

Registered number: 5819262 (England & Wales)

Kemble Water Holdings Limited
Annual report and financial statements
For the year ended 31 March 2011



Kemble Water Holdings Limited

Annual report and financial statements for the year ended 31 March

Contents

| | Pages |
|--|--------------|
| Directors and advisors | 1 |
| Chairman's introduction | 2 |
| Directors' report | 3 |
| Statement of directors' responsibilities | 26 |
| Independent auditor's report | 27 |
| Consolidated profit and loss account | 29 |
| Balance sheets | 30 |
| Consolidated cash flow statement | 31 |
| Statement of Group total recognised gains and losses | 32 |
| Reconciliation of movements in Group shareholders' funds | 32 |
| Notes to the financial statements | 33 |

Kemble Water Holdings Limited

Directors and advisors at 31 March 2011

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Kemble Water Holdings Limited

Chairman's Introduction

This has been another very successful year for Thames Water. The Group's operational performance has been excellent and the Group has again invested over £1bn to renew ageing assets and continue to improve our services to a growing number of customers. This level of investment will continue for at least the next 3 years.

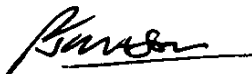
In this period, good progress has been made on the major projects at the five main sewage treatment works discharging to the tidal River Thames. These, along with the Lee Tunnel, which will intercept the largest sewage overflow in London, will provide a long term improvement to the water quality of London's major rivers. Looking further ahead, the Group has successfully completed the first phase of its public consultation on the much longer and more complex Thames Tunnel, which is being designed to intercept a further 34 unsatisfactory sewage overflows. While continuing with the design and consultation processes, the Group is giving high priority to working with the Government and Water Services Regulation Authority ("Ofwat") on establishing appropriate delivery and funding mechanisms for this immense project.

I am particularly pleased to report that the Group has achieved its leakage target for the fifth successive year, despite one of the coldest starts to a winter on record. This is significant because leakage from cast iron pipes, which are widespread in London, increases dramatically as temperatures fall. The management team has considerably increased the resources devoted to detecting and fixing leaks as early as October and made further increases as temperatures fell and remained low. The Group is proud to have once again provided its customers with the highest quality drinking water from any major supplier, pleased that customer complaints fell by 6.7% during the year, and encouraged by a further year during which all of its 349 sewage treatment works have maintained 100% compliance with environmental standards.

The Group's financial performance has, in all the circumstances, been satisfactory. Despite cost pressures from inflation at almost 5%, efficiencies have limited the rise in operating costs to 3.4%. Turnover has been almost the same as 2009/10, with real increases in prices largely balanced out by reduced demand for water from metered customers choosing to use less water. Static turnover, increased operating expenditure and lower profits from the sale of fixed assets have led to a fall in operating profit of 17.3% to just over £0.5 billion.

The Group's draft Water Resources Management Plan met with mixed reviews in the year. It was encouraging that the plans for the next 15 years received broad endorsement but disappointing that the longer term aspects were not approved at this stage. There is more work to do in considering a wider range of potential long term supply and demand options. This will be concluded in time for the next plan.

The Group continues to be fully and positively engaged in the many consultations currently taking place with regard to the future structure and regulation of the industry. There is considerable opportunity through this work to improve efficiency and quality of services to customers. Throughout these discussions, it is encouraging to note the understanding of all stakeholders that for a Group like Thames Water, with an annual investment programme of over £1bn, the raising of finance at an attractive cost is a significant challenge but a key deliverable. Maintaining investors' confidence can only be achieved through efficient delivery of the capital programme underpinned by a stable and transparent regulatory environment.



Sir Peter Mason KBE

Chairman

9 June 2011

Kemble Water Holdings Limited

Directors' Report

Introduction

Unless otherwise stated, all current year data included in this review is for the year ended 31 March 2011 ("2011")

Kemble Water Holdings Limited (the "Company") and its subsidiaries form the Kemble Water Holdings group of companies (the "Group"). The Group is also referred to as the Thames Water Group or Thames Water

Nature of business

The principal activity in the Group is the regulated business in its wholly owned subsidiary, Thames Water Utilities Limited ("TWUL")

Background

TWUL is the largest supplier of water and provider of sewerage services in the UK based on the number of customers served. It is one of 10 companies currently holding appointments as water and sewerage undertakers¹ in England and Wales, with a further 11 companies holding appointments as water only undertakers

In total, the area served by TWUL occupies approximately 13,331 km² and encompasses more than 9% of the area of England and Wales. This includes London and extends as far as Cirencester in the west, Dartford in the east, Banbury in the north and Haslemere in the south. This area has a population of about 13.6m people, which represents nearly a quarter of the total population of England and Wales. In approximate terms TWUL supplies 3.6m properties (just over 8.7m people) with water, and collects sewage from 5.1m properties (about 13.8m people), including 97% of households in its sewerage region

¹ A company that has been appointed to provide water and/or sewerage services to customers in England and Wales is known as an "undertaker". The Company's Instrument of Appointment - usually referred to as "the Licence" - was issued by the Secretary of State for the Environment in August 1989

Kemble Water Holdings Limited

Directors' Report (continued)

Highlights

This was the first year of the new AMP, which has been financially challenging for the Group. However, the Group has achieved its regulatory outputs, and outperformed the Final determination ("FD") by almost £13m.

Other achievements include

- Delivering over £1bn of investment in the year
- Customer complaints fell by 6.7% (2010: 14.0%)
- Staging the water industry's first Health and Safety Excellence Awards for the main contractors carrying out the work on the Group's 2010-15 investment programme
- Meeting the Group's water-efficiency target. Ofwat set a goal of saving 4 million litres a day ("Mld") by encouraging water-wise behaviour by customers. The Group saved 5Mld.
- Opening mainland UK's first desalination plant at Beckton in East London so that, 1m people when need can be supplied with high-quality tap water taken from brackish water in the tidal River Thames
- Meeting the Group's annual leakage target despite the coldest start to a winter in 100 years, and maintaining 100% security of water supply to all its customers
- Maintaining the Group's drinking water quality performance at the high level of 99.97% compliance
- Agreeing terms to build Europe's first reactor to make premium-grade phosphate fertiliser, derived from struvite deposits on pipes at Slough sewage works
- Reducing emissions by 11% on 1990 levels, despite serving 3m more customers today than 20 years ago, and becoming the first UK utility to be re-accredited with the Carbon Trust Standard
- Continuing focus on meeting customers needs including further reduction of 182 properties at risk of sewer flooding
- Continued investment in the London Tideway Improvements programme to clean up the River Thames. £675m of upgrades to London's 5 main sewage works and the £635m Lee Tunnel, to stop sewage overflows to the River Lee, a tributary of the Thames
- Running a 6 week unbilled customer amnesty to encourage people who use water but do not receive a bill to come forward. This amnesty resulted in more than 1,300 new accounts being set up, making it fairer on paying customers.

Kemble Water Holdings Limited

Directors' Report (continued)

Financial results

Financial Key Performance Indicators (KPIs)

| Performance Measure | Year to 31 March 2011 £m | Year to 31 March 2010 £m | % Movement |
|--|---------------------------------------|---------------------------------------|------------|
| Turnover | 1,641.9 | 1,659.5 | (1.1%) |
| Operating expenditure ² | 647.9 | 602.3 | 7.6% |
| Operating profit ³ | 535.4 | 647.5 | (17.3%) |
| Total capital expenditure (see note 12) ⁴ | 1,035.0 | 782.5 | 32.3% |

Turnover

Turnover reduced by £17.6m, down 1.1% to £1,641.9m. Whilst this reflects real increases in price ('K'), as agreed with Ofwat, together with increases linked to the Retail Price Index ("RPI") turnover was reduced largely as a result of lower metered consumption reflecting the Group's customers wise use of water and lower property sales.

Operating expenditure

Whilst the Group has continued its emphasis on driving operating efficiencies and ensuring the delivery of its regulatory outputs, operating costs have increased by 7.6% to £647.9m (2010: £602.3m). This year on year increase is largely due to average RPI of nearly 5% together with increased bad debt provisioning resulting from the impact of the economic downturn, higher business rates and additional costs associated with the coldest start to winter for 100 years.

Operating profit

As a result of reduced turnover, increased operating expenditure and lower profit on the sale of surplus properties, operating profit has fallen by 17.3% to £535.4m (2010: £647.5m).

² Operating expenditure: Operating costs, excluding depreciation and the Infrastructure renewals charge ("IRC")

³ Operating profit: turnover less operating costs for the Company but including profit on sale of assets for the regulated business

⁴ Total capital expenditure: Total expenditure on tangible fixed assets excluding contributions received, see note 12 to the financial statements

Kemble Water Holdings Limited

Directors' Report (continued)

Financial results (continued)

Capital expenditure

2011 has been a successful year for capital delivery with the Group investing over £1bn and completing all of its capital regulatory outputs within the first year of the Asset Management Period 5 ('AMP5'). This is a great start to the new AMP and a solid platform to deliver the Group's required investment programme of nearly £5bn over the regulatory period.

Treasury policy

The Group's treasury operations are managed centrally by a small specialist team, which operates with the delegated authority of, and under policies approved by, the Board of Directors. The Treasury function does not act as a profit centre and does not undertake any speculative trading activity. The key objectives of the funding strategy are defined by the regulatory regime within which the Group operates and are intended to ensure that it meets all funding related requirements under the terms of TWUL's Licence. This includes maintaining cash reserves and access to undrawn committed bank facilities sufficient to fund at least 12 months net cash flow and to maintain an investment grade credit rating (see "Debt financing" section below) as set out in condition F of the Licence.

A key objective of treasury policy is to ensure compliance with financial covenants including interest cover and gearing ratios, maintain liquidity and a balanced debt maturity profile and ensure that at least 85% of the interest cost within the Securitisation Group, being Thames Water Utilities Holdings, TWUL and its wholly owned subsidiaries is based on either fixed or RPI-linked interest rates.

Financial risk management

The Group has an Executive team ("Executive"), which receives regular reports from all areas of the business to enable prompt identification of financial and other risks so that appropriate actions can be taken.

The operation of the Treasury function is governed by policies and procedures, which set out guidelines for the management of interest rate risk and foreign exchange risk and the use of financial instruments. Treasury policy and procedures are incorporated within the financial control procedures of the Group.

The Group's operations expose it to a variety of financial risks that include the effects of changes in debt market prices, price risk, liquidity risk, interest rate risk and exchange rate risk.

Derivative financial instruments, including cross currency swaps, interest rate swaps and forward currency contracts are employed to manage the interest rate and currency risk arising from the primary financial instruments used to finance the Group's activities. Matching of assets and liabilities in foreign currencies is also applied wherever practicable. The Group actively maintains a broad portfolio of debt, diversified by source and maturity and designed to ensure the Group has sufficient available funds for operations.

The Group is exposed to commodity price risk, especially energy price risk as a result of its operations. The Group aims to manage its risk by fixing contract prices where possible.

Financing

The Group had committed facilities in place with a syndicate of relationship banks to the value of £1,250m, all of which were undrawn at 31 March 2011. This includes a new £75m revolving credit facility at Kemble Water Finance which was agreed on 25 March 2011. In addition, due to pre-funding activity undertaken in the final quarter of the year, the Group had £802.5m of cash on short-term deposit. This cash balance together with undrawn facilities will provide the Group with the necessary liquidity to fund the operation of the business for at least the next fifteen months.

Kemble Water Holdings Limited

Directors' Report (continued)

Debt financing

Debt financing is held or raised by the Company or through the Company's wholly owned subsidiaries, Kemble Water Structure Limited, TWUL and Thames Water Utilities Cayman Finance Limited ("TWUCF") Previously, debt had been raised through Thames Water Utilities Finance Limited and Kemble Water Finance Limited

Moody's Investor Service rates Class A debt as issued by Thames Water Utilities Cayman Finance Limited ("TWUCF"), A3 long term with stable outlook Moody's also issues a Corporate Family Rating for the Securitisation Group of companies (comprising Thames Water Utilities Holdings Limited, TWUL and its subsidiaries), which stands at Baa3, reflecting the ability to issue Class B debt beyond 31 March 2011 Standard and Poor's Rating Services rates Class A debt as issued by TWUCF at A- with a stable outlook The Standard and Poor's rating was upgraded from BBB+ to A- on 19 April 2010 reflecting an improvement in the operating performance of the Group Accordingly, the Group maintains an investment grade issuer credit rating in accordance with the requirements of TWUL's Licence

In July 2010 TWUCF issued its inaugural Class B bond Class B debt is rated Baa1 by Moody's Investor Service and BBB by Standard and Poor's Following a second Class B bond issue in September 2010 the proceeds were used to refinance £833m of term loan due in December 2011 in Kemble Water Finance Limited

On 7 April 2011 the Group completed the refinancing of an £835m variable term loan facility at Kemble Water Structure Limited The refinancing at Kemble Water Finance Limited comprised a £400m fixed rate bond and £425m variable rate loan facilities The refinancing also included the restructuring of the related floating to fixed interest rate swaps

Capital structure

Key features of the Group's capital structure are as follows

- All debt issued by the Securitisation Group is documented pursuant to a Common Terms Agreement as part of the Whole Business Securitisation entered into in August 2007
- Until March 2010 all debt issued by the Securitisation Group was ranked in the same class ("Class A") The ratio of Class A net debt to Regulated Capital Value ("RCV") within the Securitisation Group is limited to 75%
- Since 1 April 2010, the Group and the Securitisation Group has the option to issue Subordinated Debt ("Class B") At the same time, there is an increase in the combined Class A and Class B (together "Senior") net Debt/RCV ratio to a maximum of 85%
- Each Obligor (the companies within the Securitisation Group) had entered into the Security Trust and Inter-creditor Deed ("STID") with the Security Trustee pursuant to which Thames Water Utilities Holdings Limited guarantees the obligations of each other Obligor under the finance documents and the Company and its wholly owned subsidiaries guarantee the obligations of each other under the finance documents, in each case to the Security Trustee
- Following an event of default, the documents provide for an automatic 18 month standstill of the claims of the creditors that have entered into the STID

Covenant compliance

Under the terms of its finance documents, the Group is required to comply with various covenants such as interest cover and net debt to RCV These covenants are measured and submitted to the Security Trustee semi-annually and involve both the actual data and forecasts and the two main ratios are discussed further below

Kemble Water Holdings Limited

Directors' Report (continued)

Adjusted Interest cover ratio (trigger: 1.3x)⁵: For the year to 31 March 2011 the ratio was 2.1x (2010 2.1x). There has been no movement in the year.

Senior Debt/RCV ratio (trigger: 85%)⁶: At 31 March 2011 the ratio was 77.4% (2010 68.3%). The movement in the ratio is due to two new class B bond issuances of £550m and £300m during the year.

There are other variations on these ratios on class A and Senior Debt, which the Group is also required to calculate to show compliance with its covenants. The Group is compliant with these ratios as at 31 March 2011.

Key performance measures

The table below shows the Group's performance against its key performance measures, which, with two exceptions were all achieved.

| Key performance measures | | Target | 2011 actuals | Target achieved |
|--|------------------|--------|--------------|-----------------|
| Customer Services levels | | | | |
| Inadequate pressure (DG2) | Properties | 34 | 14 | ✓ |
| Interruptions to supply (DG3) | Points | 0.35 | 0.58 | ✗ |
| Billing queries (DG6) | % | 99.9 | 99.9 | ✓ |
| Complaint handling (DG7) | % | 99.6 | 99.6 | ✓ |
| Meter reading (DG8) | % | 99.7 | 99.7 | ✓ |
| Abandoned rate (DG9) | % | 7.5 | 5.1 | ✓ |
| Security of Supply | | | | |
| Security of supply score | Annual average | 100 | 100 | ✓ |
| Security of supply score | Critical period | 99 | 100 | ✓ |
| Leakage | Mid | 674 | 665 | ✓ |
| Pollution incidents | | | | |
| Serious or significant pollution incidents | Number | 0 | 10 | ✗ |
| Quality | | | | |
| Water quality mean zonal compliance | %(2010 Calendar) | 99.97 | 99.97 | ✓ |
| Sewage works compliance | %(All measures) | 100 | 100 | ✓ |
| Serviceability | | | | |
| Water non-infrastructure (process) | | Stable | Stable | ✓ |
| Water infrastructure (network) | | Stable | Stable | ✓ |
| Wastewater non-infrastructure (process) | | Stable | Stable | ✓ |
| Wastewater infrastructure (network) | | Stable | Stable | ✓ |

⁵ A trigger event would lead to lock up which would mean nil distributions outside of the Securitisation Group until resolved to the Security Trustee's satisfaction. Adjusted interest cover ratio is calculated as operating cash flow adjusted for expenditure on depreciation and infrastructure renewals divided by interest paid.

⁶ A trigger event would lead to lock up which would mean nil distributions outside of the Securitisation Group until resolved to the Security Trustee's satisfaction.

