

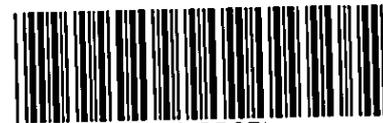
SOUTHERN WATER SERVICES LIMITED

**OPERATING AND FINANCIAL REVIEW,
REPORT OF THE DIRECTORS
AND
ACCOUNTS**

**FOR THE YEAR ENDED
31 MARCH 2007**

Registered No 2366670

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SOUTHERN WATER SERVICES LIMITED

Operating and Financial Review, Report of the Directors and Accounts for the year ended 31 March 2007

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OPERATING AND FINANCIAL REVIEW

This section is prepared in accordance with the Accounting Standards Board's Reporting Statement: Operating and Financial Review, January 2006.

A. OUR BUSINESS

Southern Water Services Limited (Southern Water) holds an appointment as a water and sewerage undertaker for the South East area of England. Drinking water supplies and wastewater services are provided in an area covering Kent, Sussex, Hampshire and the Isle of Wight. These activities, which are referred to as the appointed business, account for 99% of turnover. There are also a number of minor activities which are not regulated under the appointment and which are described here as the non-appointed activities.

Water services

Southern Water supplies high quality drinking water to more than 1 million customers across the region, through a network of approximately 14,000 km of mains, 94 water treatment works and numerous pumping stations and service reservoirs.

The average daily volume supplied in 2006-07 was 489 million litres a day. Of the 938,000 households served, 33% have a meter and pay by reference to the amount of water supplied. 81% of business customers are metered.

Wastewater services

Domestic and trade wastewater services are provided to around 1.7 million domestic and business customers. During 2006-07, 370 wastewater treatment works treated an average of 758 million litres of wastewater every day, delivered by a network of more than 21,000km of sewers.

Around 1 million of these customers are also provided with water services by Southern Water, the remainder receive their supply from one of the small water companies which hold appointments for water supply only within the region.

Of the total water and wastewater services turnover, 19% is derived from commercial customers whilst the remainder is from households.

Non-appointed activities

Southern Water also carries out a small number of non-appointed activities associated with the core business. The largest of these is the provision of property search information for homebuyers. During the year almost 80,000 searches were sold. The full implementation of Home Improvement Packs is likely to lead to an increase in demand for this service in future.

During the year a number of non-appointed business areas were sold or in the process of being sold, including the provision of leisure facilities at Bewl Water, the largest reservoir in the region, and the provision of aerial mast sites at treatment works and other company sites. This has enabled the business to focus on delivering the best services for water and sewerage customers.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Regulation of the water industry

The Water Services Regulation Authority (WSRA) replaced the office of the Director General of Water Services on 1 April 2006. However, the WSRA has continued to operate under the organisation's former name 'Ofwat'

Ofwat's main duties are ensuring companies can finance their functions, protecting customers' interests and promoting competition. It is also responsible for setting price limits for all appointed water and sewerage undertakers. These price limits apply to the weighted average of water and wastewater charges.

Price limits were last set in 2004 for the period 2005-06 to 2009-10. The allowed increases are shown in Figure 1. Associated with these price limits are a set of required outputs and efficiency targets. Price limits for the subsequent five-year period will be set in 2009. Preparations for the 2009 periodic review have already begun, and more details are set out below.

Figure 1: Price limits

	2005-06	2006-07	2007-08	2008-09	2009-10
Allowed increase ('K' factor)	12.6%	3.9%	3.5%	5.8%	2.6%

Charges can be increased by RPI plus the 'K' factor

Competition

The Water Act 2003 set out a framework for the development of competition within the water industry. The Act allows for the licensing of water suppliers who can provide either retail services only, or use incumbent companies' networks for the delivery of water supplies to their own customers.

Under this regime currently only water customers consuming more than 50 million litres of water a year can switch supplier. To date, no customers of any incumbent water undertaker have switched supplier. Ofwat is reviewing the framework for competition in conjunction with Ministers.

