Modern Water plc
Annual Report and Accounts 2007

MODERNWATER

Corporate statement

Modern Water was established to build and exploit a portfolio of water technologies to address problems of the availability of fresh water and the treatment and disposal of wastewater. By 2025 it is forecast that two thirds of the world's population will live in countries classified as water stressed. Climate change is likely to further exacerbate this situation.

Managed by an executive team with impressive experience in the water industry, Modern Water is at the leading edge of new and important technology, which is vital to the future sustainability of the world's most precious commodity.

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Our
highlights

- Successful first six months as a PLC since IPO in June 2007
- Agreement signed to locate commercial proving plant in Gibraltar
- Gibraltar plant due to be operational by mid 2008
- High level of interest in our technology from the Gulf, Australasia and the Mediterranean region
- Cash balances of £29 million at 31 December 2007

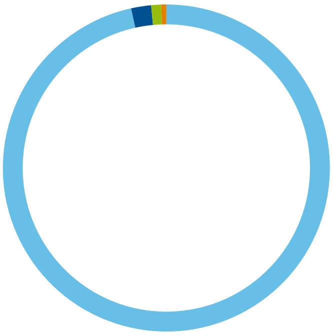
"Sustainability and environmental responsibility lie at the heart of our business."

Summary of chairman's statement

- Raised £30 million on admission to AIM in June 2007
- First manipulated osmosis desalination proving plant in a commercial environment to be operational by mid 2008
- September 2007 invested in Stonybrook Purification who are developing a new generation of membrane technology
- Patent granted for hydro-osmotic power which represents a potentially important new revenue stream

It is with great pleasure that I make my first full report as Executive Chairman of Modern Water plc. The past year has been an exceptional one. The company was founded at the end of 2006. In June 2007, we raised £30 million on admission to the AIM market of the London Stock Exchange, and we were delighted that the share offer was well oversubscribed. Following admission, the management team has been steadily delivering against its plans whilst successfully laying important commercial and technical foundations for future growth.

With the lack of availability of fresh water becoming ever more acute we anticipate that there will continue to be growing demand for water and water-related products. With expectations that by 2025 two thirds of the world's population will live in countries that are classified as water stressed, our portfolio of technologies will revolutionise the provision of fresh water.



70%

of the world's surface is covered in water, 97.5% of that is salt water

United Nations, Water for Life report

World water resources

- Seas and oceans 97.5%
- Glaciers, snow and permafrost 1.725%
- Ground water 0.775%
- Lakes, swamps and rivers 0.025%

Sustainability and environmental responsibility lie at the heart of our business. Our technology has a positive impact on the environment as it reduces energy use by desalination plants and lowers the consumption and disposal of hazardous chemicals. Our processes reduce or eliminate the harmful emissions of salt brine seen in traditional desalination plants. We are also developing an exciting renewable and emission-free form of energy.

Since admission to AIM, a core focus has been the commercial roll out of our technology. I am pleased to report that there has been a very high level of interest internationally, particularly for our desalination technology. This has been most marked in the Gulf, Australasia and the Mediterranean region.

I am delighted to announce, as part of this roll out, we have agreed to locate the first manipulated osmosis desalination proving plant in a commercial environment in Gibraltar. This is an important step and gives us the opportunity to demonstrate the significant advantages of our desalination technology, including lower energy, capital and operational costs and higher output.

We continue to monitor other water-related technology, with a particular focus on areas complementary to our existing products. As a result in September 2007 we made an investment in Stonybrook Purification, a company that is developing a new generation of membrane technology.

Ongoing investment in intellectual property has resulted in a recent patent grant approval for hydro-osmotic power, which generates power by mixing water with different levels of salinity. This is a natural extension of our work in desalination and represents a potentially important new revenue stream.

To support the roll out of our technologies we have continued to build a strong management team. We have made a range of impressive appointments in all key areas, with particular focus on sales and technical support. We are delighted to continue to attract high calibre staff who are well respected in the water and desalination sectors. I would like to take this opportunity to thank all of our staff who have helped to ensure that the first period as a quoted company has been such a success.

We expect that the high level of interest in our ground-breaking technologies will continue, and that the foundations and key relationships we have put in place will grow into successful long-term partnerships. The board looks forward to continuing this positive growth in 2008.

Neil McDougall
Executive Chairman
29 February 2008

"Our technology greatly impacts upon the reduction of long-term damage to the planet caused by the use of fossil fuels."

Summary of business review

- New Gibraltar proving plant will illustrate the efficiency of our technology against traditional desalination methods
- Increased ownership of Surrey Aquatechnology to 100% in June 2007
- Good progress has been achieved in securing the patents for the company's own technology
- Moved into current offices in Guildford and finalised the development of our stand alone IT and accounting systems

Introduction

The group has continued to grow following our admission to AIM on 12 June 2007. Based in new offices, with our key executive team of technical and business development professionals, we are confident that we have solid foundations from which to rapidly grow our business.

Market

Availability of fresh water and the treatment of wastewater remain at the forefront of the environmental agenda. The serious issues facing the developed world are now being recognised and the importance of sustainable solutions to these issues is increasingly urgent.

The company is experiencing continuing interest in its technology offering within its target markets. We believe our technology provides significant benefits over current technology. We are continuing to invest in developing further applications for our core manipulated osmosis technology to ensure we retain our technological advantage.

We have seen significant market interest from developers for the implementation of all our technology offerings on a single site.

Gibraltar

The company has announced the first contract for a manipulated osmosis desalination plant in a commercial environment. The proving plant will be located next to the existing desalination plant in Gibraltar and will use the same feedwater, producing 100m^3/day of fresh water.

42,000

estimated number of people who die each week from diseases related to low-quality drinking water and lack of sanitation
(WHO/UNICEF)

This is an important project for us and will enable us to illustrate the efficiency of our technology against traditional desalination methods. This showcase has attracted significant interest and will be an important part of our marketing strategy.

Commercial progress

During the year the company made a number of investments in technology. The initial investments in Poseidon Water, Cymtox and Surrey Aquatechnology were completed prior to the AIM admission.

On completion of the AIM listing, Modern Water acquired the balance of Surrey Aquatechnology shares to take the company to 100% ownership.

In November 2007, Modern Water purchased an additional 20% of Cymtox to take the shareholding to 37%. Cymtox is continuing to make significant progress in the development of its commercial product.

In line with our strategy to invest in new complementary technologies, in September 2007 the company made an investment in Stonybrook Purification. Stonybrook, a spin out from Stonybrook University, is developing a membrane platform that enables water treatment systems to process more water to a higher standard, faster and at a lower cost.

Technical developments

The company continues to sponsor research on further applications for our osmotic technology, led by Professor Sharif and his team at the University of Surrey. This work has resulted in a number of new patent applications.

One area of successful research has been in the use of manipulated osmosis for generating power. This will allow power to be generated from the brine output of existing desalination plants. In the future this will allow power to be generated where there are fresh and sea water resources. Development of this technology is continuing and we are reviewing suitable locations for a large scale proving plant.

Intellectual property

Good progress has been achieved in securing the patents for the company's own technology.

The osmotic energy patent has been granted by the European Patent Office. The company has also received other individual country patent approvals for the manipulated osmosis process, including the sole right to use the technology in South Africa.

In addition, as part of Modern Water's drive to gain access to leading research, the company has agreed to join the Questor Group, which provides Modern Water with valuable links to Queens University Belfast, Dublin City University and Stevens Institute of Technology. Other members of the Questor Group include BP, Shell and Coca-Cola.

Corporate social responsibility

The company is committed to the improvement and sustainability of the environment in which we operate. As the lack of available fresh water becomes an increasingly pressing problem, our range of technologies provide environmentally sound solutions to address this global issue. The technology we have developed for osmotic power generation is renewable and complements other renewable energy sources, such as solar and wind. The process allows for sustainable desalination whilst significantly reducing energy consumption. Our technology greatly impacts upon the reduction of long-term damage to the planet caused by the use of fossil fuels. Our application of renewable energy in the treatment of water for industrial and domestic use will ensure this process is both sustainable and energy efficient.

As a team, we are aware of our responsibility to conduct business and develop the company with a focus on environmental accountability. As the company grows, our intention is to place increased emphasis on our corporate social responsibility for the long-term benefit of the planet. To this end, we are working towards ensuring that all the paper we print on is from sustainable sources. The inks used in our annual report are vegetable oil based and we recycle all waste paper and card at our UK head office.

2,400

litres of water are required to produce a hamburger
FT Special report, March 2007

People and premises

In terms of headcount, the company is growing rapidly. Appointments have focused on technical and business development professionals, reflecting our increasing focus on the roll out and commercialisation of our technologies, attracting impressively high calibre people. Recruitment is ongoing as the business continues to grow, and our key executive team is now in place to drive the company forward.

Following the completion of our IPO, the company finalised the development of its stand alone IT and accounting systems, and moved to its current offices in Guildford.

Risks and uncertainties

The risks inherent in the operation of the company are well understood and control measures have been established to ensure that risks are adequately controlled both in terms of frequency and consequences. Risks are reviewed by the board on a regular basis. Treasury risks are described in more detail in the financial review. Other risks reviewed include business controls, management structure and recruitment programmes, corporate and capital structure and the security of company assets such as intellectual property and patents.

1.1 billion

people in the world do not have access to safe water; this is roughly one sixth of the world's population

Water Aid

Financial review

Summary

The financial position of the company is strong, having raised £30 million at IPO. At the year end cash balances were in excess of £29 million after funding the acquisition of two subsidiaries, two further investments and the infrastructure to support business development.