Kemble Water Holdings Limited

Directors' Report (continued)

Key performance measures - highlights

Below is a summary of some of the key changes in the business that the Group has used to drive its improvement against targets

Water Service and Environmental Performance

- Between 2005 and 2011, the Group has reduced leakage by 27% by replacing old Victorian pipes mainly under London. Despite the coldest start to a winter for 100 years the Group has now met Ofwat's annual leakage target for the last five years. This improved performance follows the acquisition of the Group by a consortium of investors led by the Macquarie European Infrastructure Funds in 2006.
- This year the Group's ongoing mains replacement programme moved out of London for the first time, with projects starting in Slough and Reading. This work continues to contribute to the overall range of measures and initiatives in keeping leakage under control.
- The Group's drinking water quality performance remains high at 99.97% compliance. Whilst the Group aims to achieve 100% compliance, many of the failures recorded at customers' taps are caused by the condition or maintenance of customers' pipework and fittings. To that extent, 100% compliance is not within the control of the Group. However, management continue to strive to achieve this aim and the Group is one of the best performing companies in the industry.
- The Company achieved 100% compliance with the Environment Agency's standards on treated effluent across all of the 349 treatment works.
- The Group always encourages people to use water wisely – something which has resulted in a saving of 5Mld last year (two Olympic-size swimming pools), surpassing Ofwat's 4Mld target.

Sewerage Service and Environmental Performance

- During this year, the number of homes at the highest risk of internal sewer flooding due to lack of sewer capacity has reduced to 1,526 (2010: 1,604). The Group's ambition is to virtually eliminate this service failure.
- Every year the Group clears approximately 55,000 blockages in sewers at cost of around £12m, three quarters of these are caused by 'sewer abuse' which is when anything other than human waste or toilet paper goes down into the drains.
- The Group achieved 100% compliance with the Environment Agency's standards on treated effluent across all of the 349 treatment works.
- Sludge is a by-product of the sewage treatment process. The majority of this has been recycled and used on agricultural land as fertiliser.
- The Group has maintained its 100% compliance with statutory requirements for dealing with sludge and was able to meet the new tougher quality requirements in the voluntary code of practice known as the 'Safe Sludge Matrix'.

Kemble Water Holdings Limited

Directors' Report (continued)

Key performance measures – highlights (continued)

Security of Supply

- The Group has maintained 100% Security of Supply to all its customers

Customer Service

- Digital communications are now at the forefront of modern business and the Group is very proud to have been the only UK water Group named in the 'Social Brands 100' report
- The Group's new customer centre at Kemble Court in Reading was opened in May 2010 and has already led to improvements in the way the Group plans and coordinates its work and responds to customer queries
- The Group has also made it easier for customers to speak directly to an agent and has introduced an additional feature to enable customers to find out about anything affecting water supply on the same phone line. As a result of these changes, there has been a marked reduction in the number of calls that have been abandoned this year
- This year the Group staged its biggest-ever public consultation on the proposed Thames Tunnel receiving some 3,000 individual responses. The next phase of the public consultation is due to start in September 2011 before the Group submits a final planning application for the scheme in 2012

Incidence Rate – accidents per 1,000 employees

Management continue to focus on health and safety. The headlines for 2011 show a significant improvement in the Group's processes and compliance capability.

- The number of reportable accidents fell to an Accident Incident Rate ("AIR") of 0.39 injuries per 1,000 employees, (2010: 0.50) across the business, a 22% improvement
- The Group introduced a new Health and Safety Management System with over 400 managers now trained in risk assessment and managing health and safety. The Group aims to have all people managers trained by mid year
- An AMP5 contractors' conference was held during the year with a presentation of the Excellence in Health and Safety Awards, recognising improvement, achievement and excellence
- The Group introduced flu vaccinations which has been taken up by 300 staff at a number of locations

Kemble Water Holdings Limited

Directors' Report (continued)

Principal risks and uncertainties

Risk overview

The Group's Risk Management process is integrated within its businesses, and is designed both to identify emerging risks and to minimise the adverse impact of emerging and existing risks. Each business area is responsible for managing its risks, and maintains a risk register, which is reviewed regularly. Significant risks are escalated and reviewed by the Executive team and ultimately the Board of Directors.

The Group is exposed to a number of potential risks and uncertainties that could have a material impact on its long-term performance. These include:

Delivery of Thames Tunnel – As an innovative solution to the challenge of reducing sewage discharges into the Thames, the design and construction of the Thames Tunnel presents a number of major technical and logistical challenges. These include the need to identify and secure a number of construction sites in central London, to obtain the planning consents needed from London boroughs and to manage the inevitable disruption. As well as the many stakeholder issues, a key challenge is to finance the project, which has a different scale and risk profile to other Group activities. A number of possible funding and delivery models are being considered between the Group, Ofwat and Defra, including delivery by a specialist project Company appointed under the Flood and Water Management Act 2010.

PR14 determination – All UK water and sewerage companies must justify the operating costs and capital investment needed to deliver service to customers in the five-year period from April 2015. Failure to demonstrate the Group's case to Ofwat's satisfaction may mean that the Group is unable to invest in asset improvements that the Group believes will benefit its customers in the long term.

Failure to meet regulatory targets – The Group is required to meet targets set by Ofwat, the Environment Agency, the Drinking Water Inspectorate and other regulators. In order to achieve this, the Group must continue to deliver cost and efficiency savings in line with a challenging Final Determination, while maintaining and improving operational performance. Performance against these is the subject of frequent management review.

Managing increased competition in the water industry – A White Paper is expected in December 2011 leading to legislation from 2012 setting out a framework for competition beyond 2015. Separate proposals are potentially anticipated for upstream (wholesale) and downstream (retail) competition. Competition will impact the structure and financing arrangements of water companies, and may lead to significant implementation costs.

Transfer of private drains and sewers – The Government has committed to transferring responsibility for operation, maintenance and replacement of private sewers and pumping stations to water and sewerage companies, with effect from 1 October 2011. Limited information is available on these assets, and companies will have to provide an acceptable level of customer service and obtain retrospective funding from Ofwat for the costs incurred in the current regulatory period.

Employee pension scheme funding – The Group operates two defined benefit pension schemes. Whilst the Group has reduced its future exposure by closing the final salary schemes to new entrants, and moving a number of senior employees onto a defined contribution scheme, the Group remains liable for the historic rights earned by past and present employees. There is a risk that further falls in asset values will increase the deficit further and require further employer contributions to safeguard members' benefits.

Kemble Water Holdings Limited

Directors' Report (continued)

Principal risks and uncertainties (continued)

Failure to maintain adequate funding arrangements – As at 31 March 2011, the Group has adequate cash at bank and short term deposits of £802.5m and undrawn committed bank facilities (£1.175bn) in place to provide liquidity as required. The Group will need to renew £425m of 364 day committed facilities by 30 July 2011. The Group has been extremely successful in raising new debt financing in difficult market conditions, with circa £1.8bn raised in the financial year to 31 March 2011. However, due to continuing uncertainties in credit markets, there is a risk that the cost of raising new debt and refinancing bank facilities will put pressure on key financial covenants (as defined by the Group's capital structure). Whilst RPI at March 2011 is at a recent high, the impact of a falling RPI rate on the RCV could create further pressure on financial covenant headroom, specifically the ratio of net debt to RCV.

Future changes in laws or regulations – The Group is not funded by Ofwat for changes in obligations that would affect the whole economy. Consequently the Group may, for example, have to meet the obligations resulting from changes in environmental legislation or Corporation tax without recourse to Ofwat. However, changes that are specific to, or are more material for, the water industry may be funded by Ofwat as a Relevant Change of Circumstance.

Failure of a major asset – A failure at one of the Group's major assets could significantly impact the safety of its workforce and the public, as well as interrupting supply to customers and breaching environmental and regulatory targets. The impact would be both financial and reputational, and as a result the Group has a specific process to manage the identified risks.

The effects of climate change and long-term changes in weather patterns – As the Group continues to supply an increasing population, the effects of climate change could adversely affect its ability to maintain its Security of Supply Index (SoSi) requirements. Consequently, in addition to substantially enhanced demand management measures, the Group is currently making provision for new sources of potable water, greater network integrity and together with other water companies and regulators is actively contributing to work to identify the wider water resources needs across the South East of England.

Shortage of skilled labour – The shortage of available skilled labour in London and the South East creates an environment in which the Group must compete with other organisations for staff with the necessary skills, particularly engineering, in order to deliver the capital programme agreed in the Final Determination and additional major planned projects. Failure to deliver agreed targets may result in fines, intervention by Ofwat and less favorable future periodic determinations.

Impact of low inflation or deflation – In return for their capital investment in assets, regulated water companies earn a return on their Regulated Capital Value (RCV), which is adjusted by the RPI. In times of low inflation or deflation, the return on this investment will decrease relative to the cost of funding, reducing cash flow and shareholder value.

Customer experience measures – The measure for customer performance is evolving from quantitative to qualitative criteria. All water companies will need to adapt processes in order to optimise performance against these new criteria, to be measured against Ofwat's Service Incentive Mechanism ("SIM").

Kemble Water Holdings Limited

Directors' Report (continued)

Transforming Thames – Making Tomorrow Better

The Transforming Thames project has continued to progress under the banner of 'Making Tomorrow Better'. The transition to the asset management based Thames Operating Model ("TOM") was completed in December 2010 which, enabled the new organisational structures to come into full operation from 4 January 2011. This places the Group in a good position to fulfil the significant challenges presented in Ofwat's FD and to deliver efficiently the £5bn capital programme agreed with Ofwat for AMP ending 31 March 2015.

An integrated Delivery Plan has been compiled to ensure that all the key change initiatives being undertaken across the business, such as the Delivering Performance Excellence (DPE), Work Asset Management and Information ("WAMI"), Supervisory Control And Data Acquisition ("SCADA"), Customer Service Transformation and IS strategy programmes, are aligned to strategy and that interdependencies are identified, recognised and managed across all functions. In addition, future impacts of regulatory change such as the potential private sewers programme, are anticipated through this mechanism to ensure that the Group delivers the requirements of AMP5 whilst considering its longer term strategic business plan.

To support the implementation of change across the business, a Thames Way Change Methodology has been developed to provide a framework and an accompanying toolkit including tips, techniques and templates for use by managers across the business. A core team of Change Managers has been trained in its use and will be introducing the methodology and providing support and advice to managers throughout the period of transformation, including the roll-out of WAMI.

The WAMI programme has continued at a pace and remains on schedule to transform the asset management and operational planning process of the Group. The WAMI solution has been developed and signed off, and work is now in progress to prepare and support the business in a phased "Go Live" from quarter four of 2011. It will have an impact throughout the business in the way that the Group works, introducing new systems and tools so that the Group's operational teams can complete work more efficiently as well as enabling it to give its customers a better service. Operating in a regulatory environment the Group seeks to provide the best, most cost effective value-for-money service to its customers, delivering top quality tap water to customers as required by the Drinking Water Inspectorate, treating wastewater to improve the Group's performance, as measured by SIM, and to help the Group to reduce its costs by over £100m by 2015.

The Group has demonstrated continuing improvement, whilst implementing the transformation programme, in both operational and financial performance thus providing a strong platform for the future.

Kemble Water Holdings Limited

Directors' Report (continued)

Looking further ahead

It is over 20 years since the water industry was privatised. Since then much has changed - costs of service are lower, performance is better and the industry has delivered significant quality improvements. But there is still lots to do with new challenges ahead from climate change, population growth and new quality improvements to name a few. The industry and the Group must ensure they can meet the challenges they face.

A key to this is how the sector is regulated going forward to ensure it is fit for purpose to meet these challenges.

There is considerable work underway in this area. Ofwat is reviewing what and how it regulates, the Government is expected to publish a Water White Paper on the long term direction for the sector and the economic regulatory arrangements themselves are being reviewed by David Gray (former Managing Director of Networks at Ofgem).

Looking ahead, the Group will need to be flexible through this process and be ready for any change to the regulatory environment which occurs.

However, through this period of change, there are some constants which remain. The Group will need to ensure that

- high performance is maintained and capitalise on opportunities for further improvements
- it delivers what customers want at the right price, in the right place and at the right time
- it offers value for money at an affordable price

A key challenge as highlighted on page 12 in this process will be the delivery of the proposed Thames Tunnel. Thames Water is working closely with all stakeholders to ensure this is delivered by the most appropriate means possible.

The Group is looking ahead to understand the future environment and ensuring that it takes the right actions today to protect the future.

Strategic direction statement

In 2007 the Group published its Strategic Direction Statement, setting out plans for the next 25 years. As part of its Business Planning the Group has begun the process of reviewing and updating its long term plans building on the wants and needs of customers and the challenges as diverse as future population growth and climate change.

Water resources

In August 2009 Defra called for a public inquiry into the draft Water Resources Management Plan for Thames Water Utilities Limited. The Inquiry was completed in August 2010 and the Inspector's report recommended additional work in a number of areas including the assessment of long-term solutions for supply security.

Defra issued instructions to Thames Water to complete the plan in line with the Inspector's report and advice from the Environment Agency.

The programme of work is expected to be completed by the end of 2011 with approval of the Final Plan by Defra in 2012.

Kemble Water Holdings Limited

Directors' Report (continued)

Relationships and resources

Employees

This financial year has been challenging with the largest ever five year capital investment programme commencing, continued change and transformation of the Group's business processes and the challenge of severe winter weather events. The Group's employees have continued to demonstrate high commitment and increased engagement levels throughout the year, supported by the its 'Passionate About People' strategy.

The strategy was refreshed under the Group's new HR Director and an increased focus on supporting the organisational change and transformation across the Group, alongside getting the best out of its people by giving them the right support and development. Implementation continues to engender a positive working environment which focuses on performance, contribution and values diversity and inclusion.

Overall staff turnover in 2011 has been at a similar level to 2010.

In 2011 the Group sickness rate during the year was 2.75% (2010 3.20%). The Group has an attendance management policy in place with the overall aim of reducing and managing sickness absence. In addition, there has been a focus on attendance management this year.

The Group is committed to effective talent management, running regular Talking Talent reviews to assess performance and potential across the Group. These reviews support effective learning and development interventions and focus on ensuring the Group has the future talent to deliver its business strategy. This year, the Group has continued to invest in its core leadership development programmes, future talent pipeline programmes and to develop the technical and business skills of its employees.

During this year, the following key people initiatives have been delivered to support the business strategy:

- Continuous improvement of resourcing activities to enhance the quality of new employees hired, delivery of volume recruitment and enhanced offer and security vetting processes.
- Executive reward review and implementation of pensions strategy, including launch of the new Defined Contribution pension plan for new joiners.
- Review of key people policies and a major programme to review the Group's working patterns and terms and conditions for frontline operational employees.
- Implementation of enhancements to the HR system to build on previous year's successful implementation.
- The continued focus on employee engagement across the Group resulting in a year on year increase in employee engagement, as measured through its annual employee survey.
- New intakes to the Group's Graduate, Apprentice and Bursary future talent pipeline programmes.
- Continued roll out of the Group's core 'Foundation and Advanced Leadership Development' programmes and the launch of its 'Strategic Leadership Development' programme.
- Continued performance and development reviews for all employees linked to the annual pay review.
- Effective management of significant organisational change across the Group, including implementation of the TOM and local re-organisations.

The Group is committed to the training and development of all of its employees and employees who undertook 12,355 (2010 4,387) formal training days in 2011. Over 7,000 days were spent on health and safety and contractor maintenance, nearly 2,000 on leadership training with a further 2,200 days with the Group's customer services and customer management teams.

Kemble Water Holdings Limited

Directors' Report (continued)

Relationships and resources (continued)

Stakeholders

Much of the Group's work with stakeholders centred on the Thames Tunnel project, following the launch in September of the first round of public consultation on the need for the project, its route and construction sites. In addition to 49 days of public exhibitions at 25 venues, the Group held briefings with Members of Parliament and local authorities, and attended community and residents' groups and public meetings. The general election in May saw new MPs in several constituencies in the Group's region and individual briefings and group meetings have been held with many of them, particularly where the Group's activities have a significant impact on their constituencies.

During the year, the Group held events with its stakeholders to mark milestones including the opening in June of the Group's Thames Gateway Water Treatment Works in Newham, East London, and the groundbreaking ceremony in November for the Lee Tunnel. The Group met with and attended workshops held by civil servants responsible for developing Government policy in areas including market reform, funding for large infrastructure projects, the transfer of private sewers, and social tariffs. These were in addition to several discussions with civil servants on the Water White Paper.

The Group played an active role in inquiries by the Environment, Food and Rural Affairs Select Committee, submitting written evidence as part of its examination of future water legislation and giving oral evidence as part of its scrutiny of the draft waste water National Policy Statement ("NPS"). The NPS sets out guidance for planning decisions on projects deemed of National Significance, including the construction of the Thames Tunnel, and potential upgrade and relocation of the sewage treatment works ("STW") at Deepams.

The Group met with the 'Blueprint for Water' coalition of environmental Non-Governmental Organisations to discuss their ten-point plan for the water industry, and explored opportunities for closer collaborative working. This has prompted further work on areas including metering and water efficiency, as well as water-friendly farming practices.