Competition is also possible through cross-border supplies and inset appointments, where the incumbent's licensed area of supply is altered. Competition from these areas has been limited to date with only 11 inset appointments in the industry, none in Southern Water's supply area.

Despite this slow progress to date, the development of greater competition in the sector is expected to be a key feature of the next few years.

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Strategic Goals

Southern Water is committed to delivering excellent service to its customers while safeguarding the environment and delivering returns to shareholders which reflect the risks of the business. The Board's strategy to achieve this is to focus tightly on the core activities, utilising professional partner companies to provide non-core support in areas such as IT and finance.

To support this strategy the Board has endorsed a comprehensive set of performance targets for all areas of the business to ensure that regulatory goals are met and that the business delivers for customers effectively and efficiently.

In addition, to ensure focus on key issues, the Top 10 targets for the organisation are set out annually for all staff. These are the areas where improvements are required, such as minimising pollution incidents and where focus needs to be maintained, such as Health & Safety.

The Top 10 targets for the coming year are set out below.

- 1. Minimising compliance failures at wastewater treatment works**
- 2. Minimising pollution incidents, particularly those in the most serious categories 1 and 2**
- 3. Ensuring security of water supplies by achieving the maximum level on Ofwat's Security of Supply Index and maintaining our low leakage levels**
- 4. Improving the quality of drinking water supplies on at least two key parameters**
- 5. Delivering the capital programme investment and outputs in line with the business plan profile**
- 6. Meeting the targets in Phase 2 of the Customer Services Ofwat Monitoring Plan**
- 7. Delivering customer service improvements by reducing customers' need to contact the company**
- 8. Commence a project to deliver a new Business Application Suite to improve the efficiency of finance, procurement and human resources functions**
- 9. Fully deploying new "Front Office" systems for field operatives**
- 10. Reducing further the number of incidents reportable to the HSE and accidents leading to time off work**

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Headline KPIs

The Top 10 targets are supported by a series of sub-targets and Key Performance Indicators (KPIs) for the organisation. These KPIs are the indicators which the Board regularly monitors and considers key to the achievement of its long-term objectives for the organisation as a whole.

Financial KPIs

Under the financial structure, there are a comprehensive set of covenanted financial ratios but there are two key ratios, namely the ratio of net debt to Regulatory Capital Value (RCV) and the ratio of cash income to net interest cost.

The net debt used in the net debt RCV ratio is calculated from Southern Water's Regulatory Accounts as short and long-term borrowings less cash and short-term deposits. The RCV is set by Ofwat for five year periods at periodic reviews and reflects forecast growth in the asset base. It is adjusted at each periodic review for any out-performance, shortfalls in outputs or permitted additional investment and for certain asset disposals. The ratio of senior (Class A and B) debt to RCV is targeted to be maintained at below 85%, in line with our debt covenants.

Senior adjusted cash interest cover (measured as net cash flow less Current Cost Depreciation and the Infrastructure Renewals Charge, to senior debt interest) is targeted to be maintained above 1.1 times, to meet covenanted levels.

Net debt: RCV	
2005-06 performance	76%
2006-07 performance	78%
Covenanted lock-up level	<85%

Senior cash interest cover	
2005-06 performance	1.3 times
2006-07 performance	1.3 times
Covenanted trigger level.	1.1 times

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Customer services

Ofwat has specified a range of customer service indicators which it monitors and reports on each year. The Board pays particular attention to these indicators and Southern Water's comparative performance

However, given the difficulties experienced in the customer service area over the last two years (described in Section H below), the Board is now focused on delivering the customer services improvement plan to be agreed with Ofwat. This plan covers each of the Ofwat customer service indicators – response to billing enquiries and complaints, telephone call response times and satisfaction and meter reading

Overall performance across all areas of the business is measured by Ofwat using an Overall Performance Assessment (OPA) index, which takes in a range of measures including customer service, service interruptions, water pressure, leakage, pollution incidents and so on. Price limits can be adjusted for comparatively good or poor performance on the OPA index at price reviews. The OPA score has been adversely affected by the customer service issues over the last two years. Nonetheless, the Board continue to monitor performance against this overall measure and aim to achieve an incremental improvement in the score each year. For 2005-06 the OPA score was 360 out of a maximum of 437.5 points. 2006-07 figures have not yet been published by Ofwat, but an estimate has been given