Accounting policies

The major accounting policies to note are those that deal with intangible assets and share-based payments. The company has adopted IFRS and as such is required to value intangible assets acquired as part of a business combination. The resulting appraisal values the group's intangible assets at over £13 million. The company is also required to place a value on share-based payments. This amounted to a non-cash charge on the consolidated group income statement of £1.3 million out of a total loss of £1.7 million.

Capital structure

The company is entirely equity funded which is appropriate during the current pre-revenue, development phase. As the company develops income generating investments the capital structure will be reassessed on a project-by-project basis.

Treasury risk and policy

The company is subject to the following risks:

- risks associated with variable interest rates;
- credit risks associated with having cash on deposit; and
- the risk of not having cash on deposit available at short notice.

The company has adopted a low-risk approach to treasury management appropriate to address all the above risks. Cash balances are invested in term deposit accounts, with maturity dates to suit projected liquidity requirements. A variety of institutions are used in consultation with the company's financial advisers.

Cash flows

The major cash inflow was the raising of total capital of £32 million comprising £30 million from the IPO and the remainder from the initial investors. Cash out includes transaction costs from the above (£1.6 million) and operating costs (£1.4 million), the majority of which relate to the rapid growth of the company. Cash investments totalling £350,000 have been made in four companies.

Conclusion

It has been an exciting and challenging period in the development of Modern Water. The foundations are now in place to allow the company to continue its rapid growth.

Simon Humphrey
Chief Executive
29 February 2008

Directors
and advisers

Neil McDougall
Executive Chairman
Neil McDougall leads the Modern Water team. He has extensive experience of the water industry, having been chairman of Swan Group plc, the holding company for Mid Kent Water plc; and chairman and chief executive officer of Cascal, a company which specialises in the investment and operation of domestic and international water companies and public-private partnerships.

Simon Humphrey
Chief Executive Officer
Simon Humphrey brings a host of industry and investment experience to Modern Water. Most recently he was investment manager at Laing O'Rourke where he focused on water-related opportunities. Previously he was a director of Glen Water Limited, a joint venture with Thames Water. Prior to this he was investment director at Spring Capital and investment director at Cascal.

Dr Gerald Jones
Chief Scientific Officer
Dr Jones is a leading authority within the water industry having been at WRc Limited (formerly the Water Research Centre) for 26 years. His experience also includes the directorship of a technology-based business incubator as well as the project management of a number of large multi-disciplinary R&D projects involving industrial and academic partners.

Michael Gradon
Senior Independent Non-executive Director
Michael has over 25 years' experience in senior commercial, management and legal positions. He spent 20 years at P&O and was a main board director for eight years until its takeover in 2006 by Dubai Ports World. His roles included being group commercial and legal director, chairman of P&O's property business and chief executive officer of its largest infrastructure project. He is a non-executive director of Grosvenor Limited and of Genesis Lease Limited and a member of the committee of the All England Lawn Tennis Club and the Wimbledon Championships.

Trevor Jones
Non-executive Director
Trevor has considerable managerial experience in the water industry, as former chairman of Thames Water International. Trevor was managing director of Thames Water's non-regulated business during which he was chairman of the Metronet Consortium that won two thirds of the London Underground PPP. He also has extensive experience in the international water market including the Middle East, Asia, Latin America and Australia.

Paul Shepherd
Non-executive Director
Paul is a chartered engineer with a wealth of experience in the construction and engineering industry. Until 2001, he was chairman and managing director of Shepherd Building Group, one of the UK's largest private construction groups. Activities of the group covered construction, engineering, consulting, manufacturing, housing and property development.

Mike Townend
Non-executive Director
Mike is director of capital markets at IP Group. He has 17 years' experience in all aspects of equity capital markets and was formerly managing director at Lehman Brothers. In this role, Mike focused particularly on hedge funds and alternative asset managers. He has extensive experience of raising capital, having recently completed a number of private company fundings.

Angela Leach
Company Secretary
Angela provides in-house legal services for IP Group plc and its portfolio companies and co-ordinates all external legal requirements. After spending four years at leading city law firm CMS Cameron McKenna and two years at AIM specialist Memery Crystal, Angela joined IP Group plc in January 2007. Angela specialises in all aspects of corporate and commercial law, along with intellectual property law, having obtained a postgraduate diploma in commercial intellectual property law with distinction from Nottingham Law School in June 2006.

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The Guildway
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Guildford GU3 1LR

Company number
Registered in England and Wales
number 05963927

Further details can be found
on the Modern Water website:
www.modernwater.co.uk

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Independent auditors
PricewaterhouseCoopers LLP
Chartered Accountants and
Registered Auditors
First Point, Buckingham Gate
Gatwick RH6 0PP

Solicitors
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London SE1 2AQ

Registrars
Capita IRG Plc
The Registry
34 Beckenham Road
Beckenham BR3 4TU

Principal bankers
The Royal Bank of Scotland
Abbey Gardens
4 Abbey Street
Reading RG1 3BA

Corporate
governance statement

Corporate governance
As an AIM-listed company Modern Water plc is not required to issue a statement of compliance with the principles and provisions of the 2003 Combined Code on Corporate Governance ("the Combined Code") however the board of Modern Water plc is committed to the principles of good corporate governance. This report, together with the information contained in the directors' remuneration report on pages 12 and 13, explains how the directors seek to apply the requirements of the Combined Code to procedures within the group.

The board of directors
The board comprises the Executive Chairman (Neil McDougall), the Chief Executive Officer (Simon Humphrey), the Chief Scientific Officer (Gerald Jones) and four non-executive directors (Michael Gradon, Paul Shepherd, Trevor Jones and Mike Townend).

The business and management of the company and its subsidiaries are the collective responsibility of the board. At each meeting, the board considers and reviews the performance of each of the major projects. The board has a formal written schedule of matters reserved for its review and approval. These include the approval of the annual budget, major capital expenditure, investment proposals, the interim and annual results, and a review of the overall system of internal control and risk management.

There are three standing board committees: audit, remuneration and executive. Each of these committees acts within defined terms of reference. Additional information is set out later in this report and also in the directors' remuneration report in respect of the remuneration committee.

Authority for the execution of the approved policies, business plan and daily running of the business is delegated to the executive directors.

During the period, the board met formally on nine occasions, all on a quorate basis. There were no absences from any of the formal meetings except that Paul Shepherd was unable to attend the 30 August 2007 meeting.

The company's Articles of Association require one third of the directors to stand for re-election each year at the Annual General Meeting. Accordingly, Gerald Jones and Simon Humphrey will retire and offer themselves for re-election at the forthcoming Annual General Meeting.

All directors have access to the advice and services of the Company Secretary who is responsible for ensuring that board procedures and applicable rules and regulations are observed. The board has a procedure whereby any director may seek, through the office of the Company Secretary, independent professional advice, at the company's expense, in furtherance of his duties.

Formal agendas and reports are provided to the board on a timely basis for board and committee meetings and the Executive Chairman ensures that all directors are properly briefed on issues to be discussed at board meetings. Directors are able to obtain further advice or seek clarity on issues raised at the meetings from within the company or from external sources.

Remuneration committee
Details of the committee and its policies are set out in the directors' remuneration report on pages 12 and 13.

The committee has formal terms of reference (available on request from the Company Secretary).

During the period, the committee met on one occasion and all members attended the meeting.

Audit committee
The audit committee consists of Michael Gradon (Chairman), Paul Shepherd, Trevor Jones and Mike Townend.

The committee has formal terms of reference (approved on 19 September 2007 and available on request from the Company Secretary). These include the recommendation of the appointment, reappointment and removal of the external auditors, the review of the scope and results of the interim review and external annual audit by the auditors, their cost effectiveness, independence and objectivity. The committee also reviews the nature and extent of any non-audit services provided by the external auditors. In addition, the committee reviews the effectiveness of internal controls, considers the need for an internal audit function and considers any major accounting issues and reports on such matters to the board. The committee reviews the integrity of the financial statements and formal announcements. A whistle-blowing arrangement exists whereby matters can be confidentially reported to the committee. The executive directors are not members of the committee but attend the meetings by invitation, as necessary, to facilitate its business.

The Chief Executive Officer monitors the level and nature of non-audit services and specific assignments are flagged for approval by the audit committee as appropriate. During the period PricewaterhouseCoopers LLP were appointed as the group external auditors.

The committee met once during the period.

Executive committee
The purpose of the executive committee is to assist the Chief Executive Officer in the performance of his duties. The committee consists of the Executive Chairman, the Chief Executive Officer and the Group Financial Controller. Terms of reference approved on 19 September 2007 are available on request from the Company Secretary. The committee met three times during the period.

Internal control

The board has overall responsibility for the group's system of internal control and for reviewing its effectiveness. The implementation and maintenance of the risk management and internal control systems are the responsibility of the executive directors and senior management. The internal control system is designed to manage risk rather than eliminate it and can therefore only provide reasonable and not absolute assurance against material misstatement or loss.

In accordance with the guidance set out in the Turnbull Guidance on Internal Control, the group has an ongoing process for identifying, evaluating and managing the significant risks faced by it. This process was set up during the period under review and remained in place on the date that the annual report and accounts were approved by the board. Accordingly, the board is satisfied with the process in place for identification and management of risk and that the reporting lines have been in place throughout the period under review.

The group is committed to maintaining high standards of business conduct and operates under an established internal control framework covering financial, operational and compliance controls. This is achieved through an organisational structure that has clear reporting lines and delegated authorities.

The board receives a monthly report which includes key financial information including trading and cash flow analysis and the Chief Executive Officer reports on significant changes in the business and the external marketplace to the extent they represent significant risk. A budgetary system has been established with an annual budget approved by the board. The board reviews the results monthly against budget and forecasts together with other business measures.

The principal treasury related risks are documented and approved by the board.

Relations with shareholders and investors

Copies of the annual report and accounts and the interim statement are issued to all shareholders and copies are available on the company's website: www.modernwater.co.uk. The group makes full use of its website to provide information to shareholders and other interested parties.

Shareholders are given the opportunity to raise questions at the Annual General Meeting and the directors are available both prior to and after the meeting for further discussion with shareholders.

During the period, the Executive Chairman met with institutional investors at meetings arranged by the company's brokers, KBC Peel Hunt, and the company's financial PR advisers.

Michael Gradon, as senior independent non-executive director, is available to shareholders where contact through the normal channels of Executive Chairman, Chief Executive Officer or Company Secretary is inappropriate or has failed to resolve concerns.

Going concern

The directors are required by company law to be satisfied that the group has adequate resources to continue in business for the foreseeable future. A review has been conducted and the directors have concluded that such resources are available and that the going concern basis is justified in the preparation of the financial statements.

Directors' remuneration report

Remuneration committee

The remuneration committee comprises Michael Gradon (Chairman), Paul Shepherd, Trevor Jones and Mike Townend.

The committee makes recommendations to the board, within the terms of reference agreed on 6 June 2007, on the remuneration and other benefits, including bonuses and share options, of the executive directors.

In considering the remuneration for the period, the committee consulted with the executive directors about its proposals.

Remuneration policy

The remuneration committee is aware that the remuneration package should be sufficiently competitive to attract, retain and motivate individuals capable of achieving the group's objectives and thereby enhancing shareholder value. Performance-based remuneration should be clearly aligned with business strategy and objectives and be regularly reviewed. Overall arrangements should be prudent, well communicated, incentivise effectively and recognise shareholders' expectations.

Having recently reviewed the remuneration arrangements, it is the company's intention to establish:

- a money purchase pension scheme for all staff including the executive directors; and
- a bonus/long-term incentive scheme for all senior staff including executive directors based on the achievement of individual and company performance targets.

Service contracts

The group's policy is for executive directors to have service contracts with provision for termination of no more than 12 months' notice.

Non-executive directors have letters of appointment. Appointments can be terminated by the company or the individual giving one month's notice. The services of Mike Townend are covered in a services agreement with IP2IPO Limited.

The details of the executive and non-executive directors' service contracts are summarised below:

	Date of contract	Notice period (months)
Executive directors		
Neil McDougall	18 May 2007	12
Simon Humphrey	18 May 2007	12
Gerald Jones	1 December 2006	3
Non-executive directors		
Michael Gradon	14 March 2007	1
Paul Shepherd	14 March 2007	1
Trevor Jones	3 April 2007	1
Mike Townend	18 May 2007	1

Biographical details of all directors can be found on pages 8 and 9.

Directors' remuneration

Remuneration for the executive directors comprises basic salary, medical, life and income protection insurance cover, and share options under the Modern Water Incentive Plan (see page 13). A defined contribution pension scheme will be established in 2008 for all employees in which the executive directors will participate.

The remuneration arrangements for Gerald Jones are different to the other executive directors. The company entered into a consultancy agreement with WRc plc and Gerald Jones for the provision of services by Gerald Jones for a maximum of 133 days per annum at the rate of £435 per day.

Non-executive directors' fees

The board, within the limits stipulated by the Articles of Association and following recommendation by the executive directors, determines non-executive directors' fees. The remuneration of the non-executive directors is not pensionable and the non-executive directors do not participate in any of the company's other remuneration schemes.

The remuneration of the directors during the period was as follows:

	Basic salary, allowances and fees £000	Benefits £000	**2007 Total £000**
Executive directors			
Neil McDougall	177	5	**182**
Simon Humphrey	102	4	**106**
Gerald Jones	56	—	**56**
Non-executive directors			
Michael Gradon	28	—	**28**
Paul Shepherd	29	—	**29**
Trevor Jones	15	—	**15**
Mike Townend	—	—	**—**
	407	9	**416**

Modern Water Incentive Plan ("MWIP")

The MWIP contains provisions relating to the making of awards in the form of options, conditional awards of ordinary shares and matching awards of ordinary shares. During the period, the following share options were granted:

	Number of options	Exercise price	Grant date
Neil McDougall	560,877	£1.19	6 June 2007
Simon Humphrey	1,121,753	£1.19	6 June 2007

Vesting period

Subject to satisfaction of the performance criteria, one third of the total number of options vests on 12 June 2008, one third on 12 June 2009 and the final third vests on 12 June 2010. Options lapse if unexercised by 12 June 2017.

Performance criteria

Each tranche vests subject to total shareholder return being at least equal to 10% for the 12 months preceding the relevant tranche vesting date.

Management Share Incentive Scheme ("MSIS")

The remuneration committee approves the granting of any interest in the MSIS. The scheme was adopted on 1 December 2006.

Between 1 December 2006 and 12 March 2007, the following were invited to subscribe for ordinary shares in accordance with the MSIS:

	Dates of subscription	Total number of shares held	Subscription price
Neil McDougall	1 December 2006 and 12 March 2007	3,363,400	£0.001
Simon Humphrey	1 December 2006 and 12 March 2007	1,479,000	£0.001
Gerald Jones	1 December 2006	200,000	£0.001

One third of the MSIS shares were not subject to any restrictions. The remaining two thirds of MSIS shares are subject to restrictions as to voting and dealing but are released from such restrictions following a defined period. Restrictions fell away for half of these shares on 1 December 2007. Restrictions fall away for the other half of these shares on 1 December 2008. No further invitations to subscribe will be made under the MSIS.

On behalf of the board

Michael Gradon
Chairman, remuneration committee
29 February 2008

Directors' report

The directors present their report together with the audited financial statements from 11 October 2006 to 31 December 2007.

Principal activity

The principal activity of the company and its subsidiaries during the period was sourcing, developing and deploying technology-based solutions to meet the growing demand for the economic availability of fresh water and treatment of wastewater.

Review of the business and results

A detailed review of the business is set out in the business review on pages 4 to 7. Included in this review are comments on the financial information that is used by the board on a monthly basis to monitor and assess the performance of the business. Formal key performance indicators are not currently considered necessary to adequately assess performance. This information includes the level of investments, costs, cash and headcount. Also included is a summary of significant risks and uncertainties.

The group income statement for the period is set out on page 18. The loss of the group for the period was £1.7 million. The directors are unable to recommend the payment of a dividend.

Research and development

Activities in research and development are discussed in the business review.

Future developments

Future developments and prospects are set out in the business review.

Directors

The directors in office during the period are listed below together with their beneficial interests in the share capital of the company.

	Date of appointment	Date of resignation	Number of ordinary shares of 0.25p
Pinsent Masons Director Limited	11 October 2006	31 October 2006	—
Alan Aubrey	31 October 2006	18 April 2007	—
Magnus Goodlad	31 October 2006	18 April 2007	—
William Turner	31 October 2006	18 April 2007	—
Neil McDougall	1 December 2006	—	6,265,000
Simon Humphrey	1 December 2006	—	1,812,000
Gerald Jones	1 December 2006	—	200,000
Michael Gradon	14 March 2007	—	546,518
Paul Shepherd	14 March 2007	—	231,225
Trevor Jones	3 April 2007	—	16,807
Mike Townend	30 March 2007	—	* 575,000

* Registered in the name of IP2IPO Limited

There has been no change in the interests set out above between 31 December 2007 and 29 February 2008.

Directors' liability insurance

The company maintains liability insurance for its directors and officers.

Staff policy

The group's employment policies are designed to ensure that they meet the statutory, social and market practices in the UK where the group operates. The group's employees are regularly informed of the group's financial position and the market conditions in which it operates. This is achieved through briefings to managers and staff. The training and career development of employees is an activity which is considered fundamental to the success of the group.

Employment policies are also designed to provide equal opportunities irrespective of colour, ethnic or national origin, nationality, sex, religion and marital or disabled status.

The group offers appropriate training and career development for disabled staff. If members of staff become disabled the group continues employment wherever possible and arranges retraining.

Supplier payment policy

It is the group's policy to abide by the terms of payment agreed with suppliers in respect of the goods and services invoiced to the group. Based on the calculation method defined in Statutory Instrument 571 (1997), at 31 December 2007, the group had an average of 24 days' purchases outstanding in creditors (company: 21 days).

Political and charitable donations

The group made no political and charitable donations during the period.

Financial instruments

The group's financial instruments primarily comprise cash balances. In addition, various other financial instruments such as trade debtors, creditors and borrowings arise directly from its operations. From time to time the group also enters into derivative transactions such as forward exchange contracts, the purpose of which is to manage currency and interest rate risk. Please refer to the business review for greater details of the group's risks and policies regarding financial instruments.

Annual General Meeting

The Annual General Meeting will be held at the offices of Modern Water plc on 28 April 2008 at 10.00am. The notice convening the Annual General Meeting is set out on pages 33 and 34 of the annual report.

Auditors

During the period under review PricewaterhouseCoopers LLP were appointed as group auditors. They have indicated their willingness to continue in office and, in accordance with section 385 of the Companies Act 1985, a resolution to reappoint them will be put to the Annual General Meeting.

Directors' statement as to disclosure of information to auditors

The directors who were members of the board at the time of approving the directors' report are listed on pages 8 and 9. Having made enquiries of fellow directors, each of these directors confirms that:

- to the best of each director's knowledge and belief, there is no information relevant to the preparation of their report of which the group's auditors are unaware; and
- each director has taken all the steps a director might reasonably be expected to have taken to be aware of relevant audit information and to establish that the group's auditors are aware of that information.

By order of the board

Angela Leach
Company Secretary
29 February 2008

Statement of directors' responsibilities

in respect of the annual report and the 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 group and parent company financial statements in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the company and the group and of the profit or loss of the group 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 that the financial statements comply with IFRS as adopted by the European Union; and
- prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the group will continue in business, in which case there should be supporting assumptions or qualifications as necessary.

The directors confirm that they have complied with the above requirements in preparing the financial statements.

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

The directors are responsible for the maintenance and integrity of the company's website and legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

By order of the board

Angela Leach
Company Secretary
29 February 2008

Independent auditors' report

to the members of Modern Water plc

We have audited the group and parent company financial statements (the "financial statements") of Modern Water plc for the period ended 31 December 2007 which comprise the group income statement, the group and company statements of changes in equity, the group and company balance sheets, the group and company cash flow statements, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable law and International Financial Reporting Standards ("IFRS") as adopted by the European Union are set out in the statement of directors' responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the directors' report is consistent with the financial statements. The information given in the directors' report includes that specific information presented in the business review that is cross referred from the directors' report.

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

We read other information contained in the annual report and consider whether it is consistent with the audited financial statements. The other information comprises only the chairman's statement, the business review, the directors and advisers, the corporate governance statement, the directors' remuneration report, the directors' report and the statement of directors' responsibilities. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- the group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the group's affairs as at 31 December 2007 and of its loss and cash flows for the period then ended;
- the parent company financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2007 and cash flows for the period then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the directors' report is consistent with the financial statements.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Gatwick
29 February 2008

Group
income statement
period ended 31 December 2007

	Note	£000
Administrative costs		(2,719)
Operating loss	4	**(2,719)**
Net finance income	8	**1,020**
Share of loss of associates	13	**(50)**
Loss on ordinary activities before taxation		**(1,749)**
Tax on loss on ordinary activities	9	**16**
Loss for the period		**(1,733)**
Attributable to:		
Equity holders of the company		**(1,632)**
Minority interest		**(101)**
		(1,733)
Loss per share for the period (attributable to equity holders of the company)		
Basic loss per share	10	**4.6p**
Diluted loss per share	10	**4.5p**

Modern Water plc has taken advantage of the exemption provided under section 230 of the Companies Act 1985 not to disclose the company income statement. The loss attributed to the company in the period was £1,239,000.

Group and company
statements of changes in equity
period ended 31 December 2007

Group	Note	Called up share capital £000	Share premium account £000	Merger reserve £000	Retained earnings £000	Minority interest £000	Total equity £000
Equity as at 11 October 2006		—	—	—	—	—	—
Acquisition of subsidiaries	3	27	—	12,782	—	274	13,083
Proceeds from shares issued		120	30,532	—	—	—	30,652
Share-based payments	7	—	—	—	1,252	—	1,252
Loss for the period		—	—	—	(1,632)	(101)	(1,733)
Equity as at 31 December 2007		**147**	**30,532**	**12,782**	**(380)**	**173**	**43,254**
Company							
Equity as at 11 October 2006		—	—	—	—	—	—
Acquisition of subsidiaries	3	27	—	12,782	—	—	12,809
Proceeds from shares issued		120	30,532	—	—	—	30,652
Share-based payments	7	—	—	—	1,252	—	1,252
Loss for the period		—	—	—	(1,239)	—	(1,239)
Equity as at 31 December 2007		**147**	**30,532**	**12,782**	**13**	**—**	**43,474**

The merger reserve resulted from the acquisition of Surrey Aquatechnology Limited and represents the fair value of equity-based consideration.

Group and company
balance sheets
as at 31 December 2007

	Note	Group £000	Company £000
Assets			
Non-current assets			
Property, plant and equipment	11	409	103
Intangible assets	12	13,772	—
Investments	13	257	14,026
		14,438	14,129
Current assets			
Trade and other receivables	14	688	1,179
Cash and cash equivalents	15	29,059	28,497
		29,747	29,676
Total assets		44,185	43,805
Equity and liabilities			
Equity			
Called up share capital	19	147	147
Share premium account		30,532	30,532
Merger reserve		12,782	12,782
Retained earnings		(380)	13
		43,081	43,474
Minority interest		173	—
Total equity		43,254	43,474
Liabilities			
Non-current liabilities			
Deferred tax liability	9	427	—
Current liabilities			
Trade and other payables	16	472	316
Borrowings	17	32	15
		504	331
Total liabilities		931	331
Total equity and liabilities		44,185	43,805

The financial statements on pages 18 to 32 were approved by the board of directors on 29 February 2008 and signed on its behalf by:

Simon Humphrey
Director
29 February 2008

Group and company
cash flow statements
period ended 31 December 2007

	Note	Group £000	Company £000
Cash flows from operating activities			
Cash used in operations	20	(1,270)	(1,442)
Net cash flows used in operating activities		(1,270)	(1,442)
Cash flows from investing activities			
Purchase of property, plant, equipment		(433)	(103)
Purchase of patents and development costs		(163)	—
Acquisition of subsidiaries, net of cash acquired	3	(110)	(960)
Acquisition of associates	13	(167)	(167)
Acquisition of other investments	13	(90)	(90)
Net cash flows used in investing activities		(963)	(1,320)
Cash flows from financing activities			
Proceeds from issue of shares		32,253	32,253
Transaction costs of issuing shares		(1,601)	(1,601)
Proceeds from borrowings		15	15
Repayment of borrowings		(8)	—
Interest received		633	592
Net cash flows from financing activities		31,292	31,259
Net increase in cash and cash equivalents		29,059	28,497
Cash and cash equivalents at 11 October 2006		—	—
Cash and cash equivalents at 31 December 2007	15	29,059	28,497

Notes
to the consolidated financial statements

1. Authorisation of financial statements and statement of compliance with IFRS

The consolidated and company financial statements of Modern Water plc (the "company") and its subsidiaries (together the "group") for the period ended 31 December 2007 were authorised for issue by the board of directors on 29 February 2008 and the balance sheet was signed by the Chief Executive Officer (Simon Humphrey). Modern Water plc is a public limited company incorporated and domiciled in England and Wales, whose shares are publicly traded on the Alternative Investment Market of the London Stock Exchange. The registered office and principal place of business is Bramley House, The Guildway, Old Portsmouth Road, Guildford GU3 1LR.

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 1985.

The principal accounting policies adopted by the group and company are set out below.

2. Summary of significant accounting policies

The principal accounting policies have been applied consistently throughout the period in the preparation of these financial statements.

(a) Basis of preparation

The financial statements of Modern Water plc have been prepared in accordance with EU Endorsed IFRS, IFRIC interpretations and the Companies Act 1985 applicable to companies reporting under IFRS. The financial statements have been prepared under the historical costs convention as modified by the revaluation of land and buildings, available for sale investments, financial assets and liabilities held for trading.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are:

- research and development cost acquired as part of a business combination (see section (f) and note 12); and
- share-based payments (see section (l) and note 7).

(b) Basis of consolidation

The consolidated financial statements incorporate the financial statements of the company and entities controlled by the company (its subsidiaries).

Subsidiaries

Subsidiaries are all entities over which the company has the power to govern the financial and operating policies generally accompanying a shareholding of more than half of the voting rights. The existence and effect of potential voting rights are considered when assessing whether the company controls an entity.

Subsidiaries are fully consolidated from the date on which control is established by the company.

Intercompany transactions, balances and unrealised gains on transactions between group companies are eliminated on consolidation. Subsidiaries' accounting policies are amended where necessary to ensure consistency with the policies adopted by the group.

Associates

Associates are entities over which the company has significant influence, but does not control, generally accompanied by a shareholding of 20% to 50% of the voting rights.

The equity method of accounting is used to account for the acquisition of the company's associates. The cost of investment in associate undertakings is measured at fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange plus costs directly attributable to the transaction. The company's investment in associates includes goodwill identified on acquisition, net of any accumulated impairment losses.

The company's share of its associates' post-acquisition profits or losses is recognised in the income statement and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the company's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the company does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the company and its associates are eliminated to the extent of the company's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Accounting policies of associates are changed where necessary to ensure consistency with the policies adopted by the group.

2. Summary of significant accounting policies continued

Transactions with minority interests

The group applies a policy of treating transactions with minority interests as transactions with parties external to the group. Disposals to minority interests result in gains and losses for the group that are recorded in the income statement. Purchases from minority interests result in goodwill, being the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary.

(c) Business combinations

The purchase method of accounting is used to account for the acquisition of the company's subsidiaries. The cost of acquisition is measured at the aggregate of the fair value of the assets given, equity instruments issued, less liabilities incurred or assumed at the date of exchange plus costs directly attributable to the transaction. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination that meet the definition under IFRS 3 Business Combinations are initially measured at their fair values at acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the company's share of the identifiable net assets is recorded as goodwill.

(d) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the company's share of the net identifiable assets of the acquired subsidiary/associate at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in "intangible assets". Goodwill on acquisitions of associates is included in "investments in associates" and is tested for impairment as part of the overall balance. Separately recognised goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. In accordance with IAS 34 Interim Financial Reporting and IAS 36 Impairment, impairment losses recognised in an interim period on goodwill carried at cost are not reversed at a subsequent balance sheet date. Gains and losses on the disposal of an entity include the carrying amount of goodwill related to the entity sold.

Goodwill is allocated to cash generating units ("CGUs") for the purpose of impairment testing. The allocation is made to those CGUs or groups of CGUs that are expected to benefit from the business combination in which the goodwill arose.

(e) Property, plant and equipment

All property, plant and equipment is shown at cost less subsequent depreciation and impairment. Cost includes expenditure that is attributable to the acquisition of the items. Depreciation on assets is calculated using the straight-line method to allocate the cost of each asset to its residual value over its estimated useful economic life, as follows:

Leasehold improvements	–	remaining term of the lease
Plant and machinery	–	three to five years
Office equipment	–	three to five years
Furniture, fixtures and fittings	–	three to five years

The asset's residual values and useful economic lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Subsequent costs are capitalised only when it is probable that they will result in future economic benefits flowing to the company and when they can be measured reliably. All other repairs and maintenance expenditure is charged to the income statement in the period in which it is incurred.

(f) Intangible assets

Patents

Acquired patents are initially recognised at historical cost. They have a finite useful economic life and are subsequently carried at cost less accumulated amortisation. Amortisation is calculated using the straight-line method to allocate the cost of patents over their estimated useful economic lives of 20 years from application.

Research and development

Expenditure on research activities is recognised as an expense in the period in which it is incurred.

Any internally-generated development costs are recognised as an asset only if all of the following are met:

- an asset is created that can be identified;
- it is probable that the asset created will generate future economic benefits; and
- the development cost of the asset can be measured reliably.

Where no internally generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred. Internally generated intangible assets are amortised on a straight-line basis over three years.

Development costs identified as a result of a business combination are dealt with in line with IAS 38, brought on to the consolidated balance sheet at the date of acquisition and amortised on a straight-line basis over 20 years.

2. Summary of significant accounting policies continued

(g) Impairment of intangible assets and property, plant and equipment

Purchased goodwill has an indefinite useful economic life, is subject to amortisation and is tested annually for impairment as described in section (d).

Assets that are subject to amortisation are tested for impairment when events or a change in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the carrying amount exceeds its recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and the value in use. For the purposes of assessing impairments, assets are grouped at the lowest levels for which there are identifiable cash flows (CGUs).

(h) Provisions

Provisions are recognised when the group has a present obligation as a result of a past event, and it is probable that the group will be required to settle that obligation. Provisions are measured at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date, and are discounted to present value where the effect is material.

(i) Leases

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. Assets held under finance leases are included within property, plant and equipment. The asset is initially measured at fair value, or if lower, the present value of the minimum lease payments. A corresponding liability is recognised within obligations under finance leases. The assets are either depreciated using the same method as similar fixed assets, or the length of the lease, whichever is shorter. Leasing payments are treated as consisting of a capital element and finance costs, the capital element reducing the obligation to the lessor and the finance charge being written off to the income statement over the period of the lease. All other leases are classified as operating leases. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

(j) Financial instruments

Financial assets and liabilities are recognised on the group's balance sheet when the group becomes a party to the contractual provisions of the instrument.

Cash and cash equivalents

Cash at bank comprises cash available on demand. Short-term deposits with a maturity from inception of one year or less placed with financial institutions are classified as cash equivalents if they can be converted to cash at any time without significant penalties.

Trade payables and borrowings

Trade payables are not interest bearing and are initially measured at their fair value and subsequently measured at amortised cost. Borrowings are initially recognised at their fair value and subsequently measured at their amortised cost.

Equity instruments

Equity instruments are recorded at fair value, being the proceeds received, net of direct issue costs.

Financial liabilities and equity

Financial liabilities and equity instruments are recognised and classified according to the contractual arrangements entered into.

(k) Revenue recognition

All revenue in respect of licence income will be recognised over the period of the licence and is stated exclusive of value added tax. Revenue from contracts will be recognised in accordance with IAS 11 Construction Contracts.

(l) Employee benefits

Share-based payments

Share-based incentive arrangements are provided to management, certain employees and certain professional advisers. Share options are valued at the date of grant using an appropriate option pricing model and are charged to operating profit over the vesting period of the award. The annual charge is modified to take account of options granted to employees who leave the group during the performance or vesting period and forfeit their rights to the share options and in the case of non-market related performance conditions, where it becomes unlikely they will vest.

2. Summary of significant accounting policies continued

(m) Taxation

Taxation in the income statement represents the sum of the tax currently payable and deferred tax on items charged or credited to the income statement.

The tax currently payable is based on taxable profit for the period. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred tax is measured on a non-discounted basis at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised. Deferred tax is charged or credited to the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Deferred tax liabilities are recognised on taxable temporary differences arising on investments in subsidiaries and associates, except where the company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

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 profits will be available to allow all or part of the asset to be recovered.

(n) Government grants

Government grants including non-monetary grants at fair value shall not be recognised until there is reasonable assurance that the group will comply with the conditions attaching to them and that the grants will be received.

Government grants relating to tangible fixed assets are treated as deferred income and released to the income statement over the expected useful lives of the assets concerned. Other grants are credited to the income statement as the related expenditure is incurred.

(o) Foreign currencies

The functional and presentation currency of Modern Water plc is pounds sterling (£).

Transactions in foreign currencies are initially recorded in the functional currency by applying the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the income statement.

(p) Segmental analysis

There is only one geographical operating segment so disclosures concerning segmental analysis are not applicable.

(q) Standards not yet effective

The following accounting standards have been announced and will impact on future financial statements of the group, but are not yet effective and have not been adopted early:

- Revision to IFRS 3 Business Combinations – effective for periods commencing 1 July 2009 and will result in changes to the measurement of the fair value of payments made to acquire a business and goodwill arising. Transaction costs will be expensed.
- IFRS 7 Financial Instruments – effective for periods commencing 1 January 2007 and will result in changes to disclosure of financial instruments and associated risks.

3. Business combinations

Poseidon Water Limited

On 14 December 2006 the group acquired 51% of the share capital of Poseidon Water Limited for a cash consideration of £425,000. The acquired business contributed revenues of £nil and net losses of £193,000 to the group for the period from acquisition to 31 December 2007. If the acquisition had occurred on 11 October 2006, consolidated revenue and consolidated losses for the period would have been £nil and £197,000 respectively.

Surrey Aquatechnology Limited

On 30 November 2006 the group acquired 30% of the share capital of Surrey Aquatechnology Limited ("SAL") for a cash consideration of £535,000. On 12 June 2007 the group acquired the remaining 70% of the share capital of SAL in a share-for-share exchange with a fair value consideration of £12,809,000 (10,763,600 Modern Water plc shares). The acquired business contributed revenues of £nil and net losses of £239,000 to the group for the period from acquisition to 31 December 2007. If the acquisition had occurred on 11 October 2006, consolidated revenue and consolidated losses for the period would have been £nil and £471,000 respectively.

3. Business combinations continued

Cymtox Limited

On 14 December 2006 the group acquired 17% of the share capital of Cymtox Limited for a cash consideration of £75,000. On 14 December 2007 the group acquired a further 20% of the share capital for a cash consideration of £92,000. The acquired business contributed revenues of £nil and net costs of £nil to the group for the period from acquisition to 31 December 2007. If the acquisition had occurred on 11 October 2006, consolidated revenue and consolidated losses for the period would have been £nil and £24,000 respectively.

The fair value of the identified assets and liabilities of acquisitions made in the period as at the date of acquisition were:

	Subsidiaries						Associates	
	Poseidon Water Limited 51%		Surrey Aquatechnology Limited 30%		Surrey Aquatechnology Limited 70%		Cymtox Limited 37%	
	Book value £000	Fair value £000	Book value £000	Fair value £000	Book value £000	Fair value £000	Book value £000	Fair value £000
Property, plant and equipment	5	—	—	—	2	2	—	—
Patent costs	—	—	—	—	—	57	—	—
Intangibles	—	319	—	1,301	—	1,263	—	70
Trade and other receivables	—	—	—	—	25	25	—	—
Cash and short-term deposits	413	413	622	622	437	437	63	63
Trade and other payables	(59)	(59)	—	—	(39)	(39)	(61)	(61)
Loan	(25)	(25)	—	—	—	—	—	—
Deferred tax liability	—	(89)	—	(364)	—	(354)	—	(20)
	334	559	622	1,559	425	1,391	2	52
Minority interest	49%	(274)	70%	(1,091)	30%	(418)	63%	(33)
		285		468		974		19
Purchase consideration								
Cash		425		535		—		167
Equity		—		—		12,809		—
		425		535		12,809		167
Fair value acquired		(285)		(468)		(974)		(19)
Goodwill		140		67		11,835		148
Outflow of cash to acquire business net of cash acquired								
Cash consideration		425		535		—		167
Cash and cash equivalents in acquisition		(413)		—		(437)		—
Cash outflow/(inflow) on acquisition		12		535		(437)		167

3. Business combinations continued

The goodwill is attributable to the subsidiaries' potential in their markets.

The fair value of the consideration in the acquisition of 70% of Surrey Aquatechnology was 10,763,600 ordinary shares in Modern Water plc at the admission share price of £1.19.

On acquisition, Modern Water plc management assessed the nature of the businesses acquired during the period to identify any intangible assets not recognised in the management accounts of the acquired entities. Patents identified in the businesses met the criteria for recognition as intangible assets, as they are separable from each other and measurable by way of their fair value, being the amount for which an asset could be exchanged, between knowledgeable, willing parties in an arm's length transaction. Research and development has been valued on a replacement cost basis since no reliable market price on which to base a valuation is available for similar products. This valuation assumes a discount rate of 15%.

These separable and identifiable intangible assets and related deferred tax liabilities are as follows:

	Poseidon Water Limited £000	Surrey Aquatechnology Limited £000	Cymtox Limited £000
Intangible assets			
Research and development	319	1,301	70
Patent costs	—	57	—
Deferred tax liability	89	364	20

Modern Water management reviewed the carrying value of the acquiree's assets, liabilities and contingent liabilities, and this review identified patent costs within Surrey Aquatechnology Limited of £67,000 that had not been capitalised and fixed assets in Poseidon Water Limited with nil fair value.

4. Operating loss

This is stated after charging:

	Note	2007 £000
Employee benefits – share-based	6, 7	820
Other share-based payments	7	432
Total share-based payments	7	1,252
Wages and salaries		532
Amortisation of intangible assets		70
Depreciation		26
Minimum lease payments recognised as an operating lease expense		63
Auditors' remuneration	5	199

5. Auditors' remuneration

	2007 £000
Audit services fees payable to company's auditors for the audit of parent company and consolidated financial statements	59
Other services:	
The audit of the company's subsidiaries and associates pursuant to legislation	5
Corporate finance services	130
Tax services	5
Total	199

Corporate finance services have been charged to the share premium account as they relate to the auditors' role as reporting accountants for the IPO during the period.

6. Employee benefits expense

	Note	Period ended 31 December 2007 Group £000	Company £000
Staff costs for the period, including executive directors, amounted to:			
Wages and salaries		469	367
Social security costs		56	44
Other benefits		7	5
		532	416
Equity-settled share-based payments	7	820	820
		1,352	1,236

	Group Number	Company Number
Monthly average number of employees including executive directors:		
Administration	4	2

Key management remuneration is disclosed in the directors' remuneration report on pages 12 and 13.

7. Equity-settled share-based payment plans

Equity-settled share-based payment plans expense	Period ended 31 December 2007 Group £000	Company £000
Employee benefits:		
Option scheme	180	180
Incentive share scheme	640	640
Total employee benefits	820	820
Incentive share scheme – IP2IPO Limited	432	432
	1,252	1,252

The group operates two types of equity-settled share-based payment plans for selected employees and executive directors, an option scheme and a management share incentive scheme. The number of shares issued under the plans is limited to 10% of the issued ordinary share capital of the company.

Option scheme

Two tranches of options were granted during the period. The first tranche of options over 1,682,630 shares was granted on 6 June 2007 to selected executive directors (see directors' remuneration report). The second tranche of options over 600,000 shares was issued on 12 December 2007 to certain employees. These options may be exercised under normal circumstances if, over the three years following the date of grant, the company achieves total shareholder return of 30% or more. Option exercise prices were based on the market prices at the time of grant.

The following table illustrates the number and weighted average exercise prices ("WAEP") of, and movements in, the share options during the period.

	2007 Number of options	2007 WAEP
Outstanding at the beginning of the period	—	—
Granted during the period	2,282,630	113p
Outstanding at the end of the period	2,282,630	113p

The weighted average remaining contractual life for the share options outstanding at 31 December 2007 is nine years and seven months. The range of exercise prices for options outstanding at the end of the period was 97p to 119p.

The fair value of the equity-settled share options granted is estimated as at the date of grant using a Black-Scholes model, taking into account the terms and conditions upon which the options were granted.

7. Equity-settled share-based payment plans continued

Option scheme continued

The following table lists the inputs into the model used for the options granted in the period.

Grant date	6 June 2007	12 December 2007
Option price	119p	97p
Vesting period	2.5	3.0
Assumed volatility at date of grant *	36%	36%
Risk-free discount rate	5.76%	5.47%
Expected life of option	2.5 years	3.5 years
Fair value per option	32p	33p
Share price at grant	119p	97p

* Assumed volatility was determined from historical share return volatility of the company and that of a comparable company in the same sector.

Management share incentive scheme

Between 1 December 2006 and 12 March 2007, the executive directors were invited to subscribe for 5,042,400 ordinary shares at their nominal value at the date of invitation – see directors' remuneration report on pages 12 and 13.

IP2IPO Limited was also invited to subscribe for 2,874,800 shares at their nominal value at the date of invitation in exchange for management and consulting services. Restrictions on these shares fell away on 2 November 2007.

The fair value of the incentive share scheme shares totalled £1,188,000 when measured against other share purchases at that time.

8. Finance income

	2007 £000
Bank interest receivable	1,021
Loan interest payable	(1)
	1,020

9. Tax

(a) Tax on loss on ordinary activities

	2007 £000
Deferred tax:	
Origination and reversal of timing differences – current period	16

(b) Reconciliation of the total tax charge

	2007 £000
Loss from operations before taxation	1,749
Accounting loss multiplied by the UK standard rate of corporation tax of 30%	525
Expenses not deductible for tax purposes	(414)
Losses not utilised	(111)
Deferred tax	16
Total tax credit reported in the income statement	16

(c) Deferred tax liability

Intangible assets in business combinations	£000
At 11 October 2006	—
Credited to the income statement	(16)
Acquisition of subsidiaries	443
At 31 December 2007	427

Deferred tax liabilities arose in respect of the intangible assets recognised (note 3) on the acquisitions made during the period. Deferred tax assets of £111,000 on losses have not been recognised.

10. Earnings per share

Basic earnings per share is calculated by dividing the loss of £1,632,000 attributable to the equity holders of the company by the weighted average number of shares (35,502,459) in issue during the period. The diluted loss per share is calculated by dividing the loss attributable to the equity holders by the aggregate of the weighted average number of shares in issue and the weighted average number of options in issue (786,303) during the period.

11. Property, plant and equipment

Group	Leasehold improvements £000	Plant and machinery £000	Office equipment £000	Furniture, fixtures and fittings £000	Total £000
Cost					
At 11 October 2006	—	—	—	—	—
Additions	112	120	99	102	433
Acquisition of subsidiaries (note 3)	—	—	2	—	2
At 31 December 2007	**112**	**120**	**101**	**102**	**435**
Accumulated depreciation					
At 11 October 2006	—	—	—	—	—
Charge for the period	7	2	12	5	26
At 31 December 2007	**7**	**2**	**12**	**5**	**26**
Net book amount					
At 31 December 2007	**105**	**118**	**89**	**97**	**409**
Company					
Cost					
At 11 October 2006	—	—	—	—	—
Additions	—	103	—	—	103
At 31 December 2007	—	103	—	—	103

There are no assets held under finance leases or hire purchase contracts at either 31 December 2007 or 11 October 2006.

The net book amount of property, plant and equipment is not materially different from its fair value.

12. Intangible assets

Group	Goodwill £000	Patent costs £000	Development costs £000	Research and development acquired as part of a business combination £000	**Total £000**
Cost					
At 11 October 2006	—	—	—	—	—
Additions	—	116	57	—	173
Acquisition of subsidiaries	12,042	57	—	1,620	13,719
At 31 December 2007	**12,042**	**173**	**57**	**1,620**	**13,892**
Accumulated amortisation and impairment					
At 11 October 2006	—	—	—	—	—
Acquisition of subsidiaries	—	9	—	38	47
Amortisation	—	13	3	57	73
At 31 December 2007	**—**	**22**	**3**	**95**	**120**
Net book amount At 31 December 2007	**12,042**	**151**	**54**	**1,525**	**13,772**

The acquisitions of Surrey Aquatechnology Limited and Poseidon Water Limited gave rise to the recognition of goodwill and intangible assets (see note 3).

The additions to patent costs arise from legal and other fees incurred in securing patents. The additions to development costs arise from costs incurred once there was sufficient certainty over the technical feasibility and commercial viability over the underlying desalination technology.

Goodwill is reviewed for impairment annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired. There was no goodwill impairment recorded in the period.

13. Investments

	Investment in associate £000	Other investments £000	Group £000	Investments in subsidiaries £000	Company £000
At 11 October 2006	—	—	—	—	—
Additions	167	90	257	13,769	14,026
At 31 December 2007	167	90	257	13,769	14,026

Subsidiary and associate undertakings, which contribute to the group result. All are incorporated in Great Britain.	% shareholding	Status
Modern Water Services Limited	100	Subsidiary
Surrey Aquatechnology Limited	100	Subsidiary
Poseidon Water Limited	51	Subsidiary
Cymtox Limited	37	Associate

Investment in associate
On 14 December 2006 the group acquired 17% of the share capital of Cymtox Limited for a cash consideration of £75,000. On 14 December 2007 the group acquired a further 20%, for a cash consideration of £92,000, taking its total shareholding to 37%.

The investment in Cymtox Limited includes £148,000 of goodwill. During the period Cymtox Limited recorded a loss of £62,000 (group share: nil). At 31 December 2007 Cymtox Limited had assets of £63,000 (group share: £23,000) and liabilities of £61,000 (group share: £23,000).