At a regional and local Government level, the Group continued to strengthen ties with the authorities it serves. This included giving evidence to the London Assembly Environment Committee's inquiry into flooding, and working with local authorities – both individually and through the Drain London Forum in the capital – to help them develop the Surface Water Management Plans required by the Flood and Water Management Act 2010. The Group welcomes the introduction within the Flood and Water Management Act 2010 of a social tariff for the water industry, which the Group has strongly advocated for the last three years. This will form an essential part of the package of affordability measures the Group plans to introduce to help customers least able to pay for their bills, particularly as a result of a move to increased metering.

The Group embraced a culture of open and transparent dialogue in the public realm, and throughout the year attended several formal Scrutiny and Public Meetings with Local Authorities, giving evidence at meetings and responding to questions and feedback from councillors, officers and the public.

Kemble Water Holdings Limited

Directors' Report (continued)

Relationships and resources (continued)

Public Consultations and Research

The focus on public consultations work has again increased this year. The Group has a number of major projects underway, which has led to its highest level of consultation activity to date. The Group recognises that these major projects have an impact on a large number of its stakeholders and customers and endeavours to make its plans reflect their views.

The Group's approach to consultation includes independently-facilitated stakeholder workshops, individual discussions with MPs and other stakeholders, surveys and independently-hosted online consultations.

The most significant piece of public consultation work the Group carried out during the year was on the Thames Tunnel. During Phase 1, between September 2010 and January 2011, the Group asked the public for views on its tunnel route and construction sites. The Group received over 3,000 individual responses to this initial phase of consultation. During Phase 2, planned to start in September 2011, the Group will consult on the final proposed route and construction sites, prior to submitting its planning application in 2012. The Group's first phase of public consultation was commended by a number of key stakeholders as being a good example of best practice.

The Group has also held deliberative workshops and focus groups with customers, at which it has provided them with background information on its work, in order to deepen their understanding of its business and help them to give more informed views. The topics covered this year have included the Group's approach to metering, the planned transfer to water companies of private sewers, research with commercial customers, and customer strategy and brand reputation research. The Group also undertook reputation research with a number of its other key stakeholders.

The Group's continuing commitment to consultation and research plans will help it to understand its customers better than other water and sewage companies and ensure it has (as far as possible) developed its plans in accordance with their wishes. However, the Group's need to understand, and test, customer views is growing all the time and the Group will involve customers more in taking some of the more strategic decisions it faces and not simply seek their views on elements of its investment programme. With this in mind, the Group is setting up a panel of 2,000 customers to help it to better understand its customers' needs and preferences.

Key suppliers and contractors

In 2011, the Group spent in excess of £1.4bn on construction, goods and services with a range of suppliers and contractors (2010 in excess of £1.1bn). Approximately 31 key suppliers (2010: 23) were engaged with a spend greater than £10m each. The Group's policy is to establish trading arrangements, which are made following an open non-discriminatory, competitive bidding process. Procurement processes reflect the Group's corporate responsibility commitments and, where applicable, comply with the requirements of the Utilities Contracts Regulations 2006 (as amended).

Research and development

The Group's research and development programme consists of a portfolio of projects designed to address technical needs across the range of water cycle activities. Research and Development deliver innovative technical solutions through a research programme aligned with business needs to address challenges for AMP5 and also provide specialist technical support to the business. Expenditure on research and development totalled £3.4m for the year (2010: £3.5m).

Kemble Water Holdings Limited

Directors' Report (continued)

Relationships and resources (continued)

Intellectual property

The Group protects intellectual property of material concern to the business as appropriate, including the filing of patents where necessary

Energy efficiency and renewable energy

The Group is committed to reducing its contribution to the causes of climate change and its voluntary target is to achieve by 2015 a challenging 20% reduction in green house gas ("GHG") emissions (compared to 1990 levels)⁷ in 2015 for scope 1 and scope 2 emissions⁸

The Group's total GHG ("Greenhouse Gas") emissions (Scope 1, 2 and 3) reported for the 2011 were 780,436 tonnes (2010 757,218 tonnes) of carbon emissions (CO₂e). The Group's approach to reporting GHG emissions is consistent with both the Department of Energy and Climate Change ("Decc") and Defra guidance and Ofwat reporting requirements. During the year the Group's reported emissions increased due to the impact of the severe cold weather during the winter and demand from new assets, although emissions were reduced by the Group's energy efficiency and renewable energy programmes. In addition, an increase in the carbon intensity of grid electricity, rather than the expected reduction, also contributed to higher reported emissions. Despite these setbacks, the Group remains determined to meet its targets by 2015.

Last year the Group consumed 1,179 Gigawatt Hours ("GWh") of electricity of which 183GWh was renewable electricity generated at the Group's operational sites - around 16% of the Group's total electricity use. The Group produced 96GWh of heat energy which displaced the need to consume natural gas. This generation of renewable electricity and heat helped reduce the Group's overall GHG emissions.

⁷ The Group has assumed for planning purposes that grid electricity intensity will decrease in line with the projections in the Government's Low Carbon Transition Plan in order to achieve this goal.

⁸ Scope 1 emissions are those direct emissions associated with the operation of the business. Scope 2 emissions are the indirect emissions associated with the consumption of grid electricity. However, this is reliant on the Government redefining grid emissions.

Kemble Water Holdings Limited

Directors' Report (continued)

Relationships and resources (continued)

Energy efficiency and renewable energy (continued)

The Group continues to work hard to understand and reduce its carbon footprint. During 2011 it has

- Completed and had independently reviewed an assessment of its progress against its 1990 emissions baseline. The review highlighted the fact that despite serving over 3m more customers, the Group's GHG emissions for 2011 were around 11.4% below 1990 levels.
- Completed 2 years early, the innovative biogas injection scheme at Didcot which cleans up and injects biogas (produced as a by-product of sewage treatment) into the gas grid to allow it to be used beneficially by gas customers. The scheme will produce enough biogas to supply 200 houses locally helping to reduce the UK's GHG emissions.
- Increased the Group's renewable energy generation capacity by 4 megawatts ("MW"), including 1.3 MW at Chertsey STW. These assets will help to reduce the Group's GHG emissions and energy costs going forward.
- Increased its remote metering scheme that it now covers 100% of gas and more than 95% of its electricity use. This is enabling the Group to better understand its energy consumption and to identify and target opportunities for cost effective energy efficiencies.
- Installed process sub-metering on three major operational sites to provide both local, and management level monitoring and targeting of specific energy efficiency opportunities. On average, this has yielded a 6% reduction in electricity consumption at these sites. Building on this successful pilot programme, during 2012 the Group will begin rolling out process sub-metering to a further 22 sites during 2012 which will give 65% coverage of its electricity consumption.
- Optimised the Group pumping at many points on its water network to reduce leakage and energy consumption resulting in a cut of 5.4 GWh of energy use.
- Completed surveys on 45 water pumping systems and on average have identified an average 10% energy efficiency potential on 25 of these systems, for delivery in 2011/12.
- Become the first utility Company to achieve re-accreditation to the Carbon Trust Standard, which recognises "real and sustained emissions reductions" over a three year period.

Looking to the future there are a number of significant challenges facing the business in terms of reducing the Group's GHG emissions. The Group's activities are very closely linked to the weather and as seen this winter with the extremely cold weather, the Group needed to pump more water and so use more electricity - consequently emitting more GHG. Some of the upward pressures on the Group's energy consumption and GHG emissions are beyond its control such as the weather, new obligations (including the adoption of private sewers and the construction of the Tideway Tunnels) and population growth.

However, there are responses that the Group can influence, including energy efficiency, effective energy procurement and the generation of renewable energy. The Group therefore needs to constantly innovate in the management of its energy consumption and GHG emission to ensure they are kept as low as possible. However, changes in Government policy such as the Carbon Reduction Commitment becoming a tax rather than an incentivised cap and trade scheme, and proposed changes to the Feed-in Tariff Scheme have made effective planning and delivery much more difficult.

Kemble Water Holdings Limited

Directors' Report (continued)

Social and community

Corporate responsibility

The Group continues to be committed to operating in a socially responsible way and to engaging with stakeholders and communities. Full details of the Group's performance are included in its annual report available on the Group's dedicated website www.thameswater.co.uk/cr

The Group is pleased to report that it has retained 'Platinum' ranking in the Business in the Community Corporate Responsibility Index, having achieved this ranking for the first time in 2010

Community investment

The Group's community investment programme consists of activities designed to best support the social, economic and environmental aspects of the communities in which it operates. These include the Ten for Ten programme (see below), employee volunteering projects to improve community spaces, education programmes to enhance the teaching and learning about the water industry, and a charitable giving scheme

Ten for Ten

The Group has continued with its £10m *Ten for Ten* programme to benefit customers and communities across the service area. In total the Group contributed £2.5m during the year, split into two key areas

1) Thames Water Trust Fund

This year the Group donated £1.9m to the Thames Water Trust Fund which over the year helped 3,631 disadvantaged customers to pay their water bills

2) Community projects

The key projects supported during the year are outlined below

Education related projects have been successful over the year. An additional 5 students from the University of East London were awarded engineering bursaries. In addition, the first 2 students from the University had successful summer work placements at Beckton and in field operations and are now in the second year of their degree, supported once again by the Group

The Group also funded the Creekside Education Centre at Deptford with £30,000 to assist with staffing ready for launch in May 2011. The Thames Water branded centre will educate around 3,000 schoolchildren a year and allow them to go wading in the Thames at Deptford Creek and learn about tidal ecology, the River Thames and the Group

Kemble Water Holdings Limited

Directors' Report (continued)

Social and community (continued)

2) Community projects (continued)

The Group is committed to improving key water related visitor attractions. Kew Bridge Steam Museum undertook a consultation with its visitors to understand how to make best use of the museum. From this research, and together with the Group's financial commitment, Kew Bridge Steam Museum is preparing a Heritage Lottery Fund bid, to transform itself into London's 'Museum of Water'. The improvements at the London Wetland Centre continued. In July 2010 an interactive pond exhibition was opened and in October 2010 the Thames Water Pond Zone and Down the Plug Hole exhibits were opened. Contributions to these projects totalled £300,000.

The Group has been working with various partners to improve key wildlife and recreation sites. £175,000 was provided to improve The Greenway, to enhance it for the Queens Golden Jubilee and Olympics in 2012. The Group confirmed support to the Fobney Island project in Reading, whereby the wetland will be enhanced and a meander added to the River Kennet to provide good angling and bird watching facilities. The National Trust woodland at The Chase, Newbury, is being transformed. The Group's donation has provided new footpaths, ponds, fencing and in the summer 2011 wild-roaming cattle and pigs will be introduced into the woodland.

Further community investment

Thames Water has sponsored a number of community events in partnership with key stakeholders including the Thames Festival and the London Youth Games. The Group also supports community organisations in projects which fit its Community Investment criteria including wildlife and environmental improvements. The Group's contribution in this area totalled some £270,000 in 2011.

Employee engagement

More than 300 employees took part in a number of volunteering events working with community partners in London and the Thames Valley. The Group supports its employees to participate in community, education and fundraising events through the Time To Give volunteering scheme, an entitlement of 2 days volunteering leave in addition to annual leave.

Our volunteers participated in a range of events over the year from environmental clean ups to supporting education activity days in schools. The Group was pleased to continue to work with key partners including Thames 21, a charity focusing on cleaning up the River Thames in London boroughs and local Education Business Partnerships which deliver skills-based activities in schools. Over 60 volunteers took part in the Thames Water-sponsored Reading RESCUE clean-up event, in partnership with Reading Borough Council, clearing rubbish from seven green spaces in and around Reading.

Charitable donations

The Group and its employees also took part in a variety of charity and fundraising events such as the Macmillan 'World's Biggest Coffee Morning' and numerous fun runs and cycle rides. More than 1,250 employees were involved over the year raising over £170,000 for local and national charities, charitable good causes and community organisations. The Group donated around £230,000 through its Charities Committee and direct donations to good causes, including the Group's principal charity, WaterAid.

A highlight in the charity calendar was Comic Relief night, which saw around 150 employees give up an evening to man phone lines and take donations from the public.

Kemble Water Holdings Limited

Directors' Report (continued)

Charitable donations (continued)

The Group's Charity Committee considered a number of requests directly from charities and charitable organisations. Following the Charity Committee's review it made donations to beneficiaries including disadvantaged people in London through the London Evening Standard's Dispossessed of London campaign and The Ahoy Centre, a sailing charity working with disadvantaged youth and people with disabilities.

Principal activities and likely future developments

The principal activity of the Group is the provision of water and wastewater services.

The Company's registered number is 5819262 (England and Wales).

Results and dividends

The profit and loss account on page 29 gives the Group's financial results for the year.

The Group paid interim dividends totalling £115.1m during the year (2010 £156.4m).

The Group's dividend policy is

- To pay a progressive dividend commensurate with the long-term returns and business performance after considering the business' current and expected regulatory and financial performance, regulatory restrictions, management of economic risks and debt covenants.

Directors, in assessing the dividend to be paid (to a maximum of statutory distributable reserves), are required to ensure that

- Sufficient liquidity is maintained to enable the business to meet its financial obligations for 15 months.
- Post-dividend financial ratios remain within their agreed limits at both the balance sheet date and on a forward-looking basis.

The Board does not recommend a final dividend (2010 £nil). However, the Board has proposed a further interim dividend, see note 9, page 47.

Kemble Water Holdings Limited

Directors' Report (continued)

Directors

The directors who held office during the year ended 31 March 2011 and to the date of signing were

| Director | Appointments | Resignations |
|---------------------|----------------|----------------|
| Sir Peter Mason KBE | | |
| L F Abraira | | 1 January 2011 |
| M W Baggs | | 10 June 2010 |
| E Beckley | | |
| R Blomfield-Smith | | |
| C R Deacon | | |
| Dr P Dyer | | |
| R Gadsby | 10 June 2010 | |
| C Lynam | | 10 June 2010 |
| G I W Parsons | 10 June 2010 | |
| K Roseke | | 1 January 2011 |
| A F C DeP Santos | 1 January 2011 | |
| D J Shah | | |
| M S W Stanley | | |
| R E Verrion | 1 January 2011 | |

During the year under review, none of the directors had significant contracts with the Company or any other body corporate within the Group, other than their contracts of service, except as disclosed in note 30 to the accounts

The following directors have formally appointed alternate directors to represent them when they are unavailable

| director | | | alternate director | | |
|-------------------|----------------|----------------|--------------------|----------------|------------------|
| Name | Appointment | Resignation | Name | Appointment | Resignation |
| L Abraira | | 1 January 2011 | D Mora | | 1 January 2011 |
| E Beckley | | | G I W Parsons | 7 June 2010 | 4 August 2010 |
| | | | G I W Parsons | 22 March 2011 | |
| | | | S Leong | 4 August 2010 | 11 February 2011 |
| R Blomfield-Smith | | | K Boesenberg | | |
| C R Deacon | | | R D Israel | | |
| C Lynam | | 10 June 2010 | M W Baggs | | 10 June 2010 |
| G I W Parsons | | | S Leong | 22 July 2010 | 11 February 2011 |
| K Roseke | | 1 January 2011 | S Kolenc | | 1 January 2011 |
| A F C DeP Santos | 1 January 2011 | | M C Guerreiro | 1 January 2011 | |
| D J Shah | | | R Verrion | | 1 January 2011 |
| | | | L Webb | 1 January 2011 | |
| R Verrion | 1 January 2011 | | S Kolenc | 1 January 2011 | |

Employees

The Chief Executive Officer ("CEO") and the Executive continue to hold quarterly management briefings with managers to provide the opportunity to discuss performance and how the Group can continue to move forward. This year the Group has also introduced a 'Changing Times' publication to support the changes and transformation happening across the Group. This is in addition to the continued improvement of the Group's corporate and local communication channels that provide regular communication, information and updates to employees. Corporate channels include company-wide Team Talk briefings, a weekly e-brief containing a message from the CEO, 'The Source' magazine, the Group's internal portal web pages and specific priority news updates and managers key information.

Kemble Water Holdings Limited

Directors' Report (continued)

Employees (continued)

Consultation with other employees is undertaken in partnership with the recognised Trade Unions. Consultation with management level employees typically takes place on an individual basis, except in the case of changes that affect whole areas of the business. In these circumstances, consultation takes place on a Group-wide basis with employee representatives being elected for the relevant area.

All employees are involved in both the Group's employee engagement programme and annual Performance and Development Review ("PDR") process. Each year the Group encourages all employees to participate in its annual employee engagement survey. In July 2010, the date of the last survey, over 70% of the Group's employees participated and employee engagement improved year on year. This programme also involves circa 100 volunteer employee engagement champions from around the Group who support making the Group a great place to work. It allows all employees to give their opinion and enables managers and teams to take action on key issues identified. Corporate and Business Unit objectives are agreed by the Executive, communicated and cascaded through the Group and included in the annual PDR for all employees. In addition, relevant department and team objectives are cascaded and inform employees' personal objectives which in turn are agreed with each employee's their manager and reviewed regularly. This process is intended to ensure that all employees are aligned to Group objectives.