Customer services	
2007-08 target	Achievement of agreed improvement plan
Overall Performance Assessment	
2005-06 performance	360 points
2006-07 performance	341 points (estimated)
2007-08 target	398 points

Water services

The provision of high quality drinking water is fundamental to public health. The Drinking Water Inspectorate (DWI) oversees standards of drinking water in England & Wales and Southern Water is required to monitor water quality at its water treatment works, reservoirs and at customer taps. The overall DWI measure of tests meeting the standards at customer taps is reported as percentage mean zonal compliance and is measured over the calendar year. This is the key measure of the quality of water received by customers. Maintaining mean zonal compliance as close to 100% as practicable is a key target to ensure consistently high standards for customers.

Minimising leakage is a key component of the strategy to ensure adequacy of water resources. It is also an issue which customers care deeply about. Southern Water's aim is to beat annual leakage targets set by Ofwat (92 MI/d for 2006-07 and 2007-08) maintaining its position as the water and sewerage company with the lowest leakage levels¹ in the industry.

¹ Measured on a per property basis

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Water services (continued)

Drinking water compliance	
2005 performance	99.96%
2006 performance	99.95%
2007 target	99.97%
Leakage	
2005-06 performance	93 MI/d
2006-07 performance	82 MI/d
2007-08 target	<92 MI/d

Wastewater services

Wastewater activities can have a significant effect on the natural environment. Southern Water's goal is to minimise that impact by ensuring that any pollution incidents are kept to a minimum and by ensuring that wastewater treatment works comply with the discharge consents issued by the Environment Agency. Consent compliance is measured in terms of the equivalent population served by failing works in order to reflect the impact of failures. The key target is compliance with look-up table consents (which represent the vast majority of current consents).

Pollution incidents at sewage-related premises	
2005-06 performance	16 Category 1 & 2 pollution incidents 200 Category 3 incidents
2006-07 performance	15 Category 1 & 2 pollution incidents 312 Category 3 incidents
2007-08 target	10 Category 1 & 2 pollution incidents 180 Category 3 incidents
Wastewater treatment works compliance	
2005-06 performance	<0.1% equivalent population
2006-07 performance	1.4% equivalent population
2007-08 target	0.1% equivalent population

Business re-organisation

Southern Water's strategy is to focus tightly on its core activities using professional service providers to support these activities. As part of this strategy a series of Master Framework Agreements (MFAs) have been entered into with service providers. MFAs have been signed for the provision of Engineering services (with TCS and Atkins), General Services (Wipro and TCS) and Customer Services (RR Donnelley). Under the MFA, individual work-packs are let for discrete activities, with eight work-packs having been let to date for the provision of services. These work-packs cover a diverse range of activities from Network Development services under the Engineering framework to finance and human resources administration under the General Services agreement.

A number of staff have transferred to service providers as work packs have been let. No Southern Water staff have been made redundant but a number have been freed up to move into front-line customer-focused positions. Further work-packs will be let under the framework agreements to ensure that Southern Water staff are clearly focused on providing excellent services to customers.

OPERATING AND FINANCIAL REVIEW (continued)**B. FINANCIAL PERFORMANCE****Financial Performance**

The accounting policies of the company, including any changes in accounting policies in the year, are set out on page 33

Profit and loss account

The profit and loss account of Southern Water Services Ltd is summarised in Table 1

Table 1	2007 £m	2006 £m	Change %
Turnover	575.8	541.5	6.3
Cost of sales and admin expenses ¹	(332.2)	(314.0)	5.8
Exceptional items	-	(14.1)	-
Other income	1.0	1.7	(41.2)
Operating profit	244.6	215.1	13.7
Disposal of fixed assets	20.2	5.0	304.0
Net interest	(129.4)	(126.1)	2.6
Profit before tax	135.4	94.0	44.0
Tax	(41.3)	(32.6)	26.7
Profit after tax	94.1	61.4	53.3
Dividends	(61.8)	(44.8)	37.9
Retained profit	32.3	16.6	94.6

Notes 1 Excludes exceptional items

Operating profit for 2006-07 increased by 13.7% to £244.6m. This increase results principally from the impact of inflation and the K factor on the company's turnover, which rose by 6.3% to £575.8m. This increase was required to secure and service the ongoing finance for the capital investment programme.