Investments in subsidiaries
On 14 December 2006 the group acquired 51% of the share capital of Poseidon Water Limited for a cash consideration of £425,000.

On 30 November 2006 the group acquired 30% of the share capital of Surrey Aquatechnology Limited ("SAL") for a cash consideration of £535,000. Whilst SAL was an associate, the group's share of its losses was £50,000. On 12 June 2007 the group acquired the remaining 70% of the share capital in a share for share exchange with a nominal value consideration of £27,000 (10,763,600 Modern Water plc shares).

Other investments
Other investments comprise a shareholding in Stonybrook Purification Inc., a company incorporated in the USA.

14. Trade and other receivables

	2007 Group £000	2007 Company £000
VAT and social security	97	84
Other receivables	430	417
Amounts due from subsidiary undertakings	—	608
Amounts due from associate undertakings	65	16
Prepayments	96	54
	688	1,179

Other receivables include interest due on term deposits. The amounts due from subsidiary and associate undertakings are unsecured and bear no interest.

15. Cash and cash equivalents

	2007 Group £000	2007 Company £000
Cash at bank	2,910	2,348
Short-term deposits	26,149	26,149
Cash at bank and in hand	29,059	28,497

16. Trade and other payables

Current	2007 Group £000	2007 Company £000
Trade payables	157	158
VAT and social security	33	33
Accruals	282	125
	472	316

17. Borrowings

Current	2007 Group £000	2007 Company £000
Loans	32	15
	32	15

Loans are with Finance Wales plc and The Royal Bank of Scotland. They are unsecured and repayable within one year. Whilst repayments are on time, no interest is payable.

18. Commitments and contingencies

(a) Group operating leases

Future minimum lease payments under non-cancellable operating leases as at 31 December 2007 are as follows:	2007 Group £000	2007 Company £000
Not later than one year	60	—
After one year but not more than five years	696	—
After five years	—	—
	756	—

The group's operating leases relate to property and office equipment, and have remaining terms of between two and four years. The amount recognised as an expense in the period is £63,000.

(b) Capital commitments

The company had contracted but not provided capital commitments as at 31 December 2007 of £392,000.

(c) Contingent liabilities

The group had no unprovided contingent liabilities at the balance sheet date.

19. Called up share capital

Ordinary shares of 0.25p each		2007 Number	2007 £000
Authorised		100,000,000	250
Allotted, called up and fully paid share capital			
Initial funding	(a)	74,859	—
Management share incentive scheme	(a)	39,586	—
Bonus issue	(b)	57,108,055	57
Share consolidation (2:5)	(b)	(34,333,500)	—
Issued on acquisition of subsidiary	(c)	10,763,600	27
Shares issued on IPO	(d)	25,210,085	63
		58,862,685	147

(a) Between 1 December 2006 and 14 March 2007 74,859 ordinary shares with aggregate nominal value of £75 were issued at £30 per share and 39,586 ordinary shares with an aggregate nominal value of £40 were issued at 0.1 pence per share.

(b) On 1 June 2007 there was a 500:1 bonus issue. On 6 June 2007 there was a one-for-ten consolidation followed by a four-for-one subdivision. The net result of the bonus issue, consolidation and subdivision was the creation of 22,774,555 ordinary shares with an aggregate nominal value of £57,223.

(c) On 12 June 2007 10,763,600 shares with an aggregate nominal value of £26,909 were issued to acquire 70% of the ordinary share capital of Surrey Aquatechnology Limited (note 3).

(d) On 12 June 2007 25,210,085 ordinary shares with a nominal value of £63,025 were issued and placed for £30,000,000.

20. Net cash flows from operating activities

	Period ended 31 December 2007 Group £000	Company £000
Operating loss	(2,719)	(2,237)
Adjustments for:		
Depreciation of property, plant and equipment	26	—
Amortisation of intangible assets	73	—
Equity-settled share-based payments	1,252	1,252
Movements in working capital:		
Increase in trade and other receivables	(177)	(689)
Increase in trade and other payables	275	232
Cash used in operations	(1,270)	(1,442)

Non cash flow items

The purchase consideration for the acquisition of Surrey Aquatechnology Limited comprised ordinary Modern Water shares with a fair value of £12,809,000.

21. Related party transactions

A service agreement dated 1 December 2006 made between the company and IP2IPO Limited ("IP2IPO") whereby IP2IPO provides strategic, business development and administrative services to the company for a consideration of £60,000 per annum. At 31 December 2007 fees of £8,000 were outstanding under this agreement. IP2IPO is a subsidiary of IP Group plc, a significant shareholder of the company.

A consultancy agreement dated 1 December 2006 between the company, WRc plc and Gerald Jones pursuant to which WRc plc agreed to provide the services of Gerald Jones for a maximum of 133 days per calendar year, at a rate of £435 per day. At 31 December 2007 fees of £15,000 were outstanding under this agreement.

An agreement dated 14 December 2006 between the company and Poseidon Water Limited for the provision of administrative services for fees of £50,760 per annum. At 31 December 2007 fees of £53,000 were outstanding under this agreement.

An agreement dated 14 December 2006 between the company and Cymtox Limited for the provision of administrative services for fees of £14,463 per annum. At 31 December 2007 fees of £16,000 were outstanding under this agreement.

An agreement dated 14 December 2006 between the company and Surrey Aquatechnology Limited for the provision of administrative services for fees of £6,000 per annum. At 31 December 2007 fees of £3,500 were outstanding under this agreement.

On 12 June 2007 the company acquired 70% of the shares of Surrey Aquatechnology Limited (note 3). 21% of these shares were acquired from Neil McDougall.

On 14 December 2007 the company acquired 20% of the shares of Cymtox Limited from Cynnovation Limited, a company in which Gerald Jones is a shareholder.

There is a loan agreement between the company and Cymtox Limited dated 20 December 2007. The balance at 31 December 2007 was £13,000.

The company had balances at 31 December 2007 with its subsidiary companies to fund working capital as follows:

- Surrey Aquatechnology Limited – £46,000;
- Poseidon Water Limited – £5,000; and
- Modern Water Services Limited – £486,000.

Notice of
Annual General Meeting

Notice is hereby given that the Annual General Meeting of Modern Water plc (the "company") will be held at the offices of the company, Bramley House, The Guildway, Old Portsmouth Road, Guildford GU3 1LR on 28 April 2008 at 10.00am for the purposes of considering and, if thought fit, passing the following resolutions of which resolutions 1 to 6 (inclusive) will be proposed as ordinary resolutions and resolutions 7 and 8 will be proposed as special resolutions.

1. To receive and adopt the directors' report, the audited statement of accounts and auditors' report of the company for the financial year ended 31 December 2007.
2. To receive and approve the directors' remuneration report for the year ended 31 December 2007 in accordance with section 241A of the Companies Act 1985 (the "act").
3. To reappoint PricewaterhouseCoopers LLP as auditors of the company to hold office from the conclusion of this meeting until the conclusion of the next general meeting of the company at which accounts are laid before the shareholders in accordance with the provisions of the act and to authorise the directors of the company to fix their remuneration.
4. To re-elect Simon Humphrey as a director of the company, who is retiring by rotation and offering himself for re-election in accordance with the company's Articles of Association.
5. To re-elect Gerald Jones as a director of the company, who is retiring by rotation and offering himself for re-election in accordance with the company's Articles of Association.
6. That the directors be and they are hereby generally and unconditionally authorised in accordance with the act to exercise all powers of the company to allot relevant securities within the meaning of section 80 of the act up to the aggregate nominal amount of £14,715.70, provided that the authority hereby conferred shall operate in substitution for and to the exclusion of any previous authority given to the directors pursuant to section 80 of the act and shall expire on whichever is the earlier of the conclusion of the next Annual General Meeting of the company to be held in 2009 and 28 July 2009 unless such authority is renewed, varied, or revoked by the company in general meeting save that the company may at any time before such expiry make an offer or agreement which might require relevant securities to be allotted after such expiry and the directors may allot relevant securities in pursuance of such offer or agreement as if the authority hereby conferred had not expired.
7. That the directors be and they are hereby empowered pursuant to section 95 of the act to allot equity securities (as defined in section 94 of the act) for cash as if section 89(1) of the act did not apply to any such allotment pursuant to the general authority conferred on them by resolution 6 above provided that such power shall be limited to:

   (a) the allotment of equity securities in connection with a rights issue or any other pre-emptive offer in favour of holders of equity securities where the equity securities respectively attributable to the interests of all such holders are proportionate (as nearly as may be) to the respective amounts of equity securities held by them subject only to such exclusions or other arrangements as the directors may deem necessary or expedient or consider appropriate to deal with fractional entitlements or legal or practical difficulties under the laws of or the requirements of any recognised regulatory body or stock exchange in any territory or otherwise; and

   (b) the allotment (otherwise than pursuant to sub-paragraphs 7(a) above) of equity securities up to an aggregate nominal amount of £7,357.90 representing 5% of the nominal value of the issued share capital of the company as at 29 February 2008

   and the power hereby conferred shall operate in substitution for and to the exclusion of any previous power given to the directors pursuant to section 95 of the act and shall expire on whichever is the earlier of the conclusion of the next Annual General Meeting of the company to be held in 2009 and 28 July 2009 unless such power is renewed or extended prior to or at such meeting except that the company may before the expiry of any power contained in this resolution make an offer or agreement which would or might require equity securities to be allotted after such expiry and the directors may allot equity securities in pursuance of such offer or agreement as if the power conferred hereby had not expired.
8. That the Articles of Association produced to the meeting and initialled by the chairman of the meeting for the purpose of identification be adopted as the Articles of Association of the company in substitution for, and to the exclusion of, the existing Articles of Association.

By order of the board

Angela Leach
Company Secretary
29 February 2008
Registered in England and Wales Number 5963927

Registered office
Bramley House
The Guildway
Old Portsmouth Road
Guildford GU3 1LR

Notes

1. Members are entitled to appoint a proxy to exercise all or any of their rights to attend and to speak and vote on their behalf at the meeting. A shareholder may appoint more than one proxy in relation to the Annual General Meeting provided that each proxy is appointed to exercise the rights attached to a different share or shares held by that shareholder. A proxy need not be a shareholder of the company. A proxy form which may be used to make such appointment and give proxy instructions accompanies this notice. If you do not have a proxy form and believe that you should have one, or if you require additional forms, please contact the company's registrars Capita Registrars on 020 8639 2477.
2. In order to facilitate voting by corporate representatives at the meeting, arrangements will be put in place at the meeting so that (i) if a corporate shareholder has appointed the chairman of the meeting as its corporate representative with instructions to vote on a poll in accordance with the directions of all of the other corporate representatives for that shareholder at the meeting, then on a poll those corporate representatives will give voting directions to the chairman and the chairman will vote (or withhold a vote) as corporate representative in accordance with those directions; and (ii) if more than one corporate representative for the same corporate shareholder attends the meeting but the corporate shareholder has not appointed the chairman of the meeting as its corporate representative, a designated corporate representative will be nominated, from those corporate representatives who attend, who will vote on a poll and the other corporate representatives will give voting directions to that designated corporate representative. Corporate shareholders are referred to the guidance issued by the Institute of Chartered Secretaries and Administrators on proxies and corporate representatives – www.icsa.org.uk – for further details of this procedure. The guidance includes a sample form of representation letter if the chairman is being appointed as described in (i) above.
3. To be valid any proxy from or other instrument appointment a proxy must be received by post or (during normal business hours only) by hand no later than 48 hours before the time appointed for holding the Annual General Meeting.
4. The return of a completed proxy form, other such instrument or any CREST Proxy Instruction (as described in paragraph 9 below) will not prevent a shareholder attending the Annual General Meeting and voting in person if he/she wishes to do so.
5. Any person to whom this notice is sent who is a person nominated under section 146 of the Companies Act 2006 to enjoy information rights (a "nominated person") may, under an agreement between him/her and the shareholder by whom he/she was nominated, have a right to be appointed (or to have someone else appointed) as a proxy for the Annual General Meeting. If a nominated person has no such proxy appointment right or does not wish to exercise it, he/she may, under any such agreement, have a right to give instructions to the shareholder as to the exercise of voting rights.
6. The statement of the rights of shareholders in relation to the appointment of proxies in paragraphs 1 and 2 above does not apply to nominated persons. The rights described in these paragraphs can only be exercised by shareholders of the company.
7. To be entitled to attend and vote at the Annual General Meeting (and for the purpose of the determination by the company of the votes they may cast), shareholders must be registered in the register of members of the company at 6.00pm on 26 April 2008 (or, if the meeting is adjourned, such time being not more than 48 hours prior to the time fixed for the adjourned meeting). Changes to the register of members after the relevant deadline shall be disregarded in determining the rights of any person to attend and vote at the meeting.
8. CREST members who wish to appoint a proxy or proxies through the CREST electronic proxy appointment service may do so by using the procedures described in the CREST Manual. CREST Personal Members or other CREST sponsored members, and those CREST members who have appointed a service provider(s), should refer to their CREST sponsor or voting service provider(s), who will be able to take the appropriate action on their behalf.
9. In order for a proxy appointment or instruction made using the CREST service to be valid, the appropriate CREST message (a "CREST Proxy Instruction") must be properly authenticated in accordance with CRESTCo's specifications, and must contain the information required for such instruction, as described in the CREST Manual. The message, regardless of whether it constitutes the appointment of a proxy or is an amendment to the instruction given to a previously appointed proxy must, in order to be valid, be transmitted so as to be received by the issuer's agent. For this purpose, the time of receipt will be taken to be the time (as determined by the timestamp applied to the message by the CREST Application Host) from which the issuer's agent is able to retrieve the message by enquiry to CREST in the manner prescribed by CREST. After this time any change of instructions to proxies appointed through CREST should be communicated to the appointee through other means.
10. CREST members and, where applicable, their CREST sponsors, or voting service providers should note that CRESTCo does not make available special procedures in CREST for any particular message. Normal system timings and limitations will, therefore, apply in relation to the input of CREST Proxy Instructions. It is the responsibility of the CREST member concerned to take (or, if the CREST member is a CREST personal member, or sponsored member, or has appointed a voting service provider, to procure that his CREST sponsor or voting service provider(s) take(s)) such action as shall be necessary to ensure that a message is transmitted by means of the CREST system by any particular time. In this connection, CREST members and, where applicable, their CREST sponsors or voting system providers are referred, in particular, to those sections of the CREST Manual concerning practical limitations of the CREST system and timings.
11. The company may treat as invalid a CREST Proxy Instruction in the circumstances set out in regulation 35(5)(a) of the Uncertificated Securities Regulations 2001.
12. As at 10.00am on 28 February 2008 (being the last business day prior to the publication of this Notice) the company's issued share capital consisted of 58,862,685 ordinary shares, carrying one vote each. Therefore, the total voting rights in the company as at 10.00am on 28 February 2008 were 58,862,685.

Form of proxy
Modern Water plc

Company Number: 5963927

Please read carefully the notice of meeting and explanatory notes set out below before completing this form

Please complete this form in BLOCK CAPITALS

I/We ....

of (address)...

being a member(s) of the above named company hereby appoint the chairman of the meeting or (see notes 1, 5 and 7).

....

of (address)...

as my/our proxy to vote for me/us and on my/our behalf at the Annual General Meeting of the company to be held at the offices of the company, Bramley House, The Guildway, Old Portsmouth Road, Guildford GU3 1LR at 10.00am on 28 April 2008 and at any adjournment thereof.

I/we direct my/our proxy to vote as indicated by an "X" in the appropriate column (note 2).

Ordinary resolutions	For	Against	Withheld
1. To receive and adopt the directors' report, the audited statement of accounts and auditors' report of the company for the financial year ended 31 December 2007			
2. To receive and approve the directors' remuneration report for the year ended 31 December 2007			
3. To reappoint PricewaterhouseCoopers LLP as auditors of the company and to authorise the directors of the company to fix their remuneration			
4. To re-elect Simon Humphrey as a director of the company, who is retiring by rotation and offering himself for re-election			
5. To re-elect Gerald Jones as a director of the company, who is retiring by rotation and offering himself for re-election			
6. Directors' authority to exercise all powers of the company to allot relevant securities within the meaning of section 80 of the Companies Act 1985 (the "act") up to the aggregate nominal amount of £14,715.70			
Special resolutions	**For**	**Against**	**Withheld**
7. Directors' authority pursuant to section 95 of the act to allot equity securities (as defined in section 94 of the act) for cash disapplying the statutory pre-emption rights			
8. To adopt new Articles of Association			

Signature(s) and/or common seal (notes 3 and 4).

....

....

....

Date 2008

Notes

1. A proxy need not be a member of the company. Completion and return of this form of proxy does not preclude a member from subsequently attending and voting at the Meeting. If you wish to appoint a proxy other than the chairman of the meeting, please cross out the words "the chairman of the meeting or" and write the full name and address of your proxy in the space provided. The change should be initialled.
2. If you do not indicate how you wish your proxy to vote on any resolution or on any other matter (including any amendment to any resolution), the proxy will exercise his/her discretion as to how he/she votes and as to whether or not he/she abstains from voting in such manner as he/she thinks fit.
3. This form must be signed and dated by the shareholder or his/her attorney duly authorised in writing. In the case of a corporation this form of proxy must be executed under its common seal or under the hand of an officer or attorney duly authorised in writing.
4. A form of proxy, to be valid, must be signed and dated and must be lodged, together with the power of attorney or other authority (if any) under which it is signed, or a duly certified copy of such power or authority, with the company's registrars, Capita Registrars at the following address, Capita Registrars (Proxies), PO Box 25, Beckenham, Kent BR3 4BR not less than 48 hours before the time appointed for holding the meeting.
5. In the case of joint holders, the signature of any one of them will suffice but the names of all joint holders should be stated. The vote of the senior who tenders a vote (whether in person or by proxy) will be accepted to the exclusion of the votes of the other holders. For this purpose, seniority is determined by the order in which the names stand in the register of members in respect of the joint holding.
6. Any alteration to this form must be initialled.
7. Pursuant to Regulation 41 of the Uncertificated Securities Regulations 2001, the time by which a person must be entered on the register of members in order to have the right to attend and vote at the Annual General Meeting is 6.00pm on 26 April 2008 or, if the meeting is adjourned, such time being not more than 48 hours prior to the time fixed for the adjourned meeting. Changes to entries on the register of members after that time will be disregarded in determining the right of any person to attend or vote at the meeting.

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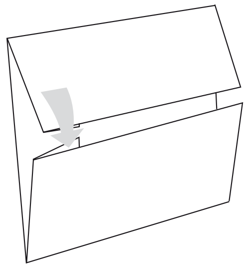

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Beckenham
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CarbonNeutral® company

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