Employment of disabled persons

The Group is committed to fulfilling its obligations in accordance with the Disability Discrimination Act 1995. The Group has policies and procedures in place that aim to ensure that both job applicants and employees with disabilities have equality of opportunity, are treated fairly and have a safe and practical workplace, free from discrimination, bullying, harassment or victimisation.

Through disability and attendance management policies, support and training is provided for employees who become disabled during the course of their employment so that they continue to work in a position appropriate to their experience and abilities.

Policy and practice on payment of creditors

The Group's policy is to pay all suppliers, contractors and service providers according to pre-agreed terms. During the year under review, the average amount due to trade creditors represented 63 days (2010: 67 days) of purchases received from these creditors.

Market value of land and buildings

In the opinion of the directors, the market value of the land and buildings of the Group does not in aggregate exceed the net book value at 31 March 2011.

Kemble Water Holdings Limited

Directors' Report (continued)

Political and charitable donations and expenditure

No political donations were made by the Group (2010 £nil) The Group made charitable donations totalling £723,576 (2010 £471,500) Details of these charitable donations are

- £106,000 (2010 £154,054) to the Charities Aid Foundation
- £58,021 (2010 £nil) to WaterAid
- £60,000 (2010 £60,000) to Thames 21, a range of charities which assist in cleaning rivers and streams within the Thames Valley
- £316,807 (2010 £197,446) of donations to educational and recreational Ten for Ten projects
- £182,748 (2010 £60,000) of other donations including donations of £159,748 to the National Trust

Going concern

The directors believe, after due and careful enquiry, that the Group has sufficient resources for its present requirements and therefore consider it appropriate to adopt the going concern basis in preparing the 2011 financial statements Further information is set out in note 1 'Basis of preparation' on page 33

Disclosure of information to the auditor

The directors who held office at the date of approval of this directors' report confirm that so far as they are each aware, there is no relevant audit information of which the Group's auditor is unaware, and each director has taken all the steps that they ought to have taken as a director to make themselves aware of any relevant audit information and to establish that the Group's auditor is aware of that information

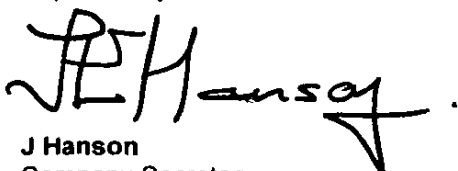
Directors' indemnities

The Group has made qualifying third party indemnity provisions for the benefit of its directors and for the benefit of other persons who are directors of associated companies and these remain in force at the date of this report

Auditor

Pursuant to Section 487 of the Companies Act 2006, the auditor will be deemed to be reappointed and KPMG Audit Plc will therefore continue in office

Approved by the Board of Directors on 9 June 2011 and signed on its behalf by



J Hanson
Company Secretary
Clearwater Court
Vastern Road
Reading RG1 8DB

Kemble Water Holdings Limited

Statement of directors' responsibilities in respect of the Directors' Report and the financial statements

The directors are responsible for preparing the Directors' 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 they have elected to prepare the Group and parent company financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice)

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and parent company and of their profit or loss for that period

In preparing each of the Group and Parent Company financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgments and estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements,
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the parent Company will continue in business

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities



15 Canada Square
London
E14 5GL
United Kingdom

Independent Auditor's Report to the members of Kemble Water Holdings Limited

We have audited the financial statements of Kemble Water Holdings Limited for the year ended 31 March 2011 set out on pages 29 to 71. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 26, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at www.frc.org.uk/apb/scope/private.cfm

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2011 and of the Group's loss for the year then ended,
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

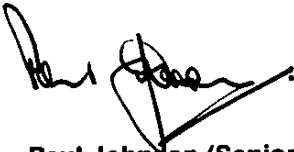
In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Independent Auditor's Report to the members of Kemble Water Holdings Limited (continued)

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us, or
- the parent company financial statements are not in agreement with the accounting records or returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit



Paul Johnson (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor

Chartered Accountants

9 June 2011

Kemble Water Holdings Limited

Consolidated profit and loss account for the year ended 31 March

| | | 2011 | 2010 |
|--|------|----------------|--------------|
| | Note | £m | £m |
| Turnover | 2 | 1,641.9 | 1,659.5 |
| Operating costs | 3 | (1,106.9) | (1,011.6) |
| Group operating profit | | 535.0 | 647.9 |
| Share of operating profit/(loss) in joint ventures | | 0.4 | (0.4) |
| Total operating profit: Group and share of joint venture and associates | | 535.4 | 647.5 |
| Profit on sale of fixed assets | | 9.0 | 38.9 |
| - interest receivable and similar income | 6 | 6.1 | 7.9 |
| - Interest payable and similar charges | 7 | (656.1) | (436.4) |
| (Loss)/profit on ordinary activities before taxation | | (105.6) | 257.9 |
| Taxation credit/(charge) on (loss)/profit on ordinary activities | 8 | 24.4 | (94.4) |
| (Loss)/profit for the year | 22 | (81.2) | 163.5 |

There is no difference between the profit on ordinary activities before taxation and the profit for the year stated above, and their historical cost equivalents

All amounts relate to continuing operations

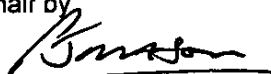
Kemble Water Holdings Limited

Balance sheets as at 31 March

| | Note | Group | | Company | |
|--|------|------------------|------------------|------------------|------------------|
| | | 31 March 2011 | 31 March 2010 | 31 March 2011 | 31 March 2010 |
| | | £m | £m | £m | £m |
| Fixed assets | | | | | |
| Intangible assets | 11 | 1,582.1 | 1,626.5 | - | - |
| Tangible assets | 12 | 10,063.6 | 9,472.2 | - | - |
| Investment in joint ventures | | | | | |
| Share of gross assets | | 3.6 | 3.5 | - | - |
| Share of gross liabilities | | (3.6) | (3.5) | - | - |
| Other fixed asset investments | 13 | 0.1 | 0.1 | 1.0 | 1.0 |
| | | 11,645.8 | 11,098.8 | 1.0 | 1.0 |
| Current assets | | | | | |
| Stocks | 14 | 8.8 | 11.3 | - | - |
| Debtors | 15 | 644.9 | 634.4 | 3,011.8 | 2,652.0 |
| Investments | 16 | 802.5 | 666.0 | - | - |
| Cash at bank and in hand | | 41.5 | 48.5 | - | - |
| | | 1,498.0 | 1,360.2 | 3,011.8 | 2,652.0 |
| Creditors amounts falling due within one year | 17 | (1,117.0) | (1,308.8) | (444.4) | (344.0) |
| Net current assets | | 381.0 | 51.4 | 2,567.4 | 2,308.0 |
| Total assets less current liabilities | | 12,026.8 | 11,150.2 | 2,568.4 | 2,309.0 |
| Creditors amounts falling due after more than one year | 18 | (9,161.7) | (8,022.1) | - | - |
| Provisions for liabilities and charges | 20 | (1,023.0) | (1,074.2) | - | - |
| Net assets excluding pension liability | | 1,842.1 | 2,053.9 | 2,568.4 | 2,309.0 |
| Net pension liability | 26 | (91.4) | (104.7) | - | - |
| Net assets including pension liability | | 1,750.7 | 1,949.2 | 2,568.4 | 2,309.0 |
| Capital and reserves | | | | | |
| Called up share capital | 21 | 1,991.6 | 1,991.6 | 1,991.6 | 1,991.6 |
| Profit and loss account | 22 | (240.9) | (42.4) | 576.8 | 317.4 |
| Total shareholders' funds | | 1,750.7 | 1,949.2 | 2,568.4 | 2,309.0 |

The notes on pages 33 to 71 form part of these accounts

The financial statements on pages 29 to 71 were approved by the Board of directors on 9 June 2011 and signed on its behalf by



Sir Peter Mason KBE
Chairman

Kemble Water Holdings Limited

Consolidated cash flow statement for the year ended 31 March

| Cash flow statement | Note | 31 March 2011 £m | 31 March 2010 £m |
|---|-------|------------------------|------------------------|
| Net cash inflow from operating activities | 27(a) | 936.7 | 1,001.9 |
| Returns on investments and servicing of finance | 27(b) | (412.5) | (367.2) |
| Taxation | | (1.5) | (17.8) |
| Net cash outflow for capital expenditure and financial investment | 27(c) | (846.9) | (707.1) |
| Equity dividends paid to shareholders | 9 | (115.1) | (156.4) |
| Net cash outflow before management of liquid resources and financing | | (439.3) | (246.6) |
| Net cash outflow from management of liquid resources | 27(d) | (136.5) | (327.2) |
| Financing | | | |
| Cash inflow from increase in debt and lease financing | 27(d) | 569.1 | 351.0 |
| Decrease in net cash | | (6.7) | (222.8) |
| Reconciliation of net cash flow to movement in net debt | | | |
| Decrease in net cash | | (6.7) | (222.8) |
| Cash inflow from increase in debt and lease financing | | | |
| - loans due within one year | | 387.9 | (190.4) |
| - loans due after more than one year | | (965.4) | (166.1) |
| - capital repayment of finance leases | | 8.4 | 5.5 |
| Cash inflow from increase in liquid resources | | 136.5 | 327.2 |
| Increase in net debt resulting from cash flows | | (439.3) | (246.6) |
| Other non-cash movements | | | |
| - RPI uplift on index-linked bond and debt issue cost amortisation | | (211.2) | (48.5) |
| - Fair value amortisation on loans at acquisition | | 10.7 | 0.5 |
| Increase in net debt | | (639.8) | (294.6) |
| Opening net debt | | (7,504.1) | (7,209.5) |
| Closing net debt | | (8,143.9) | (7,504.1) |

Kemble Water Holdings Limited

Statement of group total recognised gains and losses for the year ended 31 March

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| Group (loss)/profit for the financial year | (81.2) | 163.5 |
| Exchange adjustments | 2.6 | 0.9 |
| Actuarial loss on pension scheme (see note 26) | (1.6) | (105.1) |
| Deferred tax (relief)/charge relating to actuarial deficit on pension schemes | (3.2) | 29.5 |
| Total recognised (losses)/gains relating to the year | (83.4) | 88.8 |

No items relating to joint ventures went through the statement of total recognised gains and losses

Reconciliation of movements in shareholders' funds

| | Group | | Company | |
|--|------------------------------------|------------------------------------|-------------------------------------|-------------------------------------|
| | Year end 31 March 2011 £m | Year end 31 March 2010 £m | Year end 31 March 2011 £m* | Year end 31 March 2010 £m* |
| (Loss)/profit for the financial year | (81.2) | 163.5 | 374.5 | 141.4 |
| Exchange adjustments | 2.6 | 0.9 | - | - |
| Actuarial loss on pension scheme (see note 26) | (1.6) | (105.1) | - | - |
| Deferred tax relating to actuarial deficit on pension scheme | (3.2) | 29.5 | - | - |
| Dividend | (115.1) | (156.4) | (115.1) | (156.4) |
| Net change in shareholders' funds | (198.5) | (67.6) | 259.4 | (15.0) |
| Opening shareholders' funds | 1,949.2 | 2,016.8 | 2,309.0 | 2,324.0 |
| Closing shareholders' funds | 1,750.7 | 1,949.2 | 2,568.4 | 2,309.0 |

* The profit of Kemble Water Holdings includes the release of an impairment provision of £116.6m which was provided in the prior year

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March

1 Principal accounting policies

The following accounting policies have been applied consistently in dealing with items which the Group considered material in relation to the financial statements, except as noted below

Basis of preparation

The financial statements are prepared in accordance with the historical cost convention and with applicable accounting standards in the UK and, except for the treatment of certain capital contributions, with the Companies Act 2006. An explanation of this departure from the requirements of the Act is given in accounting policy (e) below

Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position, are set out in the Directors' Report on pages 3 to 25. The financial position of the Group, its cash flows, liquidity position and borrowing facilities are described in the Directors' Report.

The Group meets its capital programme requirements by raising new debt. Day to day working capital requirements are funded by the business. During the year, £1.83bn of new facilities were secured, of which £850m is Class B debt. There is no current requirement to raise additional finance to meet future project obligations. There are also additional committed facilities with a group of banks of £1,250m which are only likely to be used on rare occasions, in addition to the cash balances of £844.3m (2010: £714.5). Of the £1,250m, £425m 364 day facilities are due for renewal by 30 July 2011 with the remainder maturing in September 2012. The current economic conditions create uncertainty particularly over (a) the level of revenue earned from regulatory activities, (b) the increased occurrence of bad debts and (c) the availability of bank finance in the foreseeable future. The Group's forecasts and projections, taking account of reasonably possible changes in trading performance, show that the Group will be able to operate within the level of its current facilities for 15 months.

On 7 April 2011 the Group completed the refinancing of an £835m variable term loan facility at Kemble Water Structure Limited. The refinancing at Kemble Water Finance Limited comprised a £400m fixed rate bond and £425m variable rate loan facilities. The refinancing also included the restructuring of the related floating to fixed interest rate swaps.

The directors have a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

Changes in accounting estimates

Following the Government's announcement in July 2010 that statutory increases in deferment and retirement would be based on the Consumer Price Index ("CPI") rather than the Retail Price Index ("RPI"), the Group undertook a review of its Pension Schemes' rules. Following guidance contained in the Urgent Issues Task Force ("UITF") Abstract 'Accounting implications of the replacement of the Retail Price Index with the Consumer Price Index for Retirement Benefits' the Group has recognised a £27.1m credit in the Statement of total recognised gains and losses in respect of the Thames Water Mirror Image Pension Scheme ("TWMIPS"), see note 26 on page 61.

Summary of significant accounting policies

The principal accounting policies adopted in the preparation of the financial statements are set out below.

(a) Basis of consolidation

The Group financial statements consolidate the financial statements of the Company and entities controlled by the Company (its subsidiaries), made up to 31 March 2011, and incorporate the results of its share of joint ventures using equity accounting.

The results of subsidiaries disposed of during the year are included in the consolidated profit and loss account from the effective date of disposal. Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used under the relevant local GAAP into line with those used by the Group.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

Summary of significant accounting policies (continued)

(b) Subsidiaries

Control is achieved where the company has the power to govern the financial and operating policies, generally accompanied by a shareholding of more than one half of the voting rights, of an investee entity so as to obtain benefits from its activities

On acquisition, the assets and liabilities and contingent assets and liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill

All intra-group transactions, balances, income and expenses are eliminated on consolidation

(c) Revenue recognition

Revenue represents the fair value of the income receivable in the ordinary course of business for goods and services provided and are recognised in accordance with FRS 5 'Reporting the Substance of Transactions'. No adjustment is made to reduce revenue by an estimated bad debt charge to reflect the fair value as this is not deemed material. Where relevant, revenue includes an estimate of the sales value of water supplied and waste water charges to customers between the date of the last meter reading and the period end exclusive of value added tax. The estimated usage is based upon historical data, judgement and assumptions, actual results could differ from these estimates, which would result in operating revenues being adjusted in the period for which the revision to the estimates is determined. For customers who do not have a meter, the receivable billed is dependent upon the rateable value of the property, as assessed by an independent rating officer.

Additional charges added to a customer's account as a result of debt recovery activity, such as court costs or solicitors fees, are recognised as favourable operating costs when payment is received in both the statutory and regulatory accounts. The Company currently does not have any charges on income. Any outstanding revenue is recovered in the normal course of business. All water and sewerage charges billed to customers are recognised as income at the time they are billed and apportioned over the period to which they relate. For consumption by measured customers which has not yet been billed an accrual is estimated.

Where there is a change of customer in an unmeasured property but the Group cannot confirm the name, a bill is raised in the name of "The Occupier". The Group does not raise billing in the name of the Occupier for metered accounts. However, an unmeasured bill in the name of The Occupier will be cancelled and rebilled once the Group has confirmation of the customer's name. If confirmation is not received the bill is cancelled and the property is classified as empty.

Where a property is classified as empty, an empty property process is followed to verify when the property becomes occupied and/or obtain the name of the customer. The status is established with the customer at point of contact, if the property is not chargeable after 10 weeks the unfurnished/unoccupied state is confirmed visually. The empty property process comprises a number of steps. If these steps confirm that a property appears to be empty then the supply may be turned off. The property will only cease to be classified as empty when a named customer is identified and billed. The Group does not recognise income in respect of empty properties. If the Group has turned off the supply of water at the mains to a property at a customer's request then water supply charges are not payable. A customer may request the supply to be turned off in instances such as the property is to be demolished or where a house previously converted into flats (and additional supplies made) to be converted back into a house.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(c) Revenue recognition (continued)

With regard to new properties, an estimate is made of the sales value of water supplied and waste water charges to customers between the date of connection and the period end is made

The Group recognises all revenue at the time of delivery. Should the Group consider that the criteria for revenue recognition are not met for a transaction, revenue recognition would be delayed until such time as the transaction becomes fully earned. Payments received in advance of delivery are recorded as deferred revenue.

Property revenue is recognised on completion of the sale.

(d) Intangible assets

Goodwill

Purchased goodwill arising on acquisition, being the excess of the purchase price over the fair value of the net assets of a subsidiary, is capitalised and amortised to nil using the straight line method over its estimated useful economic life, of 40 years. Impairment tests on the carrying value are undertaken on an annual basis as the goodwill is amortised over a period greater than 20 years. These tests involve a comparison of the book value with the higher of the net realisable value and the value in use. A life longer than 20 years is deemed appropriate because the goodwill relates primarily to the regulated business of providing water and wastewater services which is expected to generate stable revenues and there are significant barriers to entry to this business.

Profit or loss on disposal of a previously acquired subsidiary, joint venture or associated undertaking is determined after including the attributable amount of purchased goodwill.

Other intangible assets

Other intangible assets are measured initially at cost and are amortised on a straight-line basis over their estimated useful lives. Their carrying amount is reduced by any provision for impairment where necessary.

Intangible assets currently comprise of licences and concessions. These assets are being amortised over their remaining useful lives of between 14 and 40 years.

(e) Tangible fixed assets

Tangible fixed assets comprise infrastructure assets (mains, sewers and pumped raw water storage reservoirs and sludge pipelines) and other assets (including land, buildings, properties, over ground plant and equipment).

Directly attributable costs are capitalised within fixed assets. These costs include employee costs and other internal costs that are incremental to the business due to the scale and nature of the capital implementation programme of the Group. Interest costs are not capitalised.

Infrastructure assets

Infrastructure assets comprise a network of systems. In the UK water regulated business, all expenditure on infrastructure assets is capitalised at cost and not depreciated, whilst the planned element incurred in maintaining the operating capability of the network in accordance with defined service standards is expensed as depreciation.

Following the completion of the Group's assessment of the infrastructure renewals expenditure requirement to the end of AMP7 for the Final Business Plan the Group now considers that it would be appropriate to reflect in its regulatory and statutory accounts for 2008/09 and 2009/10 an infrastructure renewals charge consistent with its expenditure plans for the AMP5 to AMP7 (2011-2025) periods.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(e) Tangible fixed assets (continued)

Capital contributions

Capital contributions received in respect of infrastructure assets have been deducted from the cost of fixed assets. This is not in accordance with Schedule 1 to the Companies Act 2006 that requires fixed assets to be stated at their purchase price without deduction of contributions, which are accordingly accounted for as deferred income. This departure from the requirement of the Act is, in the opinion of the directors, necessary for the financial statements to give a true and fair view because infrastructure assets do not have a determinable finite life.

Where material, contributions received towards the cost of other assets are accounted for as deferred income and released to the profit and loss account over the estimated economic lives of the assets.

Other assets

All other assets, comprising plant and equipment and land and buildings, are stated at cost less accumulated depreciation.

Cost includes expenditure that is directly attributable to the acquisition of the items. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably.

Freehold land is not depreciated and assets in the course of construction are not depreciated until they are commissioned. Other assets are depreciated by writing off their cost less their estimated residual value by equal instalments over their estimated useful lives down to zero, based on management's judgement and experience, which are principally as follows:

| | |
|--|-------------|
| Buildings | 15 - 50 yrs |
| Operational structures | 30 - 100yrs |
| Other | 5 - 40yrs |
| Fixtures, fittings, vehicles and computers | 3 - 7yrs |
| Fixed and mobile plant | 3 - 40yrs |

Depreciation methods, residual values and useful lives are re-assessed annually and, if necessary, changes are accounted for prospectively.

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in the profit and loss account.

Impairment of tangible and intangible assets excluding goodwill

Intangible assets and tangible fixed assets are assessed for impairment whenever there is an indication of such. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. Where the asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

The recoverable amount is the higher of fair value less costs to sell, and value in use. Value in use represents the net present value of expected future cash flows discounted on a pre-tax basis using a rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(e) Tangible fixed assets (continued)

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash-generating unit) is reduced to its recoverable amount. Impairment of non-current assets is recognised in the profit and loss account within operating costs.

Where an impairment loss subsequently reverses, it is recognised in the profit and loss account and the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but not so as to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

(f) Stocks

Stock and work in progress are stated at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs and those overheads that have been incurred in bringing the inventories to their present location and condition. Cost is calculated using the weighted average method. Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

(g) Pre-contract costs

Pre-contract costs are expensed as incurred, except where it is virtually certain that the contract will be awarded, in which case they are recognised as an asset and written off to the profit and loss account over the life of the contract.

(h) Taxation

The tax expense represents the sum of current tax and deferred tax.

Current taxation

Current tax, including UK corporation tax and foreign tax, is based on the taxable profit for the year and is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantially enacted at the balance sheet date. Taxable profit differs from the profit on ordinary activities before tax as reported in the profit and loss account 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.

Deferred taxation

Deferred tax is recognised, without discounting, in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by FRS 19 Deferred Taxation.

A net deferred tax asset is regarded as recoverable and therefore recognised only when, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits against which to recover carried forward tax losses and from which the future reversal of underlying timing differences can be deducted.

Deferred taxation is measured at the average tax rates that are expected to apply in the years in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted by the balance sheet date.

Deferred tax is charged or credited in the profit and loss account except when it relates to items charged or credited to equity, in which case the deferred tax is also dealt with via the Statement of Total Recognised Gains and Losses.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(i) Leased assets

Leases are classified according to the substance of the transaction. A lease that transfers substantially all the risks and rewards of ownership to the lessee is classified as a finance lease. All other leases are classified as operating leases.

Finance leases

Finance leases are capitalised in the balance sheet at their fair value or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease.

The corresponding liability is shown as a finance lease obligation to the lessor. Leasing repayments comprise both a capital and a finance element. The finance element is written off to the profit and loss account so as to produce an approximately constant periodic rate of charge on the outstanding obligation. Such assets are depreciated over the shorter of their estimated useful lives and the period of the lease to the first break clause.

Operating leases

Operating lease rentals are charged to the profit and loss account on a straight-line basis over the period of the lease.

(j) Pension and other post retirement benefits

Pension obligations

The Group operates two large defined benefit pension schemes. The Group accounts for these schemes in accordance with FRS 17 'Retirement Benefits'. These schemes are independently administered funds, for the substantial majority of the Group's employees. Actuarial valuations are carried out as determined by the pension scheme trustees using the projected unit credit method for both pension schemes at intervals of not more than three years, the rates of contribution payable and the pension cost being determined on the advice of the actuaries, having regard to the results of these valuations. The Group believes that the assumptions utilised in recording obligations under the two schemes are reasonable based on prior experience, market conditions and the advice of scheme actuaries. However, actual results may differ from such assumptions. For any intervening reporting period, the actuaries review the continuing appropriateness of the contribution rates (a complete actuarial valuation is performed every three years). Defined benefit assets are measured at fair value while liabilities are measured at present value (which approximates to fair value).

The difference between the assets and liabilities of the schemes are recognised as a surplus (to the extent that the surplus is recoverable) or obligation in the balance sheet.

The cost of providing pension benefits to employees is included in the profit and loss account within the cost of employee benefits. The difference between the expected return on scheme assets and interest on scheme liabilities are included within other finance income/expense in the profit and loss account.

Actuarial gains and losses are recognised outside the profit and loss account in retained earnings and are presented in the Statement of total recognised gains and losses.

In addition, the Group operates two closed defined contribution pension schemes. The Group has no further payment obligations for these schemes. However, defined funds for individuals are held within these schemes.

During 2010-11 the Group has introduced a new Defined Contribution Stakeholder Pension Scheme ("DCSPS"), managed through Standard Life Assurance Limited ("Standard Life"). In 2010-11 the only members joining this scheme were six newly-recruited executives joining the Group who were not offered a defined benefit pension arrangement. From 1 April 2011 the DCSPS will become the only scheme to which new entrants to the Group will be eligible. The remainder of the Group's Extended Leadership Team of executives have joined this scheme from 1 April 2011 and are no longer active members of a defined benefit arrangement.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(j) Pension and other post retirement benefits (continued)

Pension obligations (continued)

For further details in respect of changes in accounting estimates see note 1, page 33

In addition, the Group also operates two closed defined contribution pension schemes. The Group has no further payment obligations for these schemes, however, defined funds for individuals are held within these schemes

(k) Foreign currencies

Transactions in foreign currencies are recorded using the rate of exchange current on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into sterling at the rate of exchange current at the balance sheet date. Gains and losses arising on retranslation are included in the profit and loss account. The foreign exchange loss shown in reserves is as a result of revaluation of certain balance sheet accounts.

On consolidation, the balance sheets of overseas subsidiaries and joint ventures (none of which has the currency of a hyper inflationary economy) are translated into sterling at exchange rates applicable at the balance sheet date. The profit and loss accounts are translated into sterling using the average rate unless exchange rates fluctuate significantly in which case the exchange rate at the date the transaction occurred is used. Exchange differences resulting from the translation of such balance sheets at rates ruling at the beginning and end of the year together with the differences between profit and loss accounts translated at average rates and rates ruling at the year end, are dealt with as movements on the profit and loss reserve as shown in the Statement of Total Recognised Gains and Losses.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing exchange rate. Foreign currency borrowings are recorded at the hedged rate at the balance sheet date.

(l) Cash and cash equivalents

Cash comprises cash at bank and in hand, deposits and other short-term highly liquid investments which are readily convertible on initial investment into known amounts of cash at any time without penalty or if a maturity or period of notice of not more than 24 hours or one working day has been agreed.

(m) Debtors

Debtors are stated at nominal value (which approximates to fair value) less allowances for estimated irrecoverable amounts.

(n) Creditors

Creditors are stated at their nominal value (which approximates to fair value).

(o) Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities. Equity instruments issued by the Group are recorded at the proceeds received, net of direct issue costs.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

1 Principal accounting policies (continued)

(p) Borrowings

Interest bearing bank loans and overdrafts are recorded as the proceeds received net of direct issue costs. Finance charges, including premiums payable on settlement or redemption and direct issue costs, are accounted for on an amortised cost basis to the profit and loss account using the effective interest method and are added to the carrying amount of the instrument to the extent that they are not settled in the year in which they arise.

(q) Financial instruments and derivatives

Interest rate swap agreements and financial futures are used to manage interest rate exposure. While the Group enters into currency swaps to manage its exposure to fluctuations in exchange rates, the Group does not use derivative financial instruments for speculative purposes.

The Group currently does not apply FRS 26 'Financial Instruments Recognition and Measurement', and accordingly the disclosure requirements of FRS 29 'Financial Instruments Disclosures' are not applicable. Therefore, the presentation requirements of FRS 25 'Financial Instruments Presentation' have been applied. However, certain voluntary disclosures have been prepared to aid understanding and ensure comparability with prior year.

Foreign currency and interest rate swaps are accounted for on an amortised cost basis in accordance with FRS 4 'Capital Instruments'. Swaps are included in the appropriate caption in notes 17 and 18.

(r) Accruals and deferred income

Grants and contributions receivable in respect of depreciating fixed assets are treated as deferred income, which is credited to the profit and loss account over the estimated economic lives of the related assets.

(s) Research and development

Research expenditure is written off to the profit and loss account in the year in which it is incurred.

(t) Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Insurance provisions are recognised or released by assessing their adequacy using current estimates of future cashflows under insurance contracts.

(u) Dividends

Dividends unpaid at the balance sheet date are only recognised as a liability at that date to the extent that they are appropriately authorised and are no longer at the discretion of the Group. Unpaid dividends that do not meet these criteria are disclosed in the notes to the financial statements.

Dividend income is recognised when there is a legal right to receive.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

2 Segmental analysis

The segments by class of business are

Regulated: This incorporates the business activities of Thames Water Utilities Limited and its apportionment of fair value and goodwill derived from the purchase by Kemble Water Limited

Other/non-regulated: All other activities including provision of engineering, utility network and asset and facilities management services, land and property development and those activities carried out in managing the Group, including insurance services provided by the captive insurer to the Group and financing arrangements in the holding companies

No geographic segmental analysis is necessary as all material activity and net assets are within the UK

Profit and loss account by class of business:

| | Year end 31 March 2011 | | | Year end 31 March 2010 | | |
|---|------------------------|-------------------------------|----------------|------------------------|-------------------------------|----------------|
| | Regulated £m | Other/non -regulated £m | Total £m | Regulated £m | Other/non -regulated £m | Total £m |
| Turnover | 1,623.1 | 18.8 | 1,641.9 | 1,623.8 | 35.7 | 1,659.5 |
| Group turnover | 1,623.1 | 18.8 | 1,641.9 | 1,623.8 | 35.7 | 1,659.5 |
| Operating profit/(loss) | 600.2 | (65.2) | 535.0 | 671.1 | (23.2) | 647.9 |
| Add share of joint ventures | - | 0.4 | 0.4 | - | (0.4) | (0.4) |
| Group operating profit/(loss) | 600.2 | (64.8) | 535.4 | 671.1 | (23.6) | 647.5 |
| Profit on sale of fixed asset | 10.9 | (1.9) | 9.0 | 37.9 | 1.0 | 38.9 |
| Group profit on sale of fixed assets | 10.9 | (1.9) | 9.0 | 37.9 | 1.0 | 38.9 |
| Net interest payable | (402.6) | (247.4)* | (650.0) | (255.4) | (173.1)* | (428.5) |
| Group net interest payable | (402.6) | (247.4)* | (650.0) | (255.4) | (173.1)* | (428.5) |
| Taxation | 16.7 | 7.7 | 24.4 | (122.6) | 28.2 | (94.4) |
| Group taxation | 16.7 | 7.7 | 24.4 | (122.6) | 28.2 | (94.4) |
| Profit/(loss) after tax | 225.2 | (306.4) | (81.2) | 331.0 | (167.5) | 163.5 |
| Group profit/(loss) after tax | 225.2 | (306.4) | (81.2) | 331.0 | (167.5) | 163.5 |

* Interest payable relates to the funding required for the acquisition of the regulated group

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

2 Segmental analysis (continued)

Balance sheet by class of business:

| | 31 March 2011 | | | 31 March 2010 | | |
|--|-----------------|-------------------------------|-----------------|-----------------|-------------------------------|-----------------|
| | Regulated £m | Other/non -regulated £m | Total £m | Regulated £m | Other/non- regulated £m | Total £m |
| Fixed assets | | | | | | |
| Intangible assets | 1,581.1 | 1.0 | 1,582.1 | 1,625.5 | 1.0 | 1,626.5 |
| Tangible assets | 10,058.6 | 5.0 | 10,063.6 | 9,467.2 | 5.0 | 9,472.2 |
| Investment in joint ventures | | | | | | |
| Share of gross assets | - | 3.6 | 3.6 | - | 3.5 | 3.5 |
| Share of gross liabilities | - | (3.6) | (3.6) | - | (3.5) | (3.5) |
| Other fixed asset investments | - | 0.1 | 0.1 | - | 0.1 | 0.1 |
| | 11,639.7 | 6.1 | 11,645.8 | 11,092.7 | 6.1 | 11,098.8 |
| Current assets | | | | | | |
| Stocks | 8.2 | 0.6 | 8.8 | 7.7 | 3.6 | 11.3 |
| Debtors amounts falling due within one year | 621.9 | 23.0 | 644.9 | 603.0 | 31.4 | 634.4 |
| Debtors amounts falling due after one year (inter group loan) | 1,865.0 | (1,865.0) | - | 1,180.0 | (1,180.0) | - |
| Current asset investments | 775.8 | 26.7 | 802.5 | 573.2 | 92.8 | 666.0 |
| Cash at bank and in hand | 3.6 | 38.2 | 41.8 | 5.9 | 42.6 | 48.5 |
| | 3,274.5 | (1,776.5) | 1,498.0 | 2,369.8 | (1,009.6) | 1,360.2 |
| Creditors amounts falling due within one year | (1,016.3) | (100.7) | (1,117.0) | (1,350.5) | 41.7 | (1,308.8) |
| Net current assets/(liabilities) | 2,258.2 | (1,577.2) | 381.0 | 1,019.3 | (967.9) | 51.4 |
| Total assets/(liabilities) less current assets/(liabilities) | 13,897.9 | (1,871.1) | 12,026.8 | 12,112.0 | (961.8) | 11,150.2 |
| Creditors amounts falling due after more than one year | (7,748.7) | (1,413.0) | (9,161.7) | (5,789.7) | (2,232.4) | (8,022.1) |
| Provisions for liabilities and charges | (1,054.3) | 31.3 | (1,023.0) | (1,098.3) | 24.1 | (1,074.2) |
| Net assets/(liabilities) excluding pension (liabilities)/assets | 5,094.9 | (3,252.8) | 1,842.1 | 5,224.0 | (3,170.1) | 2,053.9 |
| Net pension (liabilities)/assets | (94.6) | 3.2 | (91.4) | (107.4) | 2.7 | (104.7) |
| Net assets/(liabilities) including pension (liabilities)/assets | 5,000.3 | (3,249.6) | 1,750.7 | 5,116.6 | (3,167.4) | 1,949.2 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

2 Segmental analysis (continued)

The Regulated business net assets above include the net book values of goodwill of £1,581.1m (2010 £1,625.5m), fair value adjustments to tangible assets of £1,932.7m (2010 £1,954.2m) and financial instruments included in creditors falling due after more than one year of £267.6m (2010 £278.3m). The non-regulated business has a goodwill apportionment of £nil (2010 £nil).

3 Operating costs

| | Year end 31 March 2011 | Year end 31 March 2010 |
|--|---------------------------|---------------------------|
| | £m | £m |
| Staff costs (note 5) | 210.7 | 208.3 |
| Materials and consumables | 135.9 | 133.7 |
| Other operating charges | 441.4 | 416.6 |
| Amortisation of goodwill and intangibles | 44.4 | 44.4 |
| Depreciation | | |
| - owned assets | 272.6 | 241.3 |
| - infrastructure assets renewal charge | 132.4 | 114.0 |
| - assets held under finance leases | 9.6 | 9.6 |
| Rentals under operating leases | | |
| - hire of plant and machinery | 9.3 | 3.1 |
| - other | 5.4 | 7.2 |
| Research and development | 3.4 | 3.5 |
| Auditor's remuneration | 0.8 | 0.5 |
| Foreign currency losses | 0.9 | 0.6 |
| | 1,256.3 | 1,182.8 |
| Own work capitalised | (159.9) | (171.2) |
| | 1,106.9 | 1,011.6 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

3 Operating costs (continued)

| Further analysis of auditor's remuneration | Year end 31 March 2011 £'000 | Year end 31 March 2010 £'000 |
|---|---------------------------------------|---------------------------------------|
| Fees payable to current auditor: | | |
| Amounts receivable by the auditor and their associates in respect of | | |
| Audit of these financial statements | 31 | 30 |
| Audit of financial statements of subsidiaries pursuant to legislation | 320 | 294 |
| Assurance services | 163 | 110 |
| Other services pursuant to such legislation | - | 66 |
| Other services relating to taxation | 18 | 4 |
| All other services | 284 | 110 |
| | 816 | 614 |

No other fees were payable to KPMG Audit Plc in respect of this year or the prior year

4 Information regarding directors

| Aggregate directors' emoluments: | Year end 31 March 2011 £'000 | Year end 31 March 2010 £'000 |
|----------------------------------|---------------------------------------|---------------------------------------|
| Salary | 320 | 455 |
| Bonus | - | 589 |
| Total | 320 | 1,044 |

Highest paid director:

Total emoluments, including payments and accruals under long term incentive schemes of the highest paid director in respect of work done for the Group during the year was £275,000 (2009 £623,877) and accrued pension under the Group's defined benefit scheme was £n/a (2010 £n/a)

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

5 Staff numbers and costs

The aggregate payroll costs were as follows:

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| - Wages and salaries | 170.3 | 178.6 |
| - Social security costs | 13.7 | 18.9 |
| - Other pension costs (note 26) | 25.4 | 11.8 |
| - Severance costs | 3.1 | 0.9 |
| | 212.5 | 210.2 |
| Employment costs included within research and development | (1.8) | (1.9) |
| Net employment costs | 210.7 | 208.3 |

The average number of persons employed by the Group (including directors) during the year, analysed by category, was as follows

| | Year end 31 March 2011 Number | Year end 31 March 2010 Number |
|------------|--|--|
| Operations | 4,578 | 4,803 |
| Support | 335 | 292 |
| | 4,913 | 5,095 |

6 Interest receivable and similar income

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---------------------|------------------------------------|------------------------------------|
| Interest receivable | 6.1 | 7.9 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

7 Interest payable and similar charges

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|--|------------------------------------|------------------------------------|
| On bank loans and overdrafts | (6.2) | (15.4) |
| Swaps | (82.8) | (16.5) |
| Amortisation of issue costs of loans | (12.8) | (6.7) |
| On all other loans | (543.8) | (373.0) |
| Finance charges payable in respect of finance leases | (5.6) | (9.8) |
| Pension interest (note 26) | (4.3) | (14.8) |
| Other finance charges | (0.6) | (0.2) |
| Interest payable and similar charges | (656.1) | (436.4) |

Amounts payable on swaps relate to interest rate swaps taken out to hedge rates on external borrowings. Refer to note 19. The net interest payable on swaps (2010 payable) is the aggregate effect of all swaps held in the Group.

8 Taxation on profit on ordinary activities

| Analysis of credit/(charge) in year | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| UK corporation tax - amounts payable in respect of corporation tax for the year | (0.8) | (15.7) |
| Adjustments in respect of previous years | 14.1 | (4.1) |
| Total current tax credit/(charge) | 13.3 | (19.8) |
| Deferred tax | | |
| Origination and reversal of timing differences | (51.6) | (57.4) |
| Adjustment in respect of previous year | (1.4) | (11.3) |
| Current year restatement due to tax rate change to 26% | 69.5 | - |
| Pension cost charge lower than pension cost relief | (5.4) | (5.9) |
| Total deferred tax credit/(charge) | 11.1 | (74.6) |
| Tax credit/(charge) on (loss)/profit on ordinary activities | 24.4 | (94.4) |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

8 Taxation on profit on ordinary activities (continued)

Factors affecting tax (charge)/credit for year

The current tax credit/(charge) for the year is lower than (2010 lower than) the standard rate of corporation tax in the UK of 28% (2010 28%) The differences are explained below

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| (Loss)/profit on ordinary activities before taxation | (105.6) | 257.9 |
| (Loss)/profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 28% (2010 28%) | 29.6 | (72.2) |
| Effects of | | |
| Capital allowances in excess of depreciation and other timing differences | 51.6 | 57.4 |
| Tax losses unable to be used | (67.2) | - |
| Disallowable expenditure and other permanent differences | (20.2) | (6.8) |
| Net pension cost charge lower than pension cost relief | 5.4 | 5.9 |
| Adjustments to tax charge in respect of previous years | 14.1 | (4.1) |
| Current tax credit/(charge) for the year | 13.3 | (19.8) |

The tax charge attributable to the profit on sale of fixed assets is £1.2m (2010 £4.9m)

Of the deferred tax credit as at 31 March 2011 of £11.1m (2010 £74.6m charge) a deferred tax credit for the year ended 31 March 2011 of £16.5m (2010 £68.7m charge) is shown as a movement within note 20 provisions for liabilities and charges and a deferred tax charge for the year ended 31 March 2011 of £5.4m (2010 £5.9m) is shown within note 26 (Pension schemes) Deferred tax not recognised in respect of tax losses is £89.2m (2010 £97.7m)

Factors affecting the future tax rate

On 23 March 2011 the Chancellor announced the reduction in the main rate of UK corporation tax to 26% with effect from 1 April 2011 This change became substantively enacted on 29 March 2011 and therefore the effect of the rate reduction creates a reduction in the deferred tax asset which has been included in the figures above

9 Dividends

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| First interim paid 5.7p (2010 7.8p) per £1.00 ordinary share | 115.1 | 156.4 |
| | 115.1 | 156.4 |

As a post balance sheet event, on 9 June 2011 the directors approved a first interim dividend of £100.0m (5.02p per ordinary share) in respect of the year ended 31 March 2011

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

10 Profit of holding company

A profit of £374.5m (2010 profit £141.4m) (pre-distribution) has been dealt with in the accounts of Kemble Water Holdings Limited. A separate profit and loss account for the Company has not been presented as permitted by Section 408 of the Companies Act 2006.

11 Intangible assets

| | Goodwill £m | Group Other intangible assets £m | Total £m |
|-------------------------------|----------------|--|----------------|
| Cost | | | |
| At the beginning of the year | 1,773.4 | 1.6 | 1,775.0 |
| Disposal | - | (1.2) | (1.2) |
| At the end of the year | 1,773.4 | 0.4 | 1,773.8 |
| Amortisation | | | |
| At the beginning of the year | (147.8) | (0.7) | (148.5) |
| Disposal | - | 1.2 | 1.2 |
| Charge for the year | (44.4) | - | (44.4) |
| At the end of the year | (192.2) | 0.5 | (191.7) |
| Net book value | | | |
| At the end of the year | 1,581.2 | 0.9 | 1,582.1 |
| At the beginning of the year | 1,625.6 | 0.9 | 1,626.5 |

Other intangible assets include concessions, licences and similar rights and assets.

The Company has no intangible assets.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

12 Tangible fixed assets

| | Group | | | | |
|-------------------------------|------------------------------|-----------------------------|-------------------------------------|--|------------------|
| | Plant and equipment £m | Land and buildings £m | Infra- structure assets £m | Assets in course of construction £m | Total £m |
| Cost | | | | | |
| At the beginning of the year | 3,138.1 | 1,982.5 | 4,385.5 | 1,176.3 | 10,682.4 |
| Reclassification* | - | - | 13.7 | - | 13.7 |
| Additions | | | | 1,035.0 | 1,035.0 |
| Transfers between items** | 317.9 | 242.9 | 461.8 | (1,022.6) | - |
| Disposals | (3.8) | (0.7) | - | - | (4.5) |
| At the end of the year | 3,452.2 | 2,224.7 | 4,861.0 | 1,188.7 | 11,726.6 |
| Capital contributions | | | | | |
| At the beginning of the year | - | - | (98.9) | - | (98.9) |
| Reclassifications | - | - | (13.7) | - | (13.7) |
| Additions | - | - | (26.4) | - | (26.4) |
| At the end of the year | - | - | (141.0) | - | (141.0) |
| Depreciation | | | | | |
| At the beginning of the year | (513.5) | (227.7) | (370.1) | - | (1,111.3) |
| Provided during the year | (234.7) | (47.5) | (132.4) | - | (414.6) |
| Disposals | 3.7 | 0.2 | - | - | 3.9 |
| At the end of the year | (744.5) | (275.0) | (502.5) | - | (1,522.0) |
| Net book value | | | | | |
| At the end of the year | 2,707.7 | 1,949.7 | 4,217.5 | 1,188.7 | 10,063.6 |
| At the beginning of the year | 2,624.6 | 1,754.8 | 3,916.5 | 1,176.3 | 9,472.2 |

* The directors have reclassified income received in respect of new infrastructure assets to capital contributions, which were incorrectly shown within additions in a prior period. The net book values have been unaffected as a result of this reclassification.

** The transfers between items within land and buildings include Thames Tunnel land purchase of £80.8m.

Depreciation has not been charged on freehold land stated in the financial statements at cost of £117.1m (2010 £34.9m).

The Company has no tangible fixed assets (2010: £nil).

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

12 Tangible fixed assets (continued)

The net book value of land and buildings comprises

| | 31 March 2011 £m | 31 March 2010 £m |
|-----------------|---------------------------------|------------------------|
| Group | | |
| Freehold | 1,939.1 | 1,749.3 |
| Long leasehold | 7.8 | 2.7 |
| Short leasehold | 2.8 | 2.8 |
| | 1,949.7 | 1,754.8 |

Details of the Group's tangible fixed assets which are held under finance leases are

| | Plant and equipment total £m |
|--------------------------------------|---------------------------------------|
| Cost | |
| At the beginning and end of the year | 272.5 |
| Depreciation | |
| At the beginning of the year | (136.5) |
| Charge for the year | (9.6) |
| At the end of the year | (146.1) |
| Net book value | |
| At the end of the year | 126.4 |
| At the beginning of the year | 136.0 |

13 Fixed asset investments

In accordance with FRS 9, where the carrying value of an individual investment is less than £nil, the negative carrying value has been disclosed in provisions for liabilities and charges within other provisions (note 20)

The associated undertakings and joint ventures are all unlisted

The Company has no (2010: none) investments in joint ventures or associates

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

13 Fixed asset investments (continued)

Group

| Interests in investments | £m |
|--------------------------------------|-----------|
| Cost | |
| At the beginning and end of the year | 0.1 |
| Net book value | |
| At the beginning and end of the year | 0.1 |

Company

| | Investment in subsidiary undertakings £m |
|--------------------------------------|---|
| Cost | |
| At the beginning and end of the year | 1.0 |

The investment relates to Kemble Water Eurobond Plc

See note 29 for a list of principal subsidiaries

14 Stocks

| | 31 March 2011 £m | 31 March 2010 £m |
|-------------------------------------|---------------------------------|---------------------------------|
| Group | | |
| Raw materials and consumables | 5.8 | 5.8 |
| Work in progress | - | 3.6 |
| Finished goods and goods for resale | 3.0 | 1.9 |
| | 8.8 | 11.3 |

The Company has no stocks (2010: £nil)

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

15 Debtors

| | Group | | Company | |
|--------------------------------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Due within one year: | | | | |
| Trade debtors | 273.4 | 251.4 | - | - |
| Amounts owed by Group undertakings | - | - | 3,011.8 | 2,652.0 |
| Corporation tax receivable | 34.8 | 20.1 | - | - |
| Other debtors | 122.1 | 112.5 | - | - |
| Prepayments and accrued income | 214.6 | 250.4 | - | - |
| | 644.9 | 634.4 | 3,011.8 | 2,652.0 |
| | £m | £m | £m | £m |
| Inter-company loans within one year | - | - | 1,990.6 | 1,990.6 |
| | - | - | | |
| Non-loan amounts due within one year | - | - | 1,021.2 | 778.1 |
| | - | - | 3,011.8 | 2,768.7 |

A loan of £1,990.6m (2010: £1,990.6m) which incurs interest at 18% (2010: 18%) is owed by the immediate subsidiary company, Kemble Water Eurobond Plc. All other amounts owed by subsidiary undertakings are unsecured, interest free and repayable on demand.

16 Investments

| | Group | | Company | |
|---------------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Short term deposits | 802.5 | 666.0 | - | - |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

17 Creditors: amounts falling due within one year

| | Group | | Company | |
|------------------------------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Secured bank loans and overdrafts | 7.6 | 395.5 | - | - |
| Trade creditors – operating | 253.9 | 247.4 | - | - |
| Trade creditors – capital | 332.3 | 201.6 | - | - |
| Obligations under finance leases | 7.9 | 8.3 | - | - |
| Corporation tax payable | - | - | 100.3 | 100.3 |
| Taxation and social security | 4.8 | 11.2 | - | - |
| Other creditors | 124.5 | 136.3 | - | - |
| Interest creditors | 212.0 | 168.1 | - | - |
| Amounts owed by group undertakings | - | - | 344.1 | 243.7 |
| Accruals and deferred income | 174.0 | 140.4 | - | - |
| | 1,117.0 | 1,308.8 | 444.4 | 344.0 |

18 Creditors: amounts falling due after more than one year

| | Group | | Company | |
|----------------------------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Secured bank loans | 1,718.9 | 2,581.5 | - | - |
| Other loans | 7,066.7 | 5,038.0 | - | - |
| Obligations under finance leases | 187.1 | 195.3 | - | - |
| Deferred income | 189.0 | 207.3 | - | - |
| | 9,161.7 | 8,022.1 | - | - |

Other loans are all secured except for a loan of £310.4m (2010: £310.4m). For further detail of security see note 28.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

19 Financial instruments

Short-term debtors and creditors

Short-term debtors and creditors have been excluded from the following financial instruments disclosures, other than the currency risk disclosures

Group financial assets

Interest rate risk profile at 31 March

| | Total at floating rates | | Total at fixed rates | | No interest | | Total book value | | Weighted average interest rate for fixed rate assets | | Weighted average period until maturity for which rate is fixed | |
|--------------------------|-------------------------|------------|----------------------|------------|-------------|------------|------------------|------------|--|-----------|--|---------------|
| | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 % | 2010 % | 2011 Years | 2010 Years |
| Current asset investment | | | | | | | | | | | | |
| - £ Sterling | 802.5 | 666.0 | - | - | - | - | 802.5 | 666.0 | - | - | - | - |
| | 802.5 | 666.0 | - | - | - | - | 802.5 | 666.0 | - | - | - | - |
| Cash at bank/hand | | | | | | | | | | | | |
| - £ Sterling | 41.8 | 48.5 | - | - | - | - | 41.8 | 48.5 | - | - | - | - |
| \$ US | - | - | - | - | - | - | - | - | - | - | - | - |
| - Other | - | - | - | - | - | - | - | - | - | - | - | - |
| | 41.8 | 48.5 | - | - | - | - | 41.8 | 48.5 | - | - | - | - |
| | 844.3 | 714.5 | - | - | - | - | 844.3 | 714.5 | - | - | - | - |

LIBOR and Bank of England base rate are the benchmark rates for floating current asset investments and cash at bank respectively

Group financial liabilities

Interest rate risk profile at 31 March

| | Total at floating rates | | Total at fixed rates * | | No interest | | Total book value | | Weighted average interest rate for fixed rate liabilities | | Weighted average period until maturity for which rate is fixed | |
|--------------------------------|-------------------------|------------|------------------------|------------|-------------|------------|------------------|------------|---|-----------|--|---------------|
| | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 £m | 2010 £m | 2011 % | 2010 % | 2011 Years | 2010 Years |
| Bank loans and overdraft | | | | | | | | | | | | |
| - £ Sterling | 122.3 | 592.1 | 1,596.5 | 2,134.8 | - | - | 1,718.8 | 2,726.9 | 5.5 | 5.2 | 18.0 | 20.9 |
| | 122.3 | 592.1 | 1,596.5 | 2,134.8 | - | - | 1,718.8 | 2,726.9 | 5.5 | 5.2 | 18.0 | 20.9 |
| Other loans and finance leases | | | | | | | | | | | | |
| - £ Sterling | 323.8 | 96.3 | 6,945.6 | 4,791.6 | - | - | 7,269.4 | 4,887.9 | 3.7 | 5.1 | 23.9 | 25.6 |
| - \$ US | - | 103.9 | - | (93.6) | - | - | - | 10.3 | - | 2.2 | - | 5.3 |
| - Other | - | - | - | 593.5 | - | - | - | 593.5 | - | 5.3 | - | 8.9 |
| | 323.8 | 200.2 | 6,945.6 | 5,291.5 | - | - | 7,269.4 | 5,491.7 | 3.7 | 5.2 | 23.9 | 23.2 |
| | 446.1 | 792.3 | 8,542.1 | 7,426.3 | - | - | 8,988.2 | 8,218.6 | 4.0 | 5.2 | 22.8 | 23.2 |

*Included in fixed rate liabilities are index linked bonds at a fixed coupon rate with an indexation adjustment based on RPI

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

19 Financial instruments (continued)

The Group's interest rate and cross currency swaps are £2,002.5m (2010 £1,493.8m) of floating to fixed interest rate swaps and £nil (2010 £235.0m) of fixed to floating interest rate swaps. Cross currency swaps hedge currency risk on £603.9m (2010 £707.7m) of foreign currency borrowings.

The Company has no interest rate swaps nor cross currency swaps (2010 £nil).

Short term borrowings at floating rates bear interest at rates linked to LIBOR. Fixed rate borrowings of £8,542.1m (2010 £7,408.6m) equate to 95% (2010 90%).

Currency risk

The Group is not exposed to any significant currency risk after matching foreign currency assets and liabilities and taking the effects of its hedging instruments into consideration.

Fair values

Fair value is the amount at which a financial instrument could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale. The table below sets out a comparison of the book and fair values of the Group's financial instruments.

| | Book Value | | Fair value | |
|--|---------------------|---------------------|---------------------|---------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Primary financial instruments held or issued to finance the Group's operations: | | | | |
| Financial assets | | | | |
| Current asset investments | 802.5 | 666.0 | 802.5 | 666.0 |
| Cash at bank and in hand | 41.8 | 48.5 | 41.8 | 48.5 |
| Financial liabilities | | | | |
| Bank loans and overdrafts | (1,718.8) | (2,656.4) | (1,759.3) | (2,716.9) |
| Other loans and finance leases | (7,127.6) | (5,491.7) | (6,798.9) | (5,553.3) |
| Derivative financial instruments held to manage the interest rate and currency profile. | | | | |
| Interest rate and index-linked swaps | (31.1) | (25.1) | (426.6) | (289.6) |
| Cross currency swaps and forward foreign currency contracts | (116.7) | (45.4) | (38.9) | (35.8) |
| | (8,143.9) | (7,504.1) | (8,179.4) | (7,881.1) |

The Company does not have bonds (2010 £nil).

Other loans include bonds, which are publicly traded. Fair values for these have been calculated using the 31 March 2011 quoted prices. Mark-to-market techniques (discounting expected cash flows at prevailing interest and exchange rates) are employed in computing fair values for the remaining fixed rate borrowing and all derivative financial instruments.

Book values of primary financial instruments include the effect of any hedging instrument. Therefore, the effect of revaluing foreign currency borrowing at closing rates is included in the fair valuation.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

19 Financial instruments (continued)

Maturities

The maturity profile of the carrying amount of the Group's financial liabilities other than short-term creditors and accruals and creditors more than 1 year, as disclosed on page 53, is as follows

| | Group | | Company | |
|----------------------------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Bank loans and overdrafts | | | | |
| - Within one year | - | 145.4 | - | - |
| - Between one and two years | - | 823.0 | - | - |
| - Between two and five years | 835.0 | 845.8 | - | - |
| - After more than five years | 883.8 | 912.9 | - | - |
| | 1,718.8 | 2,727.1 | - | - |
| Other loans | | | | |
| - Within one year | 7.6 | 250.1 | - | - |
| - Between one and two years | 470.0 | 10.3 | - | - |
| - Between two and five years | 301.5 | 549.5 | - | - |
| - after more than five years | 6,295.3 | 4,478.0 | - | - |
| | 7,074.4 | 5,287.9 | - | - |
| Finance leases | | | | |
| - Within one year | 7.9 | 8.3 | - | - |
| - Between one and two years | 56.5 | 9.4 | - | - |
| - Between two and five years | 93.2 | 138.5 | - | - |
| - after more than five years | 37.4 | 47.4 | - | - |
| | 195.0 | 203.6 | - | - |
| Total borrowings | 8,986.2 | 8,218.6 | - | - |

Loans are repayable between 2011 and 2062

Loans wholly repayable after more than five years are

| | Group | | Company | |
|-------------|------------------------|------------------------|------------------------|------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Bank loans | 883.8 | 912.9 | - | - |
| Other loans | 6,295.3 | 4,478.1 | - | - |
| | 7,179.1 | 5,391.0 | - | - |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

19 Financial instruments (continued)

Other loans include

| | | | |
|---|-----------------------------------|---|--|
| - | £200m 4.90% Secured bond due 2015 | - | £100m 1.85% Index linked bond due 2047 |
| - | £200m 5.05% Secured bond due 2020 | - | £200m 1.82% Index linked bond due 2049 |
| - | £225m 6.59% Secured bond due 2021 | - | £300m 1.68% Index linked bond due 2053 |
| - | £330m 6.75% MTN Eurobond due 2028 | - | £200m 1.77% Index linked bond due 2057 |
| - | £200m 6.50% MTN Eurobond due 2032 | - | £350m 1.76% Index linked bond due 2062 |
| - | £600m 5.13% MTN Eurobond due 2037 | | |

| Loans repayable by instalments after more than five years are | Group | | Company | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2011 £m | 31 March 2010 £m |
| Other loans and finance leases | 37.4 | 47.4 | - | - |

The range of interest rates on outstanding bank loans, other loans and finance leases are 1.23% to 11.0% (2010 1.23% to 11.0%). These interest rates are those contracted on the underlying borrowings before taking account of interest rate protection.

Borrowing facilities

At 31 March 2011 the Group has access to committed credit facilities of £1.2bn (2010 £1.1bn) of which £nil (2010 £nil) had been drawn at the balance sheet date, through its subsidiary company Thames Water Utilities Cayman Finance Limited.

The Group has access to funding through its wholly owned subsidiary, Thames Water Utilities Cayman Finance Limited's £10.0bn multi-currency bond programme, of which £4.03bn (2010 £2.15bn) is still outstanding at the balance sheet date.

Previously debt has been raised through its wholly owned subsidiary, Thames Water Utilities Finance Limited's £5.0bn debt issuance programme, of which £2.7bn (2010 £2.9bn) remains in issue at the balance sheet date. Legacy debt obligations will remain outstanding but it is not expected that any further debt will be issued by Thames Water Utilities Finance Limited.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

20 Provisions for liabilities and charges

| | Taxation including deferred tax £m | Insurance liabilities £m | Other provisions £m | Total £m |
|--|--|--------------------------------|---------------------------|------------------|
| At 1 April 2010 | (923.5) | (83.6) | (67.1) | (1,074.2) |
| Charge to profit and loss for the year | 16.5 | - | (8.5) | 8.0 |
| Other tax movement | 3.5 | - | - | 3.5 |
| Released during the year | - | 32.7 | 7.0 | 39.7 |
| At 31 March 2011 | (903.5) | (50.9) | (68.6) | (1,023.0) |

The elements of deferred taxation are as follows:

An analysis of amounts provided at current tax rates is as follows

| | £m |
|--------------------------------|--------------|
| Accelerated capital allowances | 979.6 |
| Other timing differences | (76.1) |
| At the end of the year | 903.5 |

Total deferred tax provision.

| | |
|--|--------------|
| Included above | 903.5 |
| Deferred tax asset provided on pension deficit (see note 26) | (32.1) |
| | 871.4 |

There is an unrecognised deferred tax asset in respect of tax losses where the Group does not anticipate taxable profits in the immediate future. The amount of deferred tax asset unrecognised at 26% (2010: 28%) is

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| Deferred tax asset not recognised in respect of tax losses | 89.2 | 97.7 |

Deferred taxation

On 23 March 2011 the Chancellor announced the reduction in the main rate of UK corporation tax to 26% with effect from 1 April 2011. This change became substantively enacted on 29 March 2011 and therefore the effect of the rate reduction creates a reduction in the deferred tax asset which has been included in the figures above.

The Chancellor also proposed changes to further reduce the main rate of corporation tax by 1% per annum to 23% by 1 April 2014, but these changes have not been substantively enacted and therefore are not included in the figures above. The overall effect of the further reductions from 26% to 23% if these applied to the deferred tax balance at 31 March 2011, would be to further reduce the deferred tax liability by approximately £104.2m.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

20 Provisions for liabilities and charges (continued)

Insurance liabilities

Insurance liabilities comprise provisions for claims received but not yet settled and anticipated claims not yet reported. These provisions are held by the Group's captive insurance company, Isis Insurance Company Limited, and external providers.

Other provisions

Other provisions principally relate to claims against the Group and represent management's best estimate of the value of settlement and costs. It is estimated that claims will be settled in more than one year.

Other provisions include the following items:

Metronet and Trans4m

The Group holds a 20% interest in Metronet Rail SSL Limited and Metronet Rail BCV Limited (together "Metronet").

The Group also holds a 25% interest in Trans4m Limited ("Trans4m"), the company contracted by Metronet to deliver £1.86 billion of station upgrade and civil engineering works.

As a result of significant projected cost overruns and insufficient liquidity, a PPP Administrator was appointed to Metronet in 2007. The Group continues to maintain its ownership in Metronet and Trans4m, however both companies are no longer trading, and the Group has no further obligations to provide debt or equity to Metronet or Trans4m. A liquidator has been appointed to Metronet and the companies are in the process of being wound up.

21 Share capital

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| Group and Company | | |
| Allotted, called up and fully paid | | |
| 1,991,600,000 ordinary shares of £1 each | 1,991.6 | 1,991.6 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

22 Profit and loss account

| | Group | | Company | |
|---|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| | Year end 31 March 2011 £m | Year end 31 March 2010 £m | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
| At beginning of year | (42.4) | 25.2 | 317.4 | 332.4 |
| Profit for the year | (81.2) | 163.5 | 374.5 | 141.4 |
| Exchange adjustments | 2.6 | 0.9 | - | - |
| Actuarial loss recognised in the pension schemes | (1.6) | (105.1) | - | - |
| Deferred tax relating to actuarial deficit on pension schemes | (3.2) | 29.5 | - | - |
| Dividends paid | (115.1) | (156.4) | (115.1) | (156.4) |
| At end of year | (240.9) | (42.4) | 576.3 | 317.4 |

23 Contingencies

There are claims arising in the normal course of business, which are in the process of negotiation. The Group has set aside amounts considered appropriate for all legal and similar claims as per note 20.

24 Operating leases

At 31 March, the Group was committed to making the following annual payments in respect of non-cancellable operating leases:

| | 31 March 2011 | | 31 March 2010 | |
|--|-----------------------------|-------------|-----------------------------|-------------|
| | Land and buildings £m | Other £m | Land and buildings £m | Other £m |
| Leases which expire: | | | | |
| - Within one year | - | - | 0.2 | 1.8 |
| - In the second to fifth years inclusive | 0.2 | 4.6 | 0.2 | 0.4 |
| - Over five years | 6.2 | - | 4.7 | 4.7 |
| | 6.4 | 4.6 | 5.1 | 6.9 |

The Company has no commitments in respect of non-cancellable operating leases (2010: £nil).

25 Capital commitments

| | 31 March 2011 £m | 31 March 2009 £m |
|---|------------------------|------------------------|
| Group | | |
| Contracted for but not provided in the financial statements | 1,517.2 | 1,045.3 |

In addition to these commitments, the Group has long-term capital investment plans to meet performance and asset condition requirements and to provide for new demand and growth.

The Company has no capital commitments (2010: £nil).

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes

Pension arrangements for the majority of the Group's employees are of the defined benefit type, funded through two Group pension schemes, Thames Water Pension Scheme ("TWPS") and Thames Water Mirror Image Pension Scheme ("TWMIPS") (see table below for details of each schemes' respective deficit or surplus), covering employees within the Thames Water Group, whose assets are held separately from those of the Group in independently administered funds. The defined benefit arrangements were closed to new employees from 1 April 2011. From this date, new employees have been offered membership of a defined contribution scheme managed through Standard Life, see note 1(j) page 38. Contributions to the scheme are charged to the profit and loss account in the period to which they relate.

Contributions to the defined contribution pension scheme in the year were £0.2m (2010: £nil).

The Group's defined benefit pension arrangements are of the group multi-employer scheme nature, such that the Group's pension schemes' assets and liabilities are included with those of other companies in the Group. The Group contributes the vast majority of the contributions into the schemes and any consequence of there being a surplus or a deficit in the schemes is felt by the Group. Accordingly, the directors have decided it is appropriate to recognise the net deficit of the two Group pension schemes within these financial statements.

The service cost of the Group, as included in the profit and loss account, represents the net of the total service cost of the Group schemes and the pension contributions made by the other group companies into the schemes in the financial period.

In addition to the cost of the UK Pension arrangements, the Group operates arrangements under which it augments benefits on retirement. These augmentations are funded by way of additional employer contributions to the schemes. In the year ended 31 March 2011, payments amounted to £2.1m (2010: £3.3m).

The latest full actuarial valuation was undertaken as at December 2007. This valuation has been updated at 31 March 2011 by Mercer Limited (Mercer), independent and professionally qualified consulting actuaries, using revised assumptions that are consistent with the requirements of FRS 17 and shown in this note to the accounts.

The next full actuarial valuation as at 31 December 2010 has commenced on behalf of the pension Trustee's by Hewitt Associates Limited (Hewitt) (the independent and professionally qualified consulting actuaries to the schemes) and will be completed during 2011.

The recent exceptional volatility on the credit markets has impacted the pension valuation as calculated under the requirements of FRS17.

Changes in accounting estimates

As stated in note 1 'Principal accounting policies' on page 33, the Company has recognised a £27.1m credit (net of tax) in the Statement of total recognised gains and losses in respect of the Government's announcement in July 2010 that increases in retirement benefits would be based on CPI rather than RPI for TWMIPS only.

Pension arrangements for the majority of the Group's employees are of the defined benefit type, funded through two Group pension schemes, Thames Water Pension Scheme ("TWPS") and Thames Water Mirror Image Pension Scheme ("TWMIPS") (see table below for details of each schemes' respective deficit or surplus), covering employees within the Thames Water Group, whose assets are held separately from those of the Group in independently administered funds.

Thames Water Group has taken advice from Mercer in respect of the funding position of the Group pension schemes.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes (continued)

Net liability by pension schemes before tax

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| <i>Thames Water Pension Scheme</i> | | |
| Deficit in scheme | (161.4) | (162.8) |
| <i>Thames Water Mirror Image Scheme</i> | | |
| Surplus in scheme | 59.6 | 17.4 |
| Impact of irrecoverable surplus | (21.6) | - |
| | 38.0 | 17.4 |
| Liability before deferred tax asset | (123.4) | (145.4) |

The Group has recognised a surplus in the Thames Water Mirror Image scheme to the extent that it may possibly be able to recover it by paying a reduced rate of contributions in the future. The recognisable surplus has been calculated in accordance with FRS17 as the present value of the current service cost projected over the future working lifetime of all active members of the scheme, using the assumptions adopted at 31 March 2011.

The assumptions used in the valuation of assets and liabilities of the schemes are the same for both schemes therefore the following tables are for the combined values for both schemes.

| Reconciliation of funded status to balance sheet | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| Fair value of scheme assets | 1,414.0 | 1,327.0 |
| Present value of scheme liabilities | (1,515.8) | (1,472.4) |
| Deficit in scheme | (101.8) | (145.4) |
| Impact of irrecoverable surplus | (21.6) | - |
| Liability recognised on the balance sheet | (123.4) | (145.4) |
| Deferred tax asset | 32.0 | 40.7 |
| Net pension liability | (91.4) | (104.7) |

Movement in the present value of scheme liabilities

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| Opening present value of scheme liabilities | 1,472.4 | 1,110.3 |
| Current service cost | 25.4 | 19.1 |
| Interest cost | 81.4 | 73.0 |
| Contribution by scheme participants | 0.3 | 0.2 |
| Actuarial gains on scheme liabilities | 32.1 | 326.8 |
| Actuarial loss from changes in inflation assumptions | (37.5) | - |
| Net benefit paid out | (60.4) | (60.3) |
| Termination pension cost | 2.1 | 3.3 |
| Closing present value of scheme liabilities | 1,515.8 | 1,472.4 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes (continued)

Movement in fair value of scheme assets

| | 31 March 2011 £m | 31 March 2010 £m |
|--|------------------------|------------------------|
| Opening fair value of scheme assets | 1,327.0 | 1,048.8 |
| Expected return on scheme assets | 77.3 | 58.2 |
| Actuarial gains on scheme assets | 14.6 | 221.7 |
| Contributions by the employer | 52.2 | 55.1 |
| Contribution of section 75 debt payment | 0.9 | - |
| Contributions by scheme participants | 0.3 | 0.2 |
| Termination pension costs | 2.1 | 3.3 |
| Net benefits paid out | (60.4) | (60.3) |
| Closing fair value of scheme assets | 1,414.0 | 1,327.0 |

Expense recognised in the profit and loss account:

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|----------------------------------|------------------------------------|------------------------------------|
| Current service cost | 25.2 | 19.1 |
| Interest cost | 81.5 | 73.0 |
| Expected return on scheme assets | (77.3) | (58.2) |
| | 29.4 | 33.9 |

The expense is recognised in the following line items in the profit and loss account:

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| Operating costs - staff costs | 25.1 | 19.1 |
| Other finance expense | 4.3 | 14.8 |
| Total expense charged in the profit and loss account | 29.4 | 33.9 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes (continued)

Analysis of amount recognised in the statement of total recognised gains and losses:

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| Actual return less expected return on pension scheme assets | 14.5 | 220.9 |
| Changes in assumptions underlying the present value of scheme liabilities | (32.1) | (326.0) |
| Changes in inflation assumption – CPI from RPI | 37.6 | - |
| Adjustment relating to irrecoverable surplus | (21.6) | - |
| Actuarial loss recognised in the statement of total recognised gains and losses | (1.6) | (105.1) |
| Cumulative amount of gains recognised in the statement of total recognised gains and losses | (201.6) | (200.0) |

Fair value of scheme assets and return on these assets:

The fair value of the assets held by the pension schemes, the long-term expected rate of return on each class of assets and the average expected long-term rate of return obtained by weighting the individual rates in accordance with the anticipated balance in the schemes' investment portfolio are shown in the following table

| | 31 March 2011 | | 31 March 2010 | |
|---|--|----------------|--|----------------|
| | Long-term expected rate of return | Value £m | Long-term expected rate of return | Value £m |
| Equities | 8.4% | 473.2 | 8.5% | 435.9 |
| Bonds | 5.5% | 101.3 | 5.5% | 231.0 |
| Gilts | 4.15-4.40% | 648.0 | 4.25-4.5% | 530.9 |
| Property | 7.4% | 90.6 | 7.5% | 81.1 |
| Other assets | 4.4% | 100.9 | 4.5% | 48.1 |
| Average expected long-term rate of return/total fair value of assets | 5.90% | 1,414.0 | 6.1% | 1,317.4 |

The Group employs a building block approach in determining the long-term rate of return on pension plan assets. Historical markets are studied and assets with higher volatility are assumed to generate higher returns consistent with widely accepted capital market principles. The assumed long-term rate of return on each asset class is set out within this note. The overall expected rate of return on assets is then derived by aggregating the expected return for each asset class over the actual asset allocation for the schemes.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes (continued)

The main financial assumptions used for FRS 17 purposes are as follows:

| | 31 March 2011 | 31 March 2010 |
|--------------------------------------|------------------|------------------|
| Price inflation – RPI Linked | 3.5% | 3.5% |
| Price inflation – CPI Linked | 3.0% | |
| Salary increases – TWPS | 4.5% | 4.5% |
| Salary increase – TWMIPS | 4.0% | 4.5% |
| Pension increases – RPI Linked | 3.5% | |
| Pension increases – CPI Linked | 3.0% | 3.5% |
| Discount rate for scheme liabilities | 5.5% | 5.6% |

In valuing the liabilities of the pension schemes at 31 March 2011, mortality assumptions have been made as indicated below. These mortality assumptions are based on the recent actual mortality experience of members within the schemes and the assumptions also allow for future improvements to mortality rates.

The assumptions are that TWMIPS members and TWPS members who joined the Scheme before 1 January 1995 who retire in 2028 at age 60 will live on average for a further 26 years (2010: 26 years) after retirement if they are male and for a further 28 years (2010: 28 years) after retirement if they are female. TWPS members who joined the Scheme after 1 January 1995 who retire in 2028 at age 60 are assumed to live on average for a further 28 years (2010: 28 years) after retirement if they are male and for a further 29 years (2010: 29 years) after retirement if they are female.

In addition, it is assumed that TWMIPS pensioners and TWPS pensioners who joined the Scheme before 1 January 1995 and are currently aged 60 will live on average for a further 24 years (2010: 24 years) if they are male and a further 26 years (2010: 26 years) if they are female. TWPS pensioners who joined the Scheme after 1 January 1995 and are currently aged 60 are assumed to live on average for a further 26 years (2010: 26 years) if they are male and for a further 28 years (2010: 28 years) if they are female.

History of fair value of assets, present value of liabilities, surplus in scheme and experience gains and losses:

| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2009 £m | 31 Dec 2008 £m | 31 Dec 2007 £m |
|-------------------------------------|------------------------|------------------------|------------------------|----------------------|----------------------|
| Fair value of scheme assets | 1,414.0 | 1,327.0 | 1,048.8 | 1,214.8 | 1,246.4 |
| Present value of scheme liabilities | (1,515.9) | (1,472.3) | (1,110.3) | (1,098.9) | (1,205.9) |
| (Deficit)/surplus in scheme | (101.9) | (145.3) | (61.5) | 115.9 | 40.5 |

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

26 Pension schemes (continued)

Experience adjustments:

| | 31 March 2011 £m | 31 March 2010 £m | 31 March 2009 £m | 31 Dec 2008 £m | 31 Dec 2007 £m |
|--|------------------------|------------------------|------------------------|----------------------|----------------------|
| Experience gains/(losses) on scheme assets: | | | | | |
| Amounts | 13.6 | 214.1 | (250.8) | (102.7) | 7.1 |
| Percentage of scheme assets | 5.9% | 16.7% | 24.1% | 8.5% | 0.6% |
| Experience (losses)/gains on scheme liabilities: | | | | | |
| Amounts | - | - | (44.4) | (5.4) | 11.9 |
| Percentage of scheme liabilities | - | - | 4.0% | 0.5% | 1.0% |
| Total amount recognised in the Statement of total gains and losses: | | | | | |
| Amounts | (2.0) | (111.9) | (136.4) | 3.9 | 81.2 |
| Percentage of present value of scheme liabilities | 0.1% | 7.2% | 12.0% | 0.4% | 6.7% |

The Group expects to contribute approximately £55.5m (2010 £60.2m) to the defined benefit schemes in the next financial year.

27 Analysis of cash flows

27(a) Net cash inflow from operating activities

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| Reconciliation of operating profits to net cash flow from operating activities | | |
| Group operating profit | 535.4 | 647.5 |
| Depreciation charges | 414.6 | 364.9 |
| Amortisation | 44.4 | 44.4 |
| Decrease/(increase) in stocks | 2.5 | (4.6) |
| Increase in debtors | (13.3) | (53.0) |
| (Decrease)/increase in creditors | (0.6) | 100.4 |
| Deferred income release | (13.6) | (14.6) |
| Decrease in provisions | (5.6) | (45.9) |
| Difference between pension charge and cash contributions | (27.1) | (37.2) |
| Net cash flow from operating activities | 936.7 | 1,001.9 |

Depreciation includes maintenance expenditure on infrastructure assets in accordance with FRS 15

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

27 Analysis of cash flows (continued)

27(b) Return on investment and servicing of finance

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|---|------------------------------------|------------------------------------|
| Interest received | 112.7 | 90.5 |
| Interest paid | (518.7) | (447.3) |
| Interest element of finance lease rental payments | (6.5) | (10.4) |
| | (412.5) | (367.2) |

27(c) Capital expenditure and financial investment

| | Year end 31 March 2011 £m | Year end 31 March 2010 £m |
|-------------------------------------|------------------------------------|------------------------------------|
| Purchase of tangible fixed assets | (901.5) | (726.4) |
| infrastructure renewals expenditure | - | (71.3) |
| Capital contributions received | 41.0 | 44.8 |
| Investment | 1.2 | 2.0 |
| Sale of tangible fixed assets | 12.4 | 43.8 |
| | (846.9) | (707.1) |

27(d) Analysis of net debt

| | At 1 April 2010 £m | Cash flow £m | Other non- cash movements £m | At 31 March 2011 £m |
|------------------------------------|-----------------------------|-----------------|---------------------------------------|------------------------------|
| Cash at bank and in hand | 48.5 | (6.7) | - | 41.8 |
| | 48.5 | (6.7) | - | 41.8 |
| Loans due within one year | (395.5) | 367.9 | - | (7.6) |
| Loans due after more than one year | (7,619.5) | (965.4) | (200.7) | (8,785.6) |
| Finance leases | (203.6) | 8.4 | 0.2 | (195.0) |
| | (8,218.6) | (569.1) | (200.5) | (8,988.2) |
| Liquid resources | 666.0 | 136.5 | - | 802.5 |
| Total | (7,504.1) | (439.3) | (200.5) | (8,143.9) |

The Group includes as liquid resources term deposits of less than one year, fixed and floating interest rate securities and managed funds

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

27 Analysis of cash flows (continued)

27(d) Analysis of net debt (continued)

Other non-cash changes mainly comprise the carrying value uplift by RPI, of RPI index-linked loans. This adjustment is in accordance with FRS 4 'Capital instruments', which requires the carrying value of such index-linked loans to be recalculated at each balance sheet date.

28 Guarantees

Thames Water Utilities Holdings Limited, Thames Water Utilities Limited and its direct subsidiaries are Obligors under the whole business securitisation entered into in 2007. The Obligors have all entered into a Security Trust and Intercreditor Deed. Under this document each Obligor will guarantee the obligations of each other Obligor with their future cash flows. The Secured debt as at 31 March 2011 was £7.6 billion.

At 31 March 2011 the Group has secured the overdrafts and loans of certain subsidiaries up to a maximum of £20m (2010: £40m). The Group has also guaranteed facilities for contract bonding on behalf of certain subsidiaries amounting to £0.6m (2010: £29.8m) at 31 March 2011 and certain non-Thames Water group companies amounting to £6.0m (2010: £5.4m).

The Group has provided security by way of a debenture over its assets in relation to monies owed by the Group under its credit facility agreement with Barclays Capital and other lenders. This facility amounted to £835m (2010: £1,670m), the amount outstanding at 31 March 2011 was £835m (2010: £1,490m). The chargee is Barclays Bank as security trustee to the secured creditors of the facility.

The Isis Insurance Company Limited, a wholly owned subsidiary of the Group, has letters of credit in issue totalling £5.1m (2010: £5.4m) and £3.6m (2010: £4.3m) secured under a Security Trust Agreement. Security for the letters of credit is provided to the value of £5.9m (2010: £5.9m) by a charge over assets held within its Global Treasury Funds.

In addition, there are a number of parent company guarantees in respect of subsidiary company contractual obligations that have been entered into in the normal course of business. No unprovided loss is expected to arise under these arrangements.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

29 Group undertakings

At 31 March 2011, the Group held more than 10% of the allotted share capital of the following principal undertakings

| | Country of incorporation registration and operation | Class of share capital held | Proportion of shares held directly | Proportion of shares held indirectly | Basis of consolidation | Nature of business |
|---|---|-----------------------------|------------------------------------|--------------------------------------|------------------------|---|
| UK | | | | | | |
| Kemble Water Eurobond Plc | England & Wales | Ordinary | 100% | - | Subsidiary | Investment holding company |
| Kemble Water Liberty Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Investment holding company |
| Kemble Water Structure Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Investment holding company |
| Kemble Water Finance Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Investment holding company |
| Kemble Water Investments Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Investment holding company |
| Kemble Water Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Investment holding company |
| Thames Water Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Holding company |
| Thames Water Utilities Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Water and wastewater services |
| Thames Water Utilities Finance Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Finance Company |
| Thames Water Utilities Cayman Finance Limited | Cayman Islands | Ordinary | - | 100% | Subsidiary | Finance Company |
| Isis Insurance Company Limited | Guernsey | Ordinary | - | 100% | Subsidiary | Insurance |
| Kennet Properties Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Property |
| Thames Water Investments Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Property |
| Thames Water International Services Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Marketing of technical managerial services |
| Thames Water Property Services Limited | England & Wales | Ordinary | - | 100% | Subsidiary | Property |
| Trans4m Limited | England & Wales | Ordinary | - | 25% | Investment | Contract management for stations and civil assets |
| *Metronet Rail SSL Holdings Limited | England & Wales | Ordinary | - | 20% | Investment | Maintenance and upgrade of London Underground |
| *Metronet Rail BCV Holdings Limited | England & Wales | Ordinary | - | 20% | Investment | Maintenance and upgrade of London Underground |

* These companies are in liquidation

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

29 Group undertakings (continued)

Advantage is taken of section 410 of the Companies Act 2006 and full information will be annexed to the next Annual Return delivered to the Registrar of Companies after the accounts in question have been approved under section 233

30 Related parties

During the year, the Group completed the following sales to and purchases from related parties, all of which were undertaken at arm's length commercial prices in the ordinary course of business

| Related party | Nature of transaction | Year end 31 March 2011 | Year end 31 March 2011 | Year end 31 March 2010 | Year end 31 March 2010 |
|-------------------------|--|------------------------------|------------------------------|------------------------------|------------------------------|
| | | Sale value £m | Amount due £m | Sale value £m | Amount due £m |
| | | Purchase value £m | Amount owing £m | Purchase value £m | Amount owing £m |
| Macquarie Group Limited | Fees payable for management and other services | 12.0 | 8.7 | 8.1 | 7.3 |

During the year, an indirect subsidiary of the Company made a payment of £40,000 (2010 £160,000) to C R Deacon a director for consultancy services

31 Immediate and ultimate parent company and controlling party

Kemble Water Holdings Limited is owned by a consortium of investors led by Macquarie European Infrastructure Funds 1 and 2 ("MEIF 1 & 2"), wholesale investment funds which make long-term investments in infrastructure and related businesses located across Europe. The directors do not consider there to be an ultimate parent or controlling party. Kemble Water Holdings Limited is the largest group to consolidate these financial statements.

The Company's other shareholders are international pension funds and institutional investors.

MEIF 1 & 2 invest in businesses which

- Provide an essential service to the community
- Have a strong competitive position
- Generate stable cash flows over the long term

MEIF 1 & 2 aim to deliver sustainable cash yields and moderate capital growth from their diversified portfolios of quality infrastructure investments.

MEIF 1 & 2 are managed by Macquarie Capital Funds (Europe) Limited ("MCFEL"). MCFEL is a wholly owned member of the Macquarie Group, and is authorised and regulated by the Financial Services Authority under the UK Financial Services and Markets Act 2000. MCFEL is resourced by executives of Macquarie Capital Funds.

Copies of the accounts of all of the above companies may be obtained from The Company Secretary's Office, Thames Water Group, Clearwater Court, Vastern Road, Reading, Berkshire, RG1 8DB.

Kemble Water Holdings Limited

Notes to the financial statements for the year ended 31 March (continued)

32 Post balance sheet events

Dividends

On 3 March 2011 the directors approved a fourth interim dividend of £24.4m (2.4p per ordinary share) in respect of the year ended 31 March 2011. This interim dividend was paid to Thames Water Utilities Holdings Limited ("TWUHL") on 11 April 2011, and will be used by TWUHL to settle inter-company interest owing to Thames Water Utilities Limited.

Pensions

Following extensive consultation with employees and with the agreement of the pension fund trustees the Group has changed certain provisions in respect of the TWPS for both existing and new employees.

The defined benefit scheme is now closed to new entrants. From 1 April 2011 new employees of the Group will be offered participation in the DCSPS managed through Standard Life.

For existing members of the TWPS, certain provisions have changed that will affect future benefits available to its members. Principally, the defined benefit provision from 1 May 2011 will be based on a Career Average Revalued Earnings (CARE) basis and no longer on a Final Salary basis.

Refinancing

On 7 April 2011 the Group completed the refinancing of an £835m variable term loan facility at Kemble Water Structure Limited. The refinancing at Kemble Water Finance Limited comprised a £400m fixed rate bond and £425m variable rate loan facilities. The refinancing also included the restructuring of the related floating to fixed interest rate swaps.

33 Off-balance sheet arrangements

The Group is party to a number of contractual arrangements for the purposes of the Group's principal activities that are not required to be included on its balance sheet. The principal off-balance sheet arrangements are listed below:

- Operating leases (see note 24)
- Outsourcing contracts

In respect of outsourcing contracts, the Group has entered into various arrangements to outsource the provision of certain back-office and operational functions with third party providers. These outsourced arrangements include IT support, Legal Services, metering and capital delivery. These arrangements are on commercial terms and no associated penalty or termination clauses will have a material impact on the financial position of the Group.