Costs, excluding exceptionals, increased by 5.8% to £332.2m. This increase resulted mainly from higher electricity prices and the impact of inflation, offset by operating efficiencies. The exceptional item of £14.1m in 2005-06 relates to the costs of the customer services investigation (discussed in Section H). The increased profit before tax also reflects an increase in profit from asset sales. The profit on disposals of £20.2m (2005-06 £5.0m) relates mainly to the sale and leaseback of the head office.

The profit after taxation for the year amounted to £94.1m (2006 £61.4m). In the prior year the directors recommended a final dividend of £89.29 per ordinary share, which was paid in the current financial year. Interim dividends of £1,014.39 per ordinary share (2006 £710.80 per share), totalling £56.8m were also paid during the year, resulting in total dividends paid and charged in the current financial year of £61.8m. At the year end the final dividend for 2007 had not been approved by the Board of Directors.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

B. FINANCIAL PERFORMANCE (continued)

Net cash inflow from operating activities increased to £339.7m for 2006-07 from £331.6m in 2005-06. This reflects the impact of increased turnover, offset by an increase in debtors and accruals.

The net cash outflow from returns on investment and servicing of finance decreased to £79.4m for 2006-07 from £106.7m in 2005-06, due to lower interest paid and the timing of interest payments at the year end.

There was a significant increase in outflow of cash relating to the purchase of tangible fixed assets of £505.3m (2005-06 £272.4m) and a net cash outflow before financing in 2006-07 of £305.5m (2005-06 £90.1m). During the year bonds of £200m were issued in order to help meet the ongoing requirements of the capital investment programme.

Balance sheet

At the end of the period to 31 March 2007, Southern Water had fixed assets of £3,319.5m (2005-06 £2,952.9m) an increase of £366.6m from March 2006. This increase results from the large capital investment programme. Overall net assets increased from £729.8m to £781.3m.

Regulatory Accounts

Under the terms of its appointment as a water and sewerage undertaker Southern Water is also required to produce a set of regulatory accounts, for the appointed business only, on a current cost basis. These are discussed below.

Current cost profit and loss account (appointed business)

Table 2	2007 £m	2006 £m	Change %
Turnover	566.8	533.9	6.2
Current cost operating costs	(390.3)	(376.6)	3.6
Operating income	10.0	4.9	104.1
Working capital adjustment	4.5	0.7	542.9
Operating profit	191.0	162.9	17.2
Other income	0.2	0.4	(50.0)
Financing adjustment	97.2	46.6	108.6
Net interest	(129.4)	(126.1)	2.6
Profit before tax	159.0	83.8	89.7
Tax	(40.2)	(31.3)	28.4
Profit after tax	118.8	52.5	126.3
Dividends	(59.1)	(41.8)	41.4
Retained profit	59.7	10.7	457.9

OPERATING AND FINANCIAL REVIEW (continued)**B. FINANCIAL PERFORMANCE (continued)**

Turnover of the appointed water and sewerage business increased by 6.2% or £32.9m. This increase reflects the allowed price increase of 6.33%. Whilst the majority of customers are not charged according to the volume consumed, the drought which was experienced in the south east region during 2005 and 2006 has had a negative effect on measured water sales.

Compared to the assumptions underlying Ofwat's price limits, turnover was lower than forecast. This results principally from lower water and wastewater sales to metered customers as a result of the drought. It also reflects the rate of switching from an unmetered to a metered charge basis and the assumptions made by Ofwat about the demand of customers switching to a meter.

Total operating costs increased by 3.6% to £390.3m. Within this, operating expenditure, excluding exceptionals, grew by £15.6m. The largest cost increase was power, reflecting the increase in electricity tariffs. Increased leakage detection activity and additional costs to improve customer service performance also increased operating expenditure.

Current cost depreciation (CCD) increased by £10.4m to £163.1m and the infrastructure renewals charges (IRC) increased by £2.1m to £41.5m, reflecting the increased level of capital investment in the current period.

Operating income includes current cost profit on the disposal of fixed assets. This disposal profit is lower than the figure shown in the statutory accounts, due to the different accounting basis and the disposal of some assets outside of the appointed business.

The increase in profit before tax is also affected by the significant increase in the current cost financing adjustment of £97.2m (2005-06 £46.6m), as a result of higher inflation levels during the year.

Retained profit of £59.7m has been transferred to reserves.

Current cost cashflow (appointed business)

Table 3	2007 £m	2006 £m	Change %
Net cashflow from operating activities	335.8	327.3	2.6
Net cashflow on investment and servicing of finance	(77.8)	(98.1)	(20.7)
Taxation	(16.0)	(15.8)	1.3
Net cashflow from investing activities	(486.9)	(253.1)	92.4
Equity dividends paid	(59.0)	(41.8)	41.1
Net cashflow before financing	(303.9)	(81.5)	272.9
Net cashflow inflow from financing	196.9	70.9	177.7
Increase/decrease in cash in the year	(107.0)	(10.6)	909.4

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

B. FINANCIAL PERFORMANCE (continued)

Net cash flow from operating activities increased to £335.8m for 2006-07 from £327.3m in 2005-06. Net cashflow from investing activities increased from £253.1m to £486.9m. This reflects the significant increase in the capital investment programme during 2006-07. As a result net cash outflow before financing rose to £303.9m in 2006-07 (2005-06 £81.5m).

Current cost balance sheet (appointed business)

At the end of the period to 31 March 2007, Southern Water had current cost fixed assets of £14,917m (2005-06 £13,975m) an increase of £942m from March 2006. This increase results from the effects of inflation and the large capital investment programme. Overall net assets increased from £11,856m to £12,504m.

Net debt at the year end, as per the regulatory accounts and including preference shares and mezzanine debt, was £2,749.9m (2005-06 £2,412.3m). The net debt to RCV ratio, a key performance indicator for the company and Ofwat on the above basis, reduced from 96% to 94%.

The Regulatory Capital Value, the capital value used by Ofwat for price setting purposes, was £2,914m at March 2007.

Dividend policy

Southern Water's dividend policy is to pay a dividend that is consistent with Condition K of the regulatory operating licence, to reward equity holders in accordance with the risks of the business and to pay a sustainable dividend reflecting regulatory out-performance, non-appointed profit and asset sales. The increase in dividends paid in 2006-07 reflected the cashflow from the sale of income rights relating to aerial masts.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

C. CAPITAL STRUCTURE, LIQUIDITY AND OTHER FINANCIAL MATTERS

Capital structure and borrowing covenants

Southern Water carried out a refinancing of its regulated business in 2003 with the aim of reducing its cost of capital through a substantial increase in the proportion of debt finance. As a proportion of its RCV, net debt, including preference shares, is now 94%.

At the same time a Common Terms Agreement (the CTA) between the members of the Southern Water Financing Group² and its debt investors was entered into. The CTA sets out the arrangements for the ongoing management of Southern Water's debt issuance programme, including a set of financial covenants, trigger events and events of default.

Interest rate, liquidity and cash management risk

Southern Water hedges its exposure to interest rate risk on at least 85% of its outstanding debt liabilities in respect of Class A and Class B debt for the period to the next Periodic review and at least 70% in the next period (on a rolling basis) into either index-linked or fixed rate obligations.

Additional funds are raised as required, to ensure that sufficient cash and/or facilities are available to fund the business for the next twelve months.

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.

The regulatory framework, under which revenues and the RCV are indexed, exposes Southern Water to inflation risk. This risk is managed through the use of index-linked instruments within the overall debt portfolio.

An analysis of net debt is included in Note 20 to the accounts.

Credit risk

81% of the water and wastewater services revenue is received from household customers. The 1999 Water Act prohibits the disconnection of domestic customers for failure to pay water and sewerage charges. An extensive range of collection and recovery methods are employed, as appropriate to the individual circumstances of the customer, to minimise the risk of non-payment. For non-domestic customers, the right to disconnect supplies for non-payment remains and is exercised as appropriate.

The level of provision against non-collection of charges is reviewed on an annual basis, based on the age profile of the debt and the likelihood of recovery. A material increase in uncollected revenue, compared to that assumed in the setting of price limits, may provide grounds for an interim determination of K by Ofwat.

² The Southern Water Financing Group consists of Southern Water Services Ltd, Southern Water Services (Finance) Ltd, SWS Holdings Ltd, SWS Group Holdings Ltd,

OPERATING AND FINANCIAL REVIEW (continued)

D. OPERATIONAL PERFORMANCE

Water services

Hosepipe bans, which had been imposed in Sussex, Kent and the Isle of Wight, were lifted in January 2007. This followed winter rainfall which was closer to normal levels, after two consecutive dry winters, along with investment to produce additional supplies and reduce leakage to record low levels. Further restrictions in 2007 are now unlikely. Regulatory planning assumptions underpinning water resources investment continue to be discussed with Ofwat and the Environment Agency. The longer-term view of the company is that planning should be on the basis that no restrictions should be necessary until three dry winters have been experienced.

Drinking water quality continued to be high across the region. Mean zonal compliance, based on compliance at the customer tap with DWI standards, remained high at 99.95% for the 2006 calendar year. To maintain these high standards each year over 600,000 tests are carried out on water from its source to the customer's tap. Drinking water supply operations are accredited to ISO 9001 standards. Over the current price limit period further capital investment will be made in order to reduce turbidity (cloudiness) at four sources and reduce nitrate concentrations at a further three groundwater sources.

Environmental

Southern Water recognises that its activities have an effect on the natural environment, through the abstraction of water for supply and the discharge of treated effluent to water courses and the marine environment. Both abstraction and effluent discharges are regulated by the Environment Agency via abstraction licences and discharge consents.

During the 2006 calendar year compliance with Water Resources Act "look-up table" discharge consents (which represent the vast majority of current consents) was 98.6% based on the equivalent population served by each works.

Pollution incidents occur mainly as a result of failures in the sewerage network. Incidents are classified as Category 1, 2 or 3 by the Environment Agency with categories 1 and 2 representing the most serious incidents. Whilst Southern Water always works hard to avoid any incidents occurring, the nature of wastewater operations and the extent of the sewerage network mean that some incidents are inevitable. Southern Water has an incident response team on standby to ensure that where incidents do occur, their impact on the environment is minimised.

Minimising the number of pollution incidents and ensuring compliance with discharge consents are both 'Top 10' targets for 2007-08.

OPERATING AND FINANCIAL REVIEW (continued)

D. OPERATIONAL PERFORMANCE (continued)

Bathing water quality

During the 2006 bathing water season (1st May to 30th September) the Environment Agency tested 79 beaches in the region for compliance with the EU Bathing Water Directive standards. For the second year running all 79 beaches met the mandatory standards. 78% met the much stricter guideline standards in 2006.

Customer service

Following the customer service irregularities uncovered in 2005, a plan to recover customer service performance was agreed with Ofwat. The opportunity has been taken to review all customer service operations and much transactional work such as updating account details has been off-shored. This will allow Southern Water staff to focus on continuing to raise customer service standards.

In February, a new customer billing and contact system was delivered for the company's 1.8 million water and sewerage customers, based on the state-of-the-art SAP-ISU platform. This replaced a 15-year old mainframe system which was no longer supported and had limited functionality. Whilst some teething problems have been experienced in the first few months of operation, giving rise to increased call volumes, the system is bedding in and productivity is beginning to improve.

Energy use

Southern Water is committed to exploring opportunities to minimise its impact on the environment and one of the key ways this can be done is by constantly looking at ways to reduce energy use and increase the proportion of renewable energy used at treatment works. Southern Water has been awarded Energy Efficiency Accreditation by the Carbon Trust, which recognises achievements in reducing energy use.

Six Combined Heat and Power plants (CHP), which utilise methane produced at wastewater treatment works, are now in operation. These units recycle the surplus green energy back into the national grid, to help bring green power to everyone. During 2006-07 over 10 megawatt hours of electricity were produced from CHP.

OPERATING AND FINANCIAL REVIEW (continued)

E. LOOKING AHEAD

The remainder of AMP4

2007-08 is the third year of the current five year regulatory period (AMP4)

In the first two years of AMP4, £834m of the £1.8bn capital expenditure programme for this regulatory period has been delivered and many of the required outputs have been delivered ahead of schedule. This is a considerable achievement and is likely to put the company in an industry-leading position in this respect. However, challenges remain to deliver the remainder of the programme.

The largest scheme in this programme is the provision of a new wastewater treatment works to provide secondary treatment for Brighton & Hove. This scheme is needed to ensure that the effluent discharges meet the requirements of the Urban Wastewater Directive. A decision on the proposed scheme is still awaited from the Secretary of State, following a five-week planning enquiry held in the summer of 2006.

The second major objective for AMP4 is to ensure stable 'serviceability' is achieved on above ground wastewater assets by 2007-08. Serviceability is assessed on the basis of wastewater treatment works compliance. Improving compliance is one of the top ten targets for 2007-08 and Southern Water remains confident that it will achieve a stable serviceability assessment.

On the water service side, the achievement of a maximum score of 100 on Ofwat's security of supply index – a measure of the resilience of our water supplies – is being targeted by 2008-09.

At the same time the demanding efficiency savings required by the 2004 price limits must be delivered.

The framework contracts which have been let with service providers for non-core and engineering services, and the continuing engagement of all staff will be crucial to achieving these efficiency savings and meeting the required regulatory outputs.

OPERATING AND FINANCIAL REVIEW (continued)

E. LOOKING AHEAD (continued)

The 2009 periodic review

2007-08 also sees the beginning of the process for Ofwat's 2009 periodic review of price limits for the period from 2010 to 2015 (AMP5). Work is already underway to identify the investment requirements for the period and with the benefit of extensive customer research, to understand customers' priorities.

Later this year, as the first milestone in the price review, a Strategic Direction Statement will be published, setting out a 25-year vision, reflecting customers' views on the standards they expect from Southern Water and the company's delivery plans.

Climate change will inevitably be a key influencing factor in this strategy going forward. The effect on the availability of water resources and the risk of sewer flooding from less predictable weather patterns, represent a significant challenge for the company. Carbon emission considerations will be fully incorporated into the planning process to ensure that the environmental impacts are at the heart of the decision-making processes for the review.

The key investment driver for AMP5 will be meeting the requirements of the Water Framework Directive (WFD). This requires the achievement by 2015 of "good chemical and ecological status" for surface waters and "good" status for groundwater in terms of quality and quantity. This is to be achieved through the establishment of River Basement Management Programmes, the first of which will run consecutively with AMP5. Further investment in water resources will also be required to ensure security of supply and further reduce the risk of flooding from sewers.

Overall, it is expected that the required capital investment programme will continue to be very substantial. Customers' willingness and ability to pay for these improvements will be a key issue for the review.

Work to extend the opportunities for competition for customers is also expected to be a major feature of the AMP5 period. The review of competition being carried out by Ofwat and Ministers will shed some light on the likely direction this will take. However, fundamental changes in the nature of competition in the industry are likely to require changes to the legislation.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

F. RESOURCES AND KEY RELATIONSHIPS

Management

The Board of Southern Water is responsible for the overall strategic direction of the business. During the year the Board consisted of three executive directors – the Chief Executive Officer, Finance and Corporate Strategy Directors – along with five non-executive directors. Three of these non-executive directors are independent, as required by our regulatory licence.

The day-to-day operations of the business are overseen by the Executive Management Team. This group, led by the Chief Executive Officer, consists of the heads of each department – Finance, IT, Human Resources, Operations, Assets, Customer Services, Corporate Strategy, Commercial, Legal and Communications.

People

At the year end, Southern Water had 1,784 full-time-equivalent staff (2005-06 1,922) across the region. Staff turnover was higher than normal, reflecting the transfer of a number of staff to service providers and the strategy to focus on core activities.

The importance of the role played by staff in driving the company performance is recognised by the Board and this year investment in training has been increased significantly. During the year a programme of Leadership conferences was run for staff at all levels within the organisation, designed to engage employees and come up with some business solutions which will help improve services to customers. A series of 'Toolkit' residential training weeks was also begun. These have been attended by 220 members of staff and are designed to ensure that all staff have the commercial understanding and business techniques required to manage in a rapidly changing environment.

Key partners

Capital programme partners

Much of the £1.8bn capital programme for this regulatory period will be delivered either through a series of Utility Service Contracts or a Single Entity Contract with 4D.

Utility Services Contractors – smaller schemes within the capital programme, with a total value of approximately £400m, are being delivered through Southern Water's key contractors Morrison Utility Services (mechanical & electrical maintenance and renewals), Clancy Docwra (water distribution system maintenance), Holleran, Mouchel Parkman (sewerage network schemes) and Viridor (waste management).

4D – a contract for the management, design and delivery of stand-alone construction projects for the AMP4 was let to 4D in 2005. 4D is a special purpose consortium comprising United Utilities, Costain, and Montgomery Watson Harza. Under the contract more than 270 schemes in the investment programme will be delivered.

The relationship with both 4D and the Utility Services Contractors has been important in meeting the AMP4 investment targets to date and will be crucial to the successful delivery of the remainder of the programme. In May 2007, the partnership with 4D was recognised with the award of the Partnership Initiative of the Year trophy at the Water Industry Achievement Awards.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

F. RESOURCES AND KEY RELATIONSHIPS (continued)

Capital programme partners (continued)

Other significant partners

Master Framework Agreements

During the year, Southern Water signed a series of Master Framework Agreements (MFAs) for the provision of services to the regulated business, in support of the Board's strategy of focussing on core activities. MFAs have been signed under three service areas – Customer Services, Engineering Services and General Services.

Under the MFAs, individual work-packs are let for discrete activities, allowing the company to draw on expert service providers whilst simplifying the procurement and contract negotiation process and ensuring that a long-term partnership approach to the provision of services is achieved.

Atkins and TCS have been signed as key partners under the Engineering MFA, whilst TCS and Wipro are the framework partners under the General Services MFA. To date, only RR Donnelley has been selected as a partner under the Customer Services MFA, although TCS have also been contracted to provide some back-office services within customer services. The Board is currently reviewing whether a second partnership agreement would be beneficial.

These agreements and a successful partnership with these companies are key to delivery of the Board's strategy of providing excellent customer service by ensuring that focus on core activities, whilst also delivering against Ofwat's challenging efficiency targets.

OPERATING AND FINANCIAL REVIEW (continued)

G. Risk management

Risk management is embedded within Southern Water. A central database of key risks is maintained and all managers have access to and the ability to raise risks on the database.

Risks are assessed in terms of impact in the following areas -

- financial
- reputation
- health and safety
- security of supply
- regulatory, environmental and legal

Creating clear visibility throughout the organisation of all key risks ensures that adequate controls are put in place or mitigating action taken to reduce the impact or likelihood of the risk manifesting. All risks within the database are assigned to a manager to ensure clear ownership of risks, and responsibility for their control and mitigation.

All risks scoring in the highest category are reviewed by the Chief Executive and all risks above a specified threshold are reