the balance sheet date, or if appropriate, at the forward exchange rate. Profits and losses on both individual foreign currency transactions during the year and monetary assets and liabilities are dealt with in the income statement.

Differences on foreign currency borrowings that provide a hedge against a net investment in a foreign operation are taken directly to equity until the disposal of the net investment, at which time they are recognised in the consolidated income statement. On disposal of a foreign operation, the deferred cumulative amount recognised in equity relating to that particular foreign operation shall be recognised in the income statement.

On consolidation, the income statements of the overseas subsidiaries are translated at the average exchange rates for the year and the balance sheets at the exchange rates at the balance sheet date. The exchange differences arising as a result of translating income statements at average rates and restating opening net assets at closing rates are taken to the translation reserve. Exchange differences on foreign currency borrowings are taken to reserves to the extent that they provide an effective hedge of the exchange differences arising on net investments in foreign subsidiaries.

Goodwill arising on the acquisition of an overseas subsidiary, associate or joint venture is calculated using exchange rates applicable at the date of acquisition and is subsequently re-translated at each balance sheet date.

Revenue

Provision of Services

Revenue comprises charges to customers for water, waste water and environmental services, excluding value added tax, together with the proceeds from the sale of commercial and residential properties to third parties. Revenue excludes inter-company sales.

Revenue is not recognised until the service has been provided to the customer. Revenue relates to charges due in the year, excluding any amounts paid in advance. Revenue for measured 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.

Interest

Revenue is recognised as the interest accrues (using the effective interest method that is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument to the net carrying amount of the financial asset).

Dividends

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

Rental Income

Rental income arising on investment properties is accounted for on a straight line basis over the lease term on ongoing leases.

Research and development expenditure

Research expenditure is written off in the income statement in the year in which it is incurred.

Development expenditure is charged to the income statement except where the expenditure meets the criteria for recognition as an internally generated intangible asset as outlined in IAS 38 "Intangible assets". Where the recognition criteria are met, intangible assets are capitalised and amortised over their useful economic lives from launch.

Taxation

Current tax

Current tax for the current and prior periods is, to the extent unpaid, recognised as a liability. If the amount already paid in respect of the current and prior periods exceeds the amount payable, the excess is recognised as an asset. The benefits relating to a tax loss that can be carried back to recover current tax of a previous period are held as an asset.

Deferred tax

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

Deferred income tax liabilities are recognised for all taxable temporary differences except:

- where the deferred income tax liability arises from the initial recognition of goodwill or 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 taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

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

- except where the deferred income 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 joint ventures, deferred tax assets are only recognised 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 difference can be utilised

The carrying amount of deferred income 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 income tax asset to be utilised.

Deferred income tax assets and liabilities are measured at the tax rates that apply to the period 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.

Goodwill and intangible assets

Goodwill is the excess of the fair value of the consideration paid for a business or an associate over the fair value of the identifiable assets and liabilities acquired. Goodwill is capitalised and subject to an impairment review, both annually and when there are indications that the carrying value may not be recoverable. Prior to 1 April 2004, goodwill was amortised over its estimated useful life; such amortisation ceased on 31 March 2004.

Impairment is determined by assessing the recoverable amount of the cash-generating unit to which the goodwill relates. Where the recoverable amount is less than the carrying amount, an impairment loss is recognised. When an entity is disposed of, any goodwill associated with it is included in the carrying amount of the operation when determining the gain or loss on disposal.

Other intangible assets comprise capitalised bid costs on contracts won within the Group. Costs are capitalised from the date a Group company is named as preferred bidder and then amortised over the shorter of the life of the contract or the period to the first renewal date. If preferred bidder status is withdrawn, capitalised costs will be written off immediately.

Property plant and equipment

Tangible assets, including infrastructure assets, are included at cost less accumulated depreciation and any provision for impairment. Finance costs incurred in respect of the construction of tangible fixed assets are not capitalised.

Freehold land is not depreciated. Depreciation is charged on tangible fixed assets on a straight line basis over their estimated useful economic lives, or the estimated useful economic lives of their individual major components, from the date of commissioning.

Useful economic lives are principally as follows:

Buildings	25 - 60 years
Fixed plant	5 - 40 years
Vehicles, mobile plant and computers	3 - 10 years
Water mains and sewers	40-125 years
Earth banked dams and reservoirs	200 years

Assets in the course of construction are not depreciated until commissioned. The carrying values of tangible fixed assets are reviewed for impairment if events or changes in circumstances indicate that the carrying value may not be recoverable.

In the UK regulated water services business, infrastructure assets comprise a network of systems being mains and sewers, impounding and pumped raw water storage, reservoirs, dams and sea outfalls. Prior to 1 April 2004, expenditure on infrastructure assets to increase capacity or enhance the network and to maintain the operating capability of the network base was treated as a fixed asset addition after deducting grants and contributions. This policy is not permitted under IAS 16. The opening balance for infrastructure assets was calculated with reference to the estimated fair value of the infrastructure network as a whole as the deemed historic cost. Subsequent expenditure will be classified as operating expenditure or capital and accounted for appropriately.

The carrying value of property, plant and equipment is reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Borrowing costs

Borrowing costs are recognised as an expense when incurred in accordance with the benchmark accounting treatment under IAS 23.

Accounting for leases

(i) Finance leases

Assets which are financed by leasing agreements that transfer substantially all the risks and rewards of ownership to the lessee (finance leases) are capitalised in tangible fixed assets and the corresponding capital cost is shown as an obligation to the lessor in borrowings. Depreciation is generally charged to the income statement over the shorter of the estimated useful life and the term of the lease. If the operational life of an asset is longer than the lease term, and the agreement allows an extension to that term, the asset may be depreciated over its operational life. The capital element of lease payments reduces the obligation to the lessor and the interest element is charged to the income statement over the term of the lease in proportion to the capital amount outstanding.

(ii) Operating leases

Leases where the lessor retains substantially all the risks and rewards of ownership are classified as operating leases. Lease payments are charged to the income statement on a straight line basis over the term of the lease.

Government grants and contributions

Government grants and contributions in respect of property, plant and equipment are deferred and credited to the income statement by instalments over the expected economic lives of the related assets. Government 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.

Government grants and contributions received in respect of an item of expense during the year are recognised in the income statement on a systematic basis in line with the cost that it is intended to compensate.

Investments in associates

The Group's interest in its associates, being those entities over which it has significant influence and which are neither subsidiaries nor joint ventures, are accounted for using the equity method of accounting. Under the equity method, the investment in an associate is carried in the balance sheet at cost plus post-acquisition changes in the Group's share of net assets of the associate, less distributions received and less any impairment in value of individual investments. The group income statement reflects the share of the associates' results after tax.

Financial statements of 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.

Investments in joint ventures

The group has a number of contractual arrangements with third parties which represent joint ventures, these take the form of agreements to share control over other companies. The group recognises its interest in the entity's assets and liabilities using the equity method of accounting. Under the equity method, the interest in the joint venture is carried in the balance sheet at cost plus post-acquisition changes in the group's share of its net assets, less distributions received and less any impairment in the value of individual investments.

Financial statements of jointly controlled entities 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. The group ceases to use the equity method on the date from which it no longer has joint control over, or significant influence in, the joint venture.

Inventories

Stocks are stated at cost less any provision necessary to recognise damage and obsolescence. Work in progress is stated at the lower of cost and net realisable value. Cost includes labour, materials and an appropriate proportion of overheads.

Provisions

Provision is made for self insured claims incurred but not reported, and other known liabilities which exist at the year end as a result of a past event.

Financial instruments

Cash and cash equivalents Cash equivalents are defined as including short term deposits with original maturity within 3 months. For the purposes of the consolidated cash flow statement, cash and cash equivalents consist of cash and cash equivalents net of outstanding bank overdrafts held with the same bank where there is a legal right and intention to offset.

Trade receivables and payables Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts. There is no intention to trade the receivables. Trade payables are not interest bearing and are stated at their nominal value.

Invoices for unmeasured water charges are due on predetermined dates, irrespective of date of receipt. Other trade receivables generally have 7-30 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.

Interest bearing loans and borrowings

All loans and borrowings are initially recognised at fair value less directly attributable transaction costs. After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses arising on repurchase, settlement or otherwise cancellation of liabilities are recognised respectively in investment income and finance costs.

Investments All investments are initially recorded at cost, being the fair value of the consideration given and including the acquisition charges associated with the investment. Investments are classified as either held-for-trading or available-for-sale, and are measured at subsequent reporting dates at their fair value. Where securities are held for trading purposes, gains and losses arising from changes in fair value are included in net profit or loss for the period. For available for sale investments gains and losses arising from changes in fair value are recognised directly in equity, until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the net profit or loss for the period. Fair value changes arising from foreign exchange movements or from income receivable are recorded in the income statement for the period.

Derivative financial instruments

The group uses derivative financial instruments such as foreign currency contracts and interest rate swaps to hedge its risks associated with interest rate and foreign currency fluctuations. Such derivative financial instruments are stated at fair value.

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 swap contracts is determined by reference to market values for similar instruments.

For the purposes of hedge accounting, hedges are classified as either fair value hedges where 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 cash flows that is either attributable to a particular risk associated with a recognised asset or liability or a forecasted transaction.

In relation to fair value hedges which meet the conditions for special hedge accounting, any gain or loss from re-measuring the hedging instrument at fair value is recognised immediately in the income statement. 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 commitments which meet the conditions for special 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 net profit or loss.

When the hedged firm commitment results in the recognition of a non-monetary asset or a 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 period in which the hedged firm commitment affects the net profit and loss, for example when the future sale actually occurs.

For derivatives that do not qualify for special hedge accounting, any gains or losses arising from changes in fair value are taken directly to net profit or loss for the period.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for special 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 forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to net profit or loss for the period.

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the effective portion of the hedge is recognised in equity and any gain or loss on the ineffective portion is recognised in the income statement. On disposal of the foreign operation the cumulative value of any gains or losses recognised directly in equity is transferred to the income statement.

Employee Benefits

(a) Pension Plans

(i) Defined contribution scheme

The Group operates defined contribution schemes for those members of staff who are not members of its defined benefit scheme. Two are pension plans under which the Group pays a fixed contribution into a separate entity which operates the schemes. The other provides the employees with a

lump sum on retirement, with which they then invest in an annuity. Other than this contribution the Group has no further legal or constructive obligation to make further contributions to the scheme.

Obligations for contributions to the scheme are recognised as an expense in the income statement in the period in which they arise.

(ii) **Defined benefit scheme**

The Group operates defined benefit schemes in the UK and US. A defined benefit scheme is a pension plan under which the amount of pension benefit that an employee receives on retirement is defined by reference to factors including age, years of service and compensation.

The schemes are funded by payments, determined by periodic actuarial calculations agreed between the company and the trustees to trustee administered funds.

A liability or asset is recognised in the balance sheet in respect of the Group's net obligations to the schemes calculated separately for each scheme. The liability represents the present value of the defined benefit obligations at the balance sheet date, less the fair value of the scheme assets and past service costs.

The defined benefit obligation represents the estimated amount of future benefits that employees have earned in return for their services in current and prior periods, discounted at a rate representing the yield on a high quality corporate bond at the balance sheet date, denominated in the same currency as the obligations and having the same terms to maturity as the related pension liability, applied to the estimated future cash outflows arising from these obligations. The calculation is performed by a qualified actuary using the projected unit credit method.

Actuarial gains and losses at 1 April 2004, the date of transition to IFRS, have been recognised in the Group's reserves. Actuarial gains and losses on experience adjustments and changes in actuarial assumptions that arise subsequent to 1 April 2004 are recognised in the period in which they arise directly in the statement of recognised income and expense.

(b) Equity settled share based payments

The group operates a savings related share option scheme under which options have been granted to employees. The fair value of employee services rendered in exchange for the grant of options is recognised as an expense in the income statement with a corresponding credit to equity.

The total amount which is expensed over the specified period until the options can be exercised (the vesting period) is determined by the fair value of the option at the date of the grant. The fair value of the option calculated is determined by use of mathematical modelling including the Black Scholes option pricing model.

The group re-assesses its estimate of the number of options that are expected to become exercisable at each balance sheet date. Any adjustments to the original estimates are recognised in the income statement (and equity). No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

Awards under the Long Term Incentive Plan have two separate vesting conditions, both of which are dependent on market-based conditions (Kelda shareholder return against a comparator group and against the market). The market-based conditions of the award are taken into account in valuing the award at the grant date. At each subsequent balance sheet date the Group revises its estimate of the number of employees who will receive awards. It recognizes the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to equity over the remaining vesting period.

Investment in own shares

The Group has an employee share trust (ESOT) for the granting of group shares to executives and senior employees. Shares in the Group held by the employee share trust are treated as treasury shares and presented in the balance sheet as a deduction from equity.

The finance costs and administration costs relating to the ESOT are charged to the income statement. Dividends earned on shares held in the Trust have been waived. The shares are ignored for the purposes of calculating the company's earnings per share.

Segmental reporting

The Group's primary reporting format is its business segments and its secondary format is geographical segments. A segment is a component of the Group which can be distinguished separately as providing a product or service within a particular environment which is subject to risks and rewards that are different from those of other segments. The group has identified four business segments:

- UK Regulated Water Services – Yorkshire Water
- US Operations – Aquarion
- UK Service Operations – Kelda Water Services, Safe Move and Loop
- Property Development – KeyLand

The Business Review details the activities of each segment.

Transfer pricing between business segments is set on an arms length basis similar to transactions with third parties.

The Group's geographical segments are determined by the location of the Group's assets and operations.

Non-current assets held for sale

On classification as held for sale, non-current assets are recognised at the lower of carrying amount and fair value less costs to disposal. Impairment losses on initial classification as held for sale are included in profit or loss, as are any gains and losses on subsequent re-measurement.

Exceptional items

Exceptional items are material items which derive from events or transactions that fall within the ordinary activities of the reporting entity and which individually or, if of a similar type, in aggregate need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view.

(C) New standards and interpretations not applied

During the year the IASB and IFRIC have issued a number of new standards and interpretations with an effective date after the date of these financial statements. Of these, only the following are expected to be relevant to the Group:

International Accounting Standards (IAS/IFRS)

IFRS 7	Financial Instruments: Disclosures	1 January 2007
IAS 1	Amendment – Presentation of Financial Statements: Capital Disclosures	1 January 2007
IAS 19	Amendment – Actuarial Gains and Losses, Group Plans and Disclosures	1 January 2006
IAS 39	Fair Value Option	1 January 2006
IAS 39	Amendments to IAS 39 – Transition and Initial Recognition of Financial Assets and Financial Liabilities (Day 1 Profits)	1 January 2006
IAS 39	Cash Flow Hedge Accounting	1 January 2006
IAS 39	Amendment to IAS 39 and IFRS 4 – Financial Guarantee Contracts	1 January 2006

International Financial Reporting Interpretations Committee (IFRIC)

IFRIC 4	Determining whether an arrangement contains a lease	1 January 2006
IFRIC 8	Scope of IFRS 2	1 January 2006

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.

Upon adoption of IFRS 7, the Group will have to disclose additional information about its financial instruments, their significance and the nature and extent of risks that they give rise to. More specifically, the Group will need to disclose the fair value of its financial instruments and its risk exposure in greater detail. There will be no effect on reported income or net assets.