

**SOUTHERN WATER SERVICES LIMITED**

**DIRECTORS' REPORT  
AND ACCOUNTS FOR THE YEAR ENDED  
31 MARCH 2006**

Registered No. 2366670

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**SOUTHERN WATER SERVICES LIMITED**

**Directors' Report and Accounts for the year  
ended 31 March 2006**

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## **REPORT OF THE DIRECTORS**

The directors present their report and the audited accounts for the year ended 31 March 2006.

### **PRINCIPAL ACTIVITIES**

The principal activities of the Company, also referred to as SWS, are the provision of water supply and wastewater services in the South East of England. The Company is regulated by the Water Services Regulation Authority (Ofwat) and supplies water to over 2.3 million people and provides wastewater services to 4.5 million people.

### **ISSUES AFFECTING THE BUSINESS**

#### ***Drought***

The south of England is currently experiencing the worst drought since the 1930's. Two consecutive dry winters have left resources significantly below normal levels and hosepipe and sprinkler bans have been put in place to conserve supplies. The Company has taken steps to move water around its regional supply grid, from areas of surplus to areas of drought, and is developing additional resources to help alleviate the situation.

There are also a number of further actions that are being taken. These include applications to the Environment Agency for Drought Permits, which allow the Company to temporarily extract more water from elsewhere in the environment, and an application for a Drought Order, to enable the restriction of the use of water for certain activities such as watering golf courses, sports fields and parks. The Drought Order was issued by DEFRA on 25 May 2006, however the company has currently not enforced the order due to recent rainfall. The water resource situation is under constant review and further restrictions on usage may still be required later in the year.

#### ***Brighton and Hove Area Wastewater Scheme***

To comply with the Urban Wastewater Treatment Directive, the Company is required to deliver improved wastewater treatment to the Brighton, Hove and Peacehaven area by constructing a new wastewater treatment works. This project has an estimated cost of £225m.

Following an extensive consultation and selection process, a planning application was submitted to build the wastewater treatment works at Peacehaven. East Sussex County Council and Brighton & Hove City Council were unable to determine its planning application locally, and the Company lodged an appeal to the Secretary of State. A public enquiry is scheduled to commence on the 21 June 2006.

#### ***General Levels of Service***

During the period the Company brought to the attention of Ofwat certain inconsistencies relating to the reporting of response levels to, and handling of, customer enquiries and complaints discovered in the course of a project to install a new customer billing system.

These inconsistencies have meant that some customers did not receive compensation they were due under a Guaranteed Standards Scheme (GSS) where the Company is obliged to make payments if it does not respond to letters within certain timescales. A specialist team was appointed to investigate these

## SOUTHERN WATER SERVICES LIMITED

### ISSUES AFFECTING THE BUSINESS (continued)

#### *General Levels of Service (continued)*

inconsistencies and work was also instigated to make the payments due under the GSS. The costs of the investigation, together with the costs of identifying and making the GSS payments is shown in the Accounts as an exceptional item of £14.1m.

The Company has also brought the matter to the attention of the Serious Fraud Office (SFO). A decision on whether the SFO will investigate is currently pending.

On 31 March 2006, the Company was notified by the regulator that it will be fined for its failure since April 2005 to achieve customer service performance standards under the GSS. Although no penalty has yet been fixed, the Company could be fined up to a maximum of 10% of its annual turnover, as referred to in note 22.

#### *Capital Programme delivery*

During April 2005, a contract was awarded to a consortium comprising United Utilities, Costain, and Montgomery Watson Harza to deliver a major part of the capital programme. Called 4D, the consortium will project manage, design and deliver more than 250 schemes in the investment programme. Approximately 120 staff were transferred from Southern Water to 4D. The contract has successfully delivered in line with expectations during the year ended 31 March 2006.

### PROFIT AND LOSS ACCOUNT

Turnover in 2005/06 increased by 14.0% to £541.5m (2004/05 £475.0m). This was principally due to an increase in the K factor (the annual price movement as set by Ofwat) which was required to secure and service the ongoing finance for the capital investment programme.

Cost of sales increased by 7.9% in 2005/06 to £285.2m (2004/05 £264.4m), and administration expenses, before exceptional items, increased by 11.2% to £28.8m (2004/05 £25.9m). The increase in costs resulted mainly from additional depreciation, higher electricity prices, and the effects of inflation, offset by operating efficiencies.

As previously stated, the costs of the customer service investigation, together with the costs of identifying and making GSS payments due is shown as an exceptional item of £14.1m.

Operating profit increased to £215.1m in 2005/06 compared with £186.2m in 2004/05.

Under Financial Reporting Standard (FRS) 25, which has been adopted during the year, dividends on the Company's preference shares are now categorised as interest payments. The dividends paid on these preference shares were £13.7m (2005: £13.7m) with class A1 shareholders receiving £6.0m and class B shareholders £7.7m. Class A2 shareholders did not receive a dividend payment, as the Company did not meet the outperformance requirements described in note 15.

## SOUTHERN WATER SERVICES LIMITED

### **PROFIT AND LOSS ACCOUNT (continued)**

Net interest after adjusting for FRS 25 increased to £126.1m from £120.3m in 2004/5 and the tax on profit on ordinary activities increased to £32.6m from £17.2m.

Profit after taxation for the financial year was £61.4m (2005: £51.7m). The directors recommend a final dividend of £89.29 per ordinary share (2005: £60.71) which together with an interim dividend totalling £710.80 per ordinary share (2005: £714.28) gives a total dividend of £800.09 per ordinary share for the year (2005: £774.99). The retained profit for the year of £16.6 million has been transferred to reserves.

### **CASHFLOW**

Net cash inflow from operating activities increased to £331.6m for 2005/06 from £301.6m in 2004/05, mainly due to the increased turnover. The net cash outflow from returns on investment and servicing of finance increased to £106.7m for 2005/06 from £101.5m in 2004/05, due to costs associated with a bond refinancing. There was an outflow of cash relating to the purchase of tangible fixed assets of £272.4m (2004/05 £189.4m) and a net cash outflow before financing in 2005/06 of £90.1m (2004/05 £35.1m).

The refinancing was carried out during May to July 2005. This comprised a bond issue of £500m and the repayment of £420m of bonds in issue at March 2005, together with putting in place an additional undrawn revolving credit facility of £120m. This resulted in a net cash inflow from financing during 2005/06 of £79.5m.

### **BALANCE SHEET**

At the end of the period to 31 March 2006, the Company had fixed assets of £2,952.9m (2005: £2,784.1m) an increase of £168.8m from March 2005. This increase results from the capital investment programme. As a result of a bond refinancing creditors falling due after more than one year increased to £2,611.4m from £2,517.1m at March 2005. During the year FRS 17 'Retirement benefits' was fully implemented and the pension deficit of £96.6m (2005: £98.0m) was recognised on the balance sheet. Overall net assets increased to £729.8m from £714.6m.

### **KEY PERFORMANCE INDICATORS**

Under the terms of its financing, the Company is required to operate within key financial ratios. These can be summarised as Regulatory Asset Ratios (the proportion of borrowing to its Regulated Capital Value) and Interest Cover Ratios. The Company has operated within the required levels throughout the period.

The Company is required to provide information to Ofwat on its performance against various aspects of service, these are published in Ofwat's annual 'Level of Service' report. The operational indicators have been submitted in the annual return to Ofwat for the year 2005/06. The Company has put in place plans to improve customer service performance as this does not currently meet the required standard.

## SOUTHERN WATER SERVICES LIMITED

### **FUTURE DEVELOPMENTS**

The year to 31 March 2007 is the second of the five-year regulatory period. During this period, the Company will continue to focus on delivering its large investment programme, and continuing to achieve operational performance targets as detailed in its Monitoring Plan to Ofwat, which is available on the Company website.

The Company will also focus on dealing with the key risks and uncertainties that have been highlighted by the customer services issues, the drought and the Brighton and Hove wastewater treatment works.

### **DIRECTORS AND THEIR INTERESTS**

The directors who held office during the year ended 31 March 2006 were as follows:

Robert Thian (Chairman)

Barrie Delacour

Howard Goodbourn

David Golden (Independent Non-Executive Director)

Donald Workman (Non-Executive Director)

Simon MacDonagh (Independent Non-Executive Director)

Steven Marshall - appointed 19 April 2005 (Independent Non-Executive Director)

Leslie Dawson - appointed 25 October 2005

Martin Baggs - resigned 7 October 2005

John O'Brien - resigned 10 April 2006

David Alexander - resigned 10 April 2006

Paul de Rosen - resigned 10 April 2006

None of the directors who held office during the financial year had any disclosable interests in the shares of the Company. Robert Thian has 50,000 A shares of £1 each in Southern Water Capital Limited held in a trust fund of which he is the beneficial holder, these were acquired on 11 August 2005. None of the other directors has any disclosable interests in the shares of any company within the group.

No director has, or has had, a material interest, directly or indirectly, at any time during the year under review in any contract significant to the Company's business

### **RESEARCH AND DEVELOPMENT**

The improvement of existing services and processes, together with the identification and development of new technology and solutions, are important aspects of the Company's strategy to enhance the quality of service to customers and improve methods of working. Research and development expenditure for the year amounted to £1.4m (2005: £1.5m).

## SOUTHERN WATER SERVICES LIMITED

### **EMPLOYEES**

#### ***Employee involvement***

The Company recognises the importance of its employees and is committed to effective two-way communication and consultation.

The Company has established Business Involvement Groups to facilitate meaningful consultation between Company Management and employees through elected Employee Representatives. The Groups meet regularly at both functional and company-wide levels.

The Company also recognises the rights of every employee to join a trade union and participate in its activities. SWS has a single union agreement with Unison.

The Company publishes its own in-house newspaper, 'Southern Water News' on a regular basis. General information is posted on the Company Intranet and regular team briefing sessions are also held.

#### ***Equal opportunity***

The company's policy is to promote equality of opportunity in recruitment, employment continuity, training and career development. The policy is designed to ensure that equal opportunity in these areas extends as far as practicable to people with disabilities. The Company is a member of the Employers' Forum on Disability, which supports the efforts to meet the needs of the disabled for employment and access to the Company and its buildings.

#### ***Health and safety***

The Company recognises its duties to make proper provision for the health, safety and welfare at work of its employees.

Every employee receives a copy of the corporate policy statement on health and safety. There are regular meetings of employee representatives and managers to consider all aspects of health and safety. In addition there is a health and safety management review group which ensures that there is an adequate system for meeting the company's responsibilities for health and safety to its staff, customers and members of the public.

SWS provides an internal occupational health service for employees, including the provision of physiotherapy. These services have been developed and are continuously reviewed to ensure they meet the needs of the business and our employees at work.

### **CREDITOR PAYMENT POLICY AND PRACTICE**

The Company's current policy and practice concerning the payment of its trade creditors is to follow the Better Payment Practice Code to which it is a signatory. Copies of the Code may be obtained from the Department of Trade and Industry or from the website [www.payontime.co.uk](http://www.payontime.co.uk).

## SOUTHERN WATER SERVICES LIMITED

### **CREDITOR PAYMENT POLICY AND PRACTICE (continued)**

The Company's policy and practice is to agree terms of payment when agreeing the terms of the transaction, to include the terms in contracts and to pay in accordance with its contractual and legal obligations. The Company's trade creditor days at 31 March 2006 were 22 days (2005: 36 days).

### **ENVIRONMENTAL ISSUES**

The Company is committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice, and aims to contain the environmental impact of its activities to a practicable minimum.

The Company's environmental performance is reported in its annual Sustainability Report. The Company recognises its responsibility to operate within a framework that supports sustainable development and has established, where possible, indicator targets which are measurable. Performance against these targets is monitored and reported regularly.

### **CHARITABLE DONATIONS**

The company made donations of £21,000 (2005: £53,000) to a variety of charities over the year.

No political donations were made.

### **LAND AND BUILDINGS**

In the opinion of the directors, the market value of land is significantly more than its book value, and it would not be practicable to quantify the value of land.

### **FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES**

The Company intends to at least maintain its present risk profile, as measured by its investment grade credit rating, and does not enter into treasury transactions for the purpose of speculation, but only to manage risk inherent in the business or funding on a prudent basis.

**Currency Risk** - The Company uses derivatives to ensure that no currency risk is borne in respect of any foreign currency denominated debt instrument, or in respect of any significant foreign currency purchases (excluding any fees, including Financial Guarantee Fees, payable in respect of any foreign currency denominated Authorised Credit Facility).

**Interest Rate Risk** - The Company hedges its exposure to interest rate risk on at least 85% of its total outstanding debt liabilities in respect of Class A Debt and Class B Debt for the current period to the next Periodic Review and at least 70% in the next period to the subsequent Periodic Review (on a rolling basis) into either index-linked obligations or fixed rate obligations.

## SOUTHERN WATER SERVICES LIMITED

### **FINANCIAL RISK MANAGEMENT OBJECTIVES AND POLICIES (continued)**

Inflation Risk - The regulatory framework, under which revenues and the RCV (Regulatory Capital Value) are indexed, exposes the Company to inflation risk. The Company manages this risk through the use of index-linked instruments within its overall debt portfolio.

Liquidity risk – The Company raises additional funds, as required, to ensure that it has sufficient cash and/or facilities to fund the business for the next twelve months.

Cash management risk – The Company sets exposure limits for, and deposits cash balances with, organisations whose credit ratings are rated a minimum of Moody's P1, Standard & Poor A1 or Fitch F1.

### **DIRECTORS' RESPONSIBILITIES**

Company law requires the directors to prepare Accounts for each financial period which give a true and fair view of the state of affairs of the Company as at the end of the financial period and of the profit or loss of the Company for that period.

Having assessed the future funding requirements of the Company, the directors are of the opinion that it is appropriate for the Accounts to be prepared on a going concern basis.

The directors confirm that suitable accounting policies have been used and applied consistently except where detailed in note 1 to the Accounts (Accounting policies). They also confirm that reasonable and prudent judgements and estimates have been made in preparing the Accounts for the year ended 31 March 2006 and that applicable accounting standards have been followed, subject to any material departures disclosed and explained.

The directors are responsible for ensuring that the Accounts are published, and where they are published on the Internet, for the maintenance and integrity of the website. Uncertainty regarding legal requirements is compounded, as information published on the Internet is accessible in many countries with different legal requirements relating to the preparation and dissemination of Accounts.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the Accounts comply with the Companies Act 1985. More broadly, they owe a fiduciary duty to the Company and are responsible for safeguarding its assets.

## SOUTHERN WATER SERVICES LIMITED

### PROVISION OF INFORMATION TO AUDITORS

So far as the directors are aware, there is no relevant information of which the company's auditors are unaware. The directors have taken all the steps, (such as making enquiries of other directors and the auditors and any other steps required by the director's duty to exercise due care, skill and diligence), that they ought to have taken in their duty as a director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

### AUDITORS

The auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office and a resolution that they be re-appointed will be proposed at the annual general meeting.

Approved by the Board of Directors and signed on behalf of the Board.



**Kevin Hall**

Secretary

14 June 2006

SOUTHERN WATER SERVICES LIMITED

**PROFIT AND LOSS ACCOUNT**

For the year ended 31 March 2006

	Notes 1,19	2006 £m	2006 £m	2005 £m	2005 (restated) £m
<b>Turnover</b>	1,2,3		<b>541.5</b>		475.0
Cost of sales	3		<b>(285.2)</b>		(264.4)
<b>Gross profit</b>			<b>256.3</b>		210.6
Administrative expenses					
- before exceptional items	3	<b>(28.8)</b>		(25.9)	
- exceptional items	4	<b>(14.1)</b>		-	
Administrative expenses			<b>(42.9)</b>		(25.9)
Other operating income	3		<b>1.7</b>		1.5
<b>Operating profit</b>			<b>215.1</b>		186.2
Profit on disposal of fixed assets			<b>5.0</b>		3.0
Net interest and similar charges	6		<b>(126.1)</b>		(120.3)
<b>Profit on ordinary activities before taxation</b>	4		<b>94.0</b>		68.9
Tax on profit on ordinary activities	7		<b>(32.6)</b>		(17.2)
<b>Profit on ordinary activities after taxation</b>	19		<b>61.4</b>		51.7
Dividends	8,19		<b>(44.8)</b>		(43.4)
<b>Retained profit for the financial year</b>	19		<b>16.6</b>		8.3

The above results relate entirely to continuing operations.

The Notes on pages 13 to 38 form part of these accounts.

SOUTHERN WATER SERVICES LIMITED

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**

For the year ended 31 March 2006

	Notes	2006 £m	2005 (restated) £m
<b>Profit on ordinary activities after taxation</b>		<b>61.4</b>	51.7
Actuarial (loss)/gain recognised in the pension fund	21	<b>(2.0)</b>	13.1
Movement on deferred tax relating to pension deficit		<b>0.6</b>	(3.9)
<b>Total recognised gains for the year</b>		<u><b>60.0</b></u>	<u>60.9</u>
Prior year adjustment	19	<b>(96.9)</b>	
<b>Total losses recognised since last annual report</b>		<u><b>(36.9)</b></u>	

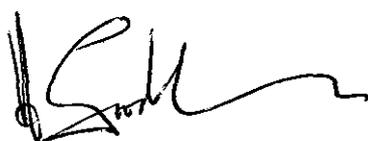
There is no difference between the profit on ordinary activities before taxation and the retained loss for the year stated above and their historical cost equivalents.

SOUTHERN WATER SERVICES LIMITED

**BALANCE SHEET**  
As at 31 March 2006

	Notes	2006 £m	2005 (restated) £m
<b>Fixed assets</b>			
Tangible assets	9	2,923.7	2,754.9
Investments	10	29.2	29.2
		<u>2,952.9</u>	<u>2,784.1</u>
<b>Current assets</b>			
Stocks	11	1.1	1.0
Debtors: amounts falling due within one year	12	119.3	106.1
Debtors: amounts falling due after one year	13	812.3	812.3
Cash and deposits		240.9	239.4
		<u>1,173.6</u>	<u>1,158.8</u>
<b>Creditors: amounts falling due within one year</b>	14	<u>(242.3)</u>	<u>(183.8)</u>
<b>Net current assets</b>		<u>931.3</u>	<u>975.0</u>
<b>Total assets less current liabilities</b>		<u>3,884.2</u>	<u>3,759.1</u>
<b>Creditors: amounts falling due after more than one year</b>	15	<u>(2,611.4)</u>	<u>(2,517.1)</u>
<b>Provision for liabilities and charges</b>	16	<u>(400.2)</u>	<u>(385.7)</u>
<b>Grants and contributions</b>	17	<u>(46.2)</u>	<u>(43.7)</u>
<b>Net assets excluding pension deficit</b>		<u>826.4</u>	<u>812.6</u>
<b>Pension deficit</b>	21	<u>(96.6)</u>	<u>(98.0)</u>
<b>Net assets including pension deficit</b>		<u>729.8</u>	<u>714.6</u>
<b>Capital and reserves</b>			
Called up share capital	18	0.1	0.1
Share premium	19	46.3	46.3
Profit and loss account	19	683.4	668.2
<b>Total shareholders' funds</b>		<u>729.8</u>	<u>714.6</u>

The accounts on pages 9 to 38 were approved by the Board on 14 June 2006 and signed on its behalf by:



**Howard Goodbourn**  
Finance Director

SOUTHERN WATER SERVICES LIMITED

**CASH FLOW STATEMENT**

for the year ended 31 March 2006

	Notes	2006 £m	2005 (restated) £m
<b>Net cash inflow from operating activities</b>	20	331.6	301.6
<b>Returns on investments and servicing of finance</b>			
Interest received		78.0	65.1
Interest paid		(162.4)	(152.3)
Issue costs of new loans		(8.6)	(0.6)
Preference share dividends		(13.7)	(13.7)
<b>Net cash outflow from returns on investments and servicing of finance</b>		(106.7)	(101.5)
<b>Taxation</b>		(17.1)	(16.9)
<b>Capital expenditure and financial investment</b>			
Purchase of tangible fixed assets		(272.4)	(189.4)
Receipt of grants and contributions		13.8	10.0
Sale of tangible assets		5.5	4.5
<b>Net cash outflow for capital expenditure and financial investment</b>		(253.1)	(174.9)
<b>Equity dividends paid</b>		(44.8)	(43.4)
<b>Net cash outflow before financing</b>		(90.1)	(35.1)
<b>Financing</b>			
Increase in borrowings		499.5	156.5
Premium arising on new loans		-	18.5
Repayment of borrowings		(420.0)	-
Repayment of long-term loan		-	4.3
<b>Net cash inflow from financing</b>		79.5	179.3
<b>(Decrease)/ increase in net cash</b>		(10.6)	144.2
<b>Reconciliation to net debt</b>			
Net debt at beginning of year		(2,307.3)	(1,996.1)
FRS 25 adjustment		-	(260.0)
Adjusted opening net debt		(2,307.3)	(2,256.1)
(Decrease)/increase in net cash		(10.6)	144.2
Movements in borrowings		(79.5)	(156.5)
Loan premium received		-	(18.5)
Debt issue costs		8.6	0.6
Other non cash changes		(23.5)	(21.0)
<b>Net debt at end of year</b>		(2,412.3)	(2,307.3)

## SOUTHERN WATER SERVICES LIMITED

### NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

#### 1 Accounting policies

##### **Basis of accounting**

The accounts have been prepared under the historical cost convention and in accordance with applicable accounting standards and, subject to the treatment of infrastructure grants and contributions described below, with the requirements of the Companies Act 1985.

##### **Basis of preparation**

The accounts contain information about SWS as an individual company and do not contain consolidated financial information as the parent of subsidiary companies. The Company is exempt under section 228 of the Companies Act 1985 from the requirement to prepare consolidated accounts as it and its subsidiary undertaking are included by full consolidation in the consolidated accounts of the holding company, Southern Water Capital Limited.

##### **Changes in accounting policies**

During the year the company has completed the final stage of the implementation of FRS 17 'retirement benefits', FRS 21 'events after the balance sheet date' and FRS 25 'disclosure of financial instruments'. The adoption of each of these standards represents a change in accounting policy and the comparative figures have been restated accordingly. Details of the effect of the prior year adjustments are given in note 19.

##### **Turnover**

Turnover represents the income receivable (excluding value added tax) in the ordinary course of the business for goods and services provided and, in respect of unbilled charges, includes an accrual for measured income.

Measured income arises from customers who have meters fitted at their premises. Therefore amounts billed are based on actual or estimated water consumption. Unmeasured income bills are based on the rateable value of properties.

The income accrual is an estimation of the amount of water and wastewater charges unbilled at the year-end. The accrual is estimated using a defined methodology based upon weighted average tariffs and historical billing and consumption information.

##### **Bad debts**

The bad debt provision is calculated by applying recovery rates to an aged debt profile to ensure that the age of debt not covered by the provision is an accurate reflection of the recoverability of debt.

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**1 Accounting policies (continued)**

**Research and development**

Expenditure on research and development is charged to the profit and loss account as it is incurred.

**Capital Instruments**

The issue costs of capital instruments have been amortised over the life of the financial instrument to which they relate.

Premiums received on issue of debt instruments are credited to the profit and loss account over the term of the debt at a constant rate on the carrying amount.

The carrying value of index-linked debt instruments is adjusted for the annual movement in the retail price index. The change in value arising from indexation is charged or credited to the profit and loss account in the year in which it arises.

**Foreign currencies**

Individual transactions denominated in foreign currencies are translated into sterling at the actual exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currency are translated at the exchange rates prevailing at the balance sheet date or at a contracted rate where appropriate. Profits and losses on both individual currency transactions settled during the year and unsettled monetary assets and liabilities are dealt with in the profit and loss account.

**Preference Shares**

The Company has adopted the provisions of FRS 25 'Financial instruments: disclosure and presentation' and has accordingly reclassified its preference shares as debt. The preference shares are redeemable on a specific date or at the Company's option anytime earlier. Dividends on preference shares classified as debt are recognised in the profit and loss account through interest payable. The value of the debt has been based on the original nominal value and share premium on issue of the shares as detailed in note 15.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

1 Accounting policies (continued)

Tangible fixed assets

- i) Infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls) comprise a network of assets covering the company's geographic area.

Expenditure on infrastructure assets relating to increases in capacity or enhancement of the network and on maintaining the operating capability of the network in accordance with defined standards of service, is treated as an addition to fixed assets and is stated at cost after deducting grants and contributions. Staff costs that directly related to the construction of a specific infrastructure asset are capitalised on the basis of the amount of time spent by individuals on projects.

The depreciation charge for infrastructure assets is the estimated level of annualised expenditure required to maintain the operating capability of the network and is based on the asset management plan determined by Ofwat as part of the price regulation process. The asset management plan is developed from historical experience combined with a rolling programme of reviews of the condition of the infrastructure assets.

- ii) Other tangible fixed assets (including aboveground assets, plant and equipment) are stated at cost less accumulated depreciation. These assets are depreciated on the straight-line method over their estimated operating lives which are principally as follows:

	Years
Buildings	10 - 60
Operational structures	15 - 80
Fixed plant	10 - 40
Vehicles, computers and mobile plant	3 - 10

Operational structures are assets used for wastewater and water treatment purposes. These include water tanks and similar assets.

- iii) Freehold land is not depreciated.
- iv) Assets in the course of construction are not depreciated until they are commissioned. Commissioning is deemed to occur when a new works is officially taken over from the contractor following completion of performance and take-over tests.

## SOUTHERN WATER SERVICES LIMITED

### NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

#### 1 Accounting policies (continued)

##### Grants and contributions

Capital grants and customer contributions in respect of additions to non-infrastructure fixed assets are treated as deferred income and released to the profit and loss account over the estimated operational lives of the related assets in accordance with the provisions of the Companies Act.

Grants and capital contributions received relating to infrastructure assets have been deducted from the cost of fixed assets as permitted by Statement of Standard Accounting Practice (SSAP) 4. This is not in accordance with Schedule 4 of the Companies Act 1985 which requires fixed assets to be stated at their purchase price or production cost. The Act does not permit the deduction of contributions; hence these would have been accounted for as deferred income.

This departure from the requirements of the Act is, in the opinion of the directors, necessary for the accounts to give a true and fair view because infrastructure assets do not have determinable finite lives. Accordingly related capital contributions would not be recognised in the profit and loss account. The effect of this treatment on tangible fixed assets is disclosed in note 9.

Revenue grants and contributions are credited to the profit and loss account in the year to which they relate.

##### Leased assets

Fixed assets leased to the Company under finance leases are capitalised and depreciated in line with the Company's depreciation policy. The interest element of finance lease repayments is charged to the profit and loss account in proportion to the balance of the capital repayments outstanding.

Rentals payable under operating leases are charged to profit and loss account as incurred.

##### Fixed Asset Investments

Investments held as fixed assets are stated at cost, less provision, if appropriate, for any impairment in value other than a temporary impairment in value. The carrying values of fixed asset investments are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable

## SOUTHERN WATER SERVICES LIMITED

### NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

#### 1 Accounting policies (continued)

##### Stocks

Stocks are valued at the lower of cost and net realisable value.

##### Taxation

The taxation charge in the profit and loss account is based on the profit for the year as adjusted for disallowable and non-taxable items using current rates and takes into account tax deferred because of timing differences between the treatment of certain items for taxation and accounting purposes. Deferred taxation is provided on all timing differences that have originated but not reversed by the balance sheet date, calculated at the rate at which it is expected the tax will arise in accordance with FRS19 "Deferred Tax". Deferred taxation balances are not discounted. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered.

##### Pensions

SWS operates pension schemes which cover the majority of the employees. An independent actuary normally conducts a valuation of the defined benefits pension scheme every three years. The Company has completed the final stage of the implementation of FRS 17 "Retirement Benefits" during the year.

In accordance with FRS 17 the pension deficit has been recognised on the balance sheet and operating and financing costs of pension and post-retirement schemes are recognised separately in the profit and loss account. Service costs are systematically spread over the service lives of the employees and financing costs are recognised in the period in which they arise. The costs of past service benefit enhancements, settlements and curtailments are also recognised in the period in which they arise.

The differences between actual and expected returns on assets and liabilities during the year, including changes in actuarial assumptions, are recognised in the statement of total recognised gains and losses.

##### Provisions

An environmental provision is made in accordance with FRS12 for the costs relating to the decommissioning of abandoned sites. No reimbursement is expected. Discounting the provision would not materially effect its final value.

#### 2 Segmental analysis

The directors believe that the whole of SWS's activities constitute a single class of business. The Company's turnover is generated wholly from within the UK.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**3 Classification of turnover and revenue costs**

Turnover represents the income receivable for providing water supply and wastewater services and is generated wholly in the United Kingdom.

Cost of sales reflects the direct costs of providing water supply and wastewater services. Administrative expenses comprise the indirect costs of the business. Other operating income relates to rents receivable.

**4 Profit on ordinary activities before taxation**

Profit on ordinary activities before taxation is stated after charging/(crediting):	<b>2006</b>	2005 (restated)
	<b>£m</b>	£m
Staff costs (note 5a)	<b>47.6</b>	50.5
Depreciation on		
- owned assets	<b>138.6</b>	118.2
- assets held under finance leases	<b>0.4</b>	0.3
	<u><b>139.0</b></u>	<u>118.5</u>
Rentals under operating leases	<b>3.7</b>	4.1
Research and development expenditure	<b>1.4</b>	1.5
Release of grants and contributions (note 17)	<b>(2.2)</b>	(2.1)
Exceptional item (See note (i) below)	<b>14.1</b>	-
Auditors' remuneration for audit work	<b>0.3</b>	0.2
Auditors' remuneration for non-audit services to the company (included in exceptional item above)	<b>1.7</b>	0.1

Note (i)

During the period the Company brought to the attention of Ofwat certain inconsistencies relating to the reporting of response levels to, and handling of, customer enquiries and complaints discovered in the course of a project to install a new customer billing system. These inconsistencies have meant that some customers did not receive compensation they were due under a Guaranteed Standards Scheme (GSS) where the Company is obliged to make payments if it does not respond to letters within certain timescales. A specialist team was appointed to investigate these inconsistencies and work was also instigated to make the payments due under the GSS. The costs of the investigation, together with the costs of identifying and making the GSS payments is shown in the Accounts as an exceptional item of £14.1m.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**5 Employee information**

	2006	2005 (restated)
	£m	£m
<b>(a) Employee costs (including directors' emoluments):</b>		
Wages and salaries	49.1	52.7
Social security costs	3.9	4.2
Pension costs	7.6	10.3
Total employee costs	<u>60.6</u>	<u>67.2</u>
Less: charged as capital expenditure	<u>(13.0)</u>	<u>(16.7)</u>
Charged to the profit and loss account	<u>47.6</u>	<u>50.5</u>

Employee costs that are charged as capital expenditure are those directly related to the construction or acquisition of assets.

	2006	2005
	No.	No.
<b>(b) Average number of persons employed</b>		
Operations	1,234	1,369
Project Delivery	-	58
Customer Services	279	263
Corporate Centre	388	372
	<u>1,901</u>	<u>2,062</u>

The prior year numbers have been restated in order to be consistent with the current year's disclosures. The total numbers have not changed.

**6 Net interest and similar charges**

	2006	2005 (restated)
	£m	£m
Interest payable on other loans	(161.7)	(152.3)
Indexation	(19.8)	(19.0)
Amortisation of issue costs	(4.4)	(2.5)
Amortisation of bond premium	0.6	0.5
Other finance expense (note 21)	(2.6)	(4.0)
Interest on preference shares	(13.7)	(13.7)
Total interest payable	<u>(201.6)</u>	<u>(191.0)</u>
Interest receivable from Southern Water Services Group Limited	56.9	57.1
Other interest receivable	18.6	13.6
Net interest charge	<u>(126.1)</u>	<u>(120.3)</u>

For the years ended 31 March 2005 and 31 March 2006, the Company paid interest of £152.2m and £161.6m respectively to Group companies.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**7 Tax on profit on ordinary activities**

	2006	2005 (restated)
	£m	£m
<b>Current tax:</b>		
UK corporation tax on profits for the year at 30% (2005: 30%)	16.7	17.1
Adjustment in respect of prior years	-	(8.4)
	16.7	8.7
<b>Deferred tax:</b>		
Origination and reversal of timing differences	14.7	9.7
Pension cost relief in excess of pension cost charge	1.2	(1.2)
Total deferred tax	15.9	8.5
Total tax on profit on ordinary activities	32.6	17.2

The rate of current tax charge on profit on ordinary activities varied from the standard rate of corporation tax due to the following factors:

	2006	2005 (restated)
	£m	£m
<b>Profit on ordinary activities before tax</b>	<b>94.0</b>	<b>68.9</b>
<b>Current tax:</b>		
UK corporation tax rate at 30% (2005: 30%) on profit for the year	28.2	20.7
Adjustments in respect of prior years	-	(8.4)
Other differences	0.8	0.1
Permanent differences	3.6	4.8
<b>Tax charge on ordinary activities</b>	<b>32.6</b>	<b>17.2</b>
Effect of deferred tax	(15.9)	(8.5)
<b>Current tax charge for year</b>	<b>16.7</b>	<b>8.7</b>

Factors that may effect future tax charges:

Based on current capital investment plans, the company expects to continue to be able to claim capital allowances in excess of depreciation in future years at a similar level to the current year.

Deferred tax liabilities have not been discounted.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**8 Dividends per share**

	<b>2006</b>	2005 (restated)	<b>2006</b>	2005 (restated)
	<b>£ per ordinary share</b>	£ per ordinary share	<b>£m</b>	£m
<b>Ordinary shares</b>				
Interim dividend –30 June	<b>177.70</b>	178.57	<b>9.9</b>	10.0
Interim dividend –30 Sept	<b>177.70</b>	178.57	<b>9.9</b>	10.0
Interim dividend –31 Dec	<b>177.70</b>	178.57	<b>10.0</b>	10.0
Interim dividend –31 Mar	<b>177.70</b>	178.57	<b>10.0</b>	10.0
Total interim dividend	<u><b>710.80</b></u>	<u>714.28</u>	<u><b>39.8</b></u>	<u>40.0</u>
Final dividend	<b>89.29</b>	60.71	<b>5.0</b>	3.4
<b>Total ordinary dividend</b>	<u><u><b>800.09</b></u></u>	<u><u>774.99</u></u>	<u><u><b>44.8</b></u></u>	<u><u>43.4</u></u>

The company adopted FRS 21 during the year. The effect of the change in accounting policy was to recognise the final proposed dividend for the year ended 31 March 2005 of £5m in the current year.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**9 Fixed assets and capital commitments**

**(a) Tangible assets**

	Freehold land & buildings	Plant & Machinery	Infra- structure assets	Assets in the course of const- ruction	Other	Total
	£m	£m	£m	£m	£m	£m
<b>Cost:</b>						
At 1 April 2005	932.9	1,007.4	1,308.5	215.1	312.0	3,775.9
Additions	15.6	14.2	14.4	271.2	1.9	317.3
Transfers	29.5	75.4	61.8	(165.1)	(1.6)	-
Grants & contributions	-	-	(9.1)	-	-	(9.1)
Disposals	(0.4)	(0.1)	(1.6)	-	-	(2.1)
<b>At 31 March 2006</b>	<b>977.6</b>	<b>1,096.9</b>	<b>1,374.0</b>	<b>321.2</b>	<b>312.3</b>	<b>4,082.0</b>
<b>Depreciation:</b>						
At 1 April 2005	233.5	301.9	306.4	-	179.2	1,021.0
Charge for the year	29.8	51.2	39.4	-	18.6	139.0
Disposals	-	(0.1)	(1.6)	-	-	(1.7)
<b>At 31 March 2006</b>	<b>263.3</b>	<b>353.0</b>	<b>344.2</b>	<b>-</b>	<b>197.8</b>	<b>1,158.3</b>
<b>Net book value:</b>						
<b>At 31 March 2006</b>	<b>714.3</b>	<b>743.9</b>	<b>1,029.8</b>	<b>321.2</b>	<b>114.5</b>	<b>2,923.7</b>
At 31 March 2005	699.4	705.5	1,002.1	215.1	132.8	2,754.9

Of the additions and transfers into infrastructure assets, the amount spent on *infrastructure renewals* during the years ended 31 March 2006 and 31 March 2005 was £45.9m and £21.2m, respectively. Of the grants and contributions set against *infrastructure assets* during the years ended 31 March 2006 and 31 March 2005, £5.1m and £3.0m respectively relates to *infrastructure renewals*.

For the years ended 31 March 2006 and 31 March 2005, the net book value of *infrastructure assets* is stated after deducting grants and contributions since privatisation of £148.1m and £139.0m, respectively.

Freehold land is stated at a cost of £48.3m and £43.6m at 31 March 2006 and 31 March 2005, respectively, and is not depreciated.

Other assets relate primarily to computer equipment, meter reading devices and motor vehicles.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

**9 Fixed assets and capital commitments (continued)**

Assets held under finance leases are capitalised and included in plant and machinery:

	2006	2005
	£m	£m
Cost	11.7	11.7
Aggregate depreciation	<u>(8.2)</u>	<u>(7.8)</u>
Net book amount	<u>3.5</u>	<u>3.9</u>

**(b) Capital commitments**

	2006	2005
	£m	£m
In respect of contracts placed	<u>741.0</u>	<u>69.1</u>

**10 Fixed asset investments**

	2006	2005
	£m	£m
<b>Shares in group undertakings</b>		
At 1 April and 31 March	<u>29.2</u>	<u>29.2</u>

The investment represents all the issued shares of Southern Water Services (Finance) Ltd (SWSF), a company incorporated in the Cayman Islands. The principal activity of the company is to raise debt finance.

**11 Stocks**

	2006	2005
	£m	£m
Raw materials	0.8	0.7
Work in progress	0.3	0.3
	<u>1.1</u>	<u>1.0</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**12 Debtors: amounts falling due within one year**

	2006 £m	2005 £m
Trade debtors	62.3	56.9
Unbilled income	40.6	37.2
Amounts owed by group undertakings	0.6	0.2
Prepayments	2.8	2.0
Other debtors	13.0	9.8
	<b>119.3</b>	<b>106.1</b>

**13 Debtors: amounts falling due after one year**

	2006 £m	2005 £m
Loan to Southern Water Services Group Limited	<b>812.3</b>	<b>812.3</b>

The loan to Southern Water Services Group Limited is secured on the assets held under the Southern Water Services Group Security agreement and repayable on 31 July 2052 with interest payable at 7%.

**14 Creditors: amounts falling due within one year**

	2006 £m	2005 (restated) £m
Bank overdraft	13.3	1.1
Trade creditors	16.0	11.0
Loans from group undertakings (see below)	30.3	30.3
Capital creditors and capital accruals	114.0	69.2
Amounts owed to group undertakings	0.6	0.5
Corporation tax	0.5	1.0
Taxation and social security	1.4	1.4
Accruals and deferred revenue	68.0	71.1
Bond premium deferred	0.6	0.7
Debt issue costs (note 15)	(2.4)	(2.5)
	<b>242.3</b>	<b>183.8</b>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**14 Creditors: amounts falling due within one year (continued)**

The loan from group undertakings is unsecured, interest free, and shall be repayable in whole or part upon demand at any time, provided that:

- (a) on the date of such demand, no class A debt is outstanding, no class B debt is outstanding and no mezzanine debt is outstanding; or
- (b) the consent of the Security Trustee is given.

**15 Creditors: amounts falling due after more than one year**

	2006	2005 (restated)
	£m	£m
Loans and other borrowings:		
Loan from SWSF Limited	2,386.7	2,287.5
Bond premium deferred	16.7	17.3
Debt issue costs	(52.0)	(47.7)
Class A1 Preference shares (see note iv below)	150.0	150.0
Class B Preference shares (see note iv below)	110.0	110.0
	2,611.4	2,517.1
	2006	2005
	£m	£m
<b>Repayments fall due as follows:</b>		
Between two and five years	-	300.0
After five years not by instalments	2,646.7	2,247.5
	2,646.7	2,547.5

As part of the Southern Water Group refinancing on 23 July 2003 SWSF raised new debt in the financial markets and advanced the borrowings to SWS. In July 2004 SWSF raised a further £175m in the financial markets which included a premium of £18.5m. In 2005 SWSF raised an additional £500m including a discount of £0.5m and repaid loans of £420m. The net proceeds were advanced by SWSF to SWS. Issue costs of £8.0m were paid by SWSF and recharged to SWS.

Under the loan agreements between SWS and SWSF, SWSF advances an amount equal to each bond or other debt raised at the same interest rate plus 0.01%. Therefore each individual back to back inter company loan has been separately disclosed.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**15 Creditors: amounts falling due after more than one year (continued)**

An analysis of the loans is shown below: -

Loans	2006 £m	2005 (restated) £m
Class A £350m 6.202% fixed rate 2029	350.0	350.0
Class A £150m 3.716% index linked 2034	161.8	157.2
Class A £35m 3.716% index linked 2034	37.7	36.7
Class A £300m 6.185% fixed rate 2007	-	300.0
Class A £350m 6.650% fixed rate 2026	350.0	350.0
Class A £150m 3.826% index linked 2023	161.8	157.3
Class A £120m 6.935% fixed rate 2013	-	120.0
Class A £350m 5.010% fixed rate 2021	349.9	-
Class A £150m 2.295% index linked 2041 (note (iv) below)	149.6	-
Class B £250m 7.879% fixed rate 2038 (note (i) below)	250.0	250.0
Artesian £165m 4.086% index linked 2033	178.0	173.0
Artesian £156.5m 3.645% index linked 2032	164.7	160.1
Senior mezzanine £127.2m 11.97% fixed rate 2038 (note (ii) below)	127.2	127.2
Junior mezzanine £106m 16.01% fixed rate 2038	106.0	106.0
Debt issue costs (note (iii) below)	(52.0)	(47.7)
Bond premium deferred	16.7	17.3
Class A1 Preference shares (note (v) below)	150.0	150.0
Class B Preference shares (note (v) below)	110.0	110.0
	<u>2,611.4</u>	<u>2,517.1</u>

These loans are guaranteed and secured pursuant to a guarantee and security agreement (the Security Agreement). The agreement is over the entire property, assets, rights and undertaking of each of SWS, SWSF, SWS Holdings Limited, and SWS Group Holdings Limited. In the case of SWS, this is to the extent permitted by the Water Industry Act 1991 and Licence.

- (i) The interest rate on the class B1 £250m is fixed at 7.879% until March 2014 when it reverts to LIBOR plus a margin to be determined with a premium of 0.01%.
- (ii) The interest rate on the senior mezzanine £125m loan is fixed at 11.97% until March 2022 when it reverts to LIBOR plus 6.25% with a premium of 0.01%. For the remaining senior mezzanine loan of £2.2m the interest rate is LIBOR plus 6.25% with a premium of 0.01%.
- (iii) Debt issue costs represent issue fees paid to SWSF. Where these costs are attributable to a specific instrument they are being amortised over the life of that instrument. The remaining costs are being amortised over the weighted average life of the loan advances noted above. As at 31 March 2006 debt issue costs amounted to £54.4m of which £2.4m represents the short-term amount which is disclosed separately in note 14.

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**15 Creditors: amounts falling due after more than one year (continued)**

- (iv) The company has entered into a swap agreement that has converted its Class A £150m from a fixed rate of 5.0% to an index linked bond with an interest rate of 2.295% plus RPI.
- (v) The preference shares issued have been classified as loans in the financial statements as stated in FRS 25. All shares are redeemable at the option of SWS at any time.

The Class A1 and B preference shares, which do not carry voting rights, were issued on the 23 July 2003, and are redeemable at their nominal value plus the share premium paid, on 31 March 2038 or at the Company's option anytime earlier. Class A1 and B shares were issued at £1,000 per share and the amounts received totalled £260.0m for both classes of shares. Class A2 preference shares were issued for £0.01 per share on the 7 May 2003 and the amount received totalled £1,500 and are redeemable at nominal value. Shareholders are entitled to receive dividends annually as follows: -

Class A1  
- £40 per share

Class A2  
- the base value dividend plus an amount for company outperformance and any savings arising from any refinancing of the mezzanine debt. The base value is £nil per share increasing by £15 every five years. (Outperformance from 1 April 2005 onwards is the difference between Southern Water Services Limited's audited 'profit before interest and taxation' and the targeted 'profit before interest and taxation' as determined by Ofwat in the periodic review.

Class B  
- £70 per share

These dividends are payable on the 31 March and 30 September each year. A dividend will not be paid to the Class A2 shareholders for the year to 31 March 2006 since the company did not meet its outperformance targets.

On winding up the preference shareholders rank above ordinary shareholders with the preference shareholders being paid in order of Class A1, Class A2 then Class B.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**16 Provision for liabilities and charges**

	2006	2005 (restated)
	£m	£m
<b>(a) Environmental obligations</b>		
At 1 April	1.3	2.9
Written back	(0.0)	(1.2)
Utilised in year	(0.2)	(0.4)
At 31 March	1.1	1.3
<b>(b) Deferred taxation</b>		
Accelerated capital allowances	409.8	392.7
Other timing differences	(10.7)	(8.3)
<b>Deferred taxation</b>	399.1	384.4
<b>Total</b>	400.2	385.7

The environmental provision relates to costs for the decommissioning of abandoned sites. No reimbursement is expected. The period over which the provision will be utilised cannot be determined thus the provision is not discounted. Discounting the provision would not materially effect its final value.

	2006	2005 (restated)
	£m	£m
<b>Movement in deferred tax provision:</b>		
Deferred tax provided at 1 April	384.4	373.0
Prior Year adjustment	-	1.7
Deferred tax charge in Profit and Loss Account	14.7	9.7
<b>Deferred tax provided at 31 March</b>	399.1	384.4

The deferred tax asset of £41.4m (2005 £42.0m) relating to the pension deficit has been deducted from the pension deficit and so has not been included in this balance.

**17 Grants and contributions**

	£m
At 1 April 2005	43.7
Receivable in year	4.7
Released to profit and loss account	(2.2)
<b>At 31 March 2006</b>	46.2

*These grants and contributions relate to non-infrastructure assets.*

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**18 Share capital**

	<b>2006</b>	2005
	<b>£m</b>	£m
Equity shares		
Authorised		
46,050,000 ordinary shares of £1 each	<b>46.1</b>	46.1
	<hr/>	<hr/>
Allotted, called up and fully paid		
56,000 ordinary shares of £1 each	<b>0.1</b>	0.1
	<hr/>	<hr/>
Non equity shares		
Authorised and issued		
Preference shares		
150,000 Class A1 shares of £1 each	<b>0.2</b>	0.2
150,000 Class A2 shares of £0.01 each	<b>0.0</b>	0.0
110,000 Class B shares of £1 each	<b>0.1</b>	0.1
	<hr/>	<hr/>

The preference shares have been classified as debt following the Company's adoption of FRS 25. They are disclosed within note 15 at an amount of £260.0m including share premium of £259.7m. The total statutory Company share premium of £306.0m includes ordinary share premium of £46.3m.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**19 Reconciliation of movement in shareholders' funds**

	Called up share capital	Share premium (restated)	Profit and loss account (restated)	Total
	£m	£m	£m	£m
At 1 April 2004	0.4	306.0	747.6	1,054.0
Prior year adjustment				
-FRS 17	-	-	(100.3)	(100.3)
-FRS 21	-	-	3.4	3.4
-FRS 25	(0.3)	(259.7)	-	(260.0)
At 1 April 2004 restated	<u>0.1</u>	<u>46.3</u>	<u>650.7</u>	<u>697.1</u>
Profit before dividends paid	-	-	51.7	51.7
Dividends	-	-	(43.4)	(43.4)
Actuarial gain on pension scheme	-	-	13.1	13.1
Movement on deferred tax relating to pension asset	-	-	(3.9)	(3.9)
At 31 March 2005	<u>0.1</u>	<u>46.3</u>	<u>668.2</u>	<u>714.6</u>
At 1 April 2005	0.1	46.3	668.2	714.6
Profit before dividends paid	-	-	61.4	61.4
Dividends paid	-	-	(44.8)	(44.8)
Actuarial loss on pension Scheme	-	-	(2.0)	(2.0)
Movement on deferred tax relating to pension asset	-	-	0.6	0.6
<b>At 31 March 2006</b>	<b><u>0.1</u></b>	<b><u>46.3</u></b>	<b><u>683.4</u></b>	<b><u>729.8</u></b>

The profit and loss reserve includes £96.6m (2005: £98.0m) stated after deferred taxation of £41.4m (2005: £42.0m) in respect of pension scheme liabilities of the group pension fund.

**Prior year adjustments arising from the implementation of new standards**

The prior year adjustments relate to the implementation of FRS 17 'retirement benefits', FRS 21 'events after the balance sheet date' and FRS 25 'disclosure of financial instruments'.

The adoption of FRS 21 has resulted in an increase in shareholders funds of £5.0m at 1 April 2005 (2004: £3.4m) due to the write back of the dividend proposed at 31 March 2005, which can now only be recognised once approved by the Board.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006

19 Reconciliation of movement in shareholders' funds (continued)

**Prior year adjustments arising from the implementation of new standards**

The adoption of FRS 17 has resulted in a decrease in operating costs by £6.6m (2005 £1.4m), an increase in interest of £2.6m (2005 £4.0m), and an increase in tax of £1.0m (reduction 2005 £0.8m), together with the recognition of the pension deficit on the balance sheet £96.6m (2005 £98.0m). The actuarial loss of £2.0m (2005: profit £13.1m) in the pension fund has been disclosed in the Statement of Total Recognised Gains and Losses.

FRS 25 has resulted in some disclosure changes with the preference shares totalling £260.0m being reclassified as liabilities and the associated dividends of £13.7m (2005 £13.7m) being disclosed as interest.

20 (a) Cash Flow from operating activities

	2006	2005 (restated)
	£m	£m
<b>Continuing operations</b>		
Operating profit and profit on ordinary activities before interest and taxation	215.1	186.2
Depreciation charge	139.0	118.5
Difference between pension charge and cash contributions	(6.6)	(0.1)
Amortisation of grants and contributions	(2.2)	(2.1)
Decrease in environmental provision	(0.2)	(1.6)
Decrease in stocks	-	0.4
(Increase)/ decrease in debtors	(15.3)	2.8
Increase/ (decrease) in creditors	1.8	(2.5)
<b>Total net cash inflow from operating activities</b>	<u>331.6</u>	<u>301.6</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**20 (b) Analysis of net debt**

	At 31 March 2005 (restated) £m	Cash Flow £m	Other non – cash changes £m	At 31 March 2006 £m
Bank overdraft	(1.1)	(12.2)	-	(13.3)
Cash deposits	239.4	1.5	-	240.9
Cash and cash equivalents	238.3	(10.7)	-	227.6
Debt issue costs	50.2	8.6	(4.4)	54.4
Loans due within one year	(30.3)	-	-	(30.3)
Loans due after one year	(2,565.5)	(79.5)	(19.0)	(2,664.0)
	<u>(2,307.3)</u>	<u>(81.6)</u>	<u>(23.4)</u>	<u>(2,412.3)</u>

**21 Pensions**

The Company accounted for pension costs during the year under FRS17. These disclosures show a net FRS 17 deficit (after deferred tax) of £96.6 million (2005 deficit: £98.0m). The deficit has arisen mainly as a result of lower expected future returns on investments and turbulence in the stock market.

**Pension schemes operated**

At 1 April 2005 the Company principally operated two schemes, details of which are shown below:

1. Southern Water Pension Scheme (SWPS), a funded defined benefit scheme, which was closed to new members in 31 December 1998 but re-opened in July 2003 and finally closed to new entrants on 1 April 2005. This scheme has nine trustee directors.
2. A second company stakeholder scheme, which is a defined contribution scheme, is also available to all employees.

The assets of the schemes are held separately from those of the company. State Street Bank and Trust Company acts as custodian for the defined benefit schemes and asset management is delegated to external fund managers.

Members of all schemes receive an annual statement of their accrued benefits.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**21 Pensions (continued)**

**Pension schemes operated**

The latest actuarial valuations of the Southern Water Pension Scheme (SWPS) and Southern Water Services Executive Pension (SWEPS) schemes were carried out as at 31 March 2004 using the projected unit method. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, the rate of future pensionable salary increases and the level of pension increases.

For closed schemes under this method the current service cost will increase as the members of the schemes approach retirement.

The principal assumptions made by the actuary in the valuation were as follows:

	<b>2004</b>	<b>2004</b>
	<b>SWPS</b>	<b>SWEPS</b>
	<b>% pa</b>	<b>% pa</b>
Return on investments	<b>6.3</b>	<b>5.6</b>
Salary growth	<b>4.3</b>	<b>4.3</b>
Pension increases on the excess over guaranteed minimum pensions	<b>2.8</b>	<b>2.8</b>

The assets of the scheme had a market value of £270.4m for the SWPS and £21.9m for the SWEPS at 31 March 2004. This was sufficient to cover 78% and 82% of the benefits of SWPS and SWEPS respectively, that had accrued to members at that date, after allowing for expected future increases in earnings.

**FRS 17 - assumptions, asset, liability and reserves disclosures**

Formal actuarial funding valuations of the two principal defined benefit schemes in the UK were carried out at 1 April 2004 and updated to 31 March 2006 by a qualified independent actuary. The following disclosures are combined for the SWPS and SWEPS. The major assumptions used by the actuary are set out in the table below.

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>% pa</b>	<b>% pa</b>	<b>% pa</b>
Price inflation	<b>3.0</b>	2.9	2.9
Rate of increase in salaries (plus an age-related promotional scale)	<b>4.3</b>	4.4	4.4
Rate of increase of pensions in payment	<b>3.0</b>	2.9	2.9
Rate of increase for deferred pensions	<b>3.0</b>	2.9	2.9
Discount rate	<b>5.0</b>	5.5	5.6
Expected return on assets	<b>6.8</b>	7.0	7.2

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**21 Pensions (continued)**

**FRS 17 - assumptions, asset, liability and reserves disclosures**

The assets and liabilities in the schemes and the expected rates of return at 31 March 2006, 31 March 2005 and 31 March 2004 were:

	<b>Rate of return 2006 %</b>	Rate of return 2005 %	Rate of return 2004 %	Value at 2006 £m	Value at 2005 £m	Value at 2004 £m
Equities	7.9%	8.1%	8.4%	273.3	223.5	192.6
Bonds	4.2%	4.7%	4.8%	108.7	94.1	87.9
Cash	4.0%	3.9%	3.9%	5.5	7.5	4.9
Total market value of Plan assets				<b>387.5</b>	325.1	285.4
Total value of Plan liabilities				<b>(525.5)</b>	(465.1)	(434.6)
Accrued deficit in the Plan				<b>(138.0)</b>	(140.0)	(149.2)
Related deferred tax asset				41.4	42.0	44.7
Net pension liability				<b>(96.6)</b>	(98.0)	(104.5)

**Analysis of amounts charged to operating profit:**

	2006 £m	2005 £m
Employer's current service cost	7.1	10.0
Employer's past service costs	0.5	0.3
Total charged to operating profit	<b>7.6</b>	10.3

**Analysis of other amounts credited to operating profit:**

	2006 £m	2005 £m
Gain on curtailment	<b>(2.5)</b>	-
Net gain credited to operating profit	<b>(2.5)</b>	-

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**21 Pensions (continued)**

**Analysis of the amount charged to other finance expense:**

	<b>2006</b>	<b>2005</b>
	<b>£m</b>	<b>£m</b>
Interest on pension scheme liabilities	<b>25.5</b>	24.3
Expected return on pension scheme assets	<b>(22.9)</b>	(20.3)
	<b>2.6</b>	4.0
<b>Total charge before tax</b>	<b>7.7</b>	14.3

**Analysis of the amounts recognised in STRGL:**

	<b>2006</b>	<b>2005</b>
	<b>£m</b>	<b>£m</b>
<i>Actuarial return less expected return on pension scheme assets</i>	<b>39.7</b>	19.2
Experience gain/(loss) arising on scheme liabilities	<b>4.6</b>	1.8
Loss on change of assumptions (financial and demographic)	<b>(46.3)</b>	(7.9)
<b>Total gain/(loss) recognised in STRGL before adjustment for tax</b>	<b>(2.0)</b>	13.1

**Analysis of the movement in the schemes' deficits during the year**

	<b>2006</b>	<b>2005</b>
	<b>£m</b>	<b>£m</b>
Deficit in the scheme at 1 April	<b>(140.0)</b>	(149.2)
Employer's contributions	<b>11.7</b>	10.4
Employer's current service cost	<b>(7.1)</b>	(10.0)
Employer's past service cost	<b>(0.5)</b>	(0.3)
Curtailment gain	<b>2.5</b>	-
Other finance income	<b>(2.6)</b>	(4.0)
Actuarial (loss)/gain	<b>(2.0)</b>	13.1
<b>Deficit in the scheme at end of year</b>	<b>(138.0)</b>	(140.0)

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**21 Pensions (continued)**

Details of experience gains and losses for the year to 31 March 2006 are as follows:

	2006	2005	2004	2003
<b>a. Actuarial gain on scheme assets</b>				
Amount (£m)	(39.7)	(19.2)	(34.0)	77.6
Percentage of the scheme assets	<u>10.2%</u>	5.9%	11.9%	32.8%
<b>b. Experience (gain)/loss on scheme liabilities</b>				
Amount (£m)	(4.6)	(1.8)	6.8	3.0
Percentage of the present value of the scheme liabilities	<u>0.9%</u>	0.4%	1.6%	0.8%
<b>c. Total actuarial loss/(gain) recognised in STRGL</b>				
Amount (£m)	2.0	(13.1)	0.3	100.0
Percentage of the present value of the scheme liabilities	<u>0.4%</u>	2.9%	0.1%	26.4%

**22 Contingent liabilities**

	2006 £m	2005 £m
Capital claims	<u>1.9</u>	<u>8.7</u>

Contractors submit claims to the Company for the estimated final cost of their works. These claims are reviewed to assess where the liability for the costs rests and the amount that will actually be settled. The expected amount is included within capital creditors and a further sum is identified as a contingent liability, representing a proportion of the difference between the contractor's claim and Southern Water's valuation.

On 31 March 2006 the company was notified by its regulator, Ofwat, that it will be fined for failing to meet customer service standards. Although no penalty has been fixed yet, the company could be fined up to a maximum of 10% of its annual turnover.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**23 Financial commitments**

	<b>2006</b>	2005
	<b>£m</b>	£m
As at 31 March 2006, the Company had annual commitments under non-cancellable operating lease agreements in respect of vehicles for which the payment extends over a number of years as follows:		
Expiring within one year	<b>0.4</b>	0.4
Expiring between two and five years	<b>2.7</b>	2.7
	<u><b>3.1</b></u>	<u>3.1</u>

Operating leases are charged to the profit and loss account over the lease term

**24 Directors' emoluments**

	<b>2006</b>	2005
	<b>£000</b>	£000
Aggregate emoluments (including benefits in kind)	<b>942</b>	1,267
Compensation for loss of office	<b>137</b>	498
	<u><b>137</b></u>	<u>498</u>

Retirement benefits accrued to two directors under a Southern Water defined benefit scheme.

Details of emoluments and benefits for the highest paid director:

	<b>2006</b>	2005
	<b>£000</b>	£000
Aggregate highest paid director's emoluments and benefits	<b>203</b>	254
	<u><b>203</b></u>	<u>254</u>

**25 Related party transactions and ultimate holding company**

The immediate parent undertaking is SWS Holdings Limited.

The ultimate parent company is Southern Water Capital (SWC). At 1 April 2005 SWC owned 80.1% of the share capital of Southern Water Investments Limited (SWIL), the other 19.9% being owned by Veolia Water Investment Limited (VWIL). On 21 November VWIL exercised an option and acquired a further 5.1% of the share capital of SWIL, increasing its shareholding to 25%. On 10 April 2006 VWIL sold its entire shareholding to SWC. The major shareholders in Southern Water Capital are Royal Bank Investments Limited and PPI Investments SP, Inc.

Southern Water Capital Limited prepares consolidated accounts, copies of which may be obtained from the Company Secretary of Southern Water Services Limited, at Southern House, Yeoman Road, Worthing, BN13 3NX.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2006**

**25 Related party transactions and ultimate holding company (continued)**

The transactions and balances with the Company's related parties, as defined by Financial Reporting Standard 8, and the extent of the transactions with them are summarised below.

This includes other companies in the Southern Water group, companies controlled by directors, and the major shareholders.

	<b>2006</b> £m	2005 (restated) £m
<b>Debtors: amounts falling due within one year</b>		
SWSF	0.6	0.2
<b>Debtors: amounts falling due after one year</b>		
Loans to Southern Water Services Group Limited	812.3	812.3
<b>Creditors: amounts falling due within one year</b>		
Loan from SWSF	30.3	30.3
Management charges from Southern Water Investments Limited	0.5	0.5
Debt issue costs paid to SWSF	(2.4)	(2.5)
Bond premium on loan from SWSF	0.6	0.7
<b>Creditors: amounts falling due after one year</b>		
Loans from SWSF	2,386.7	2,287.5
Bond premium on loan from SWSF	16.7	17.3
Debt issue costs paid to SWSF	(52.0)	(47.7)
<b>Turnover</b>		
Recharges for consultancy to Veolia Water UK plc	0.1	-
<b>Administration expenses</b>		
Consultancy fees for R Thian paid to Renex Limited	0.1	0.1
Consultancy fees for D Golden paid to Management & Procurement Services Limited	0.0	0.1
<b>Interest Payable</b>		
SWSF	161.6	152.2
<b>Interest Receivable</b>		
Southern Water Services Group Limited	56.9	57.1
SWSF	4.3	2.3
<b>Dividends payable</b>		
SWS Holdings Limited	44.8	43.4

## SOUTHERN WATER SERVICES LIMITED

### INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTHERN WATER SERVICES LIMITED

We have audited the financial statements of Southern Water Services Limited for the year ended 31 March 2006 which comprise the Profit and Loss Account, the Balance Sheet, the Cash Flow Statement, the Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out therein.

#### **Respective responsibilities of directors and auditors**

As described in the Statement of Directors' Responsibilities the company's directors are responsible for the preparation of the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

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

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. We also report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

#### **Basis of audit opinion**

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

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

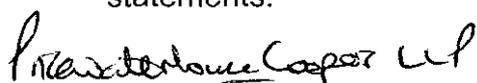
SOUTHERN WATER SERVICES LIMITED

**INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTHERN WATER SERVICES LIMITED**

**Opinion**

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 March 2006. and of its profit and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.



*PricewaterhouseCoopers LLP*

*Chartered Accountants and Registered Auditors*

*Gatwick*

15 June 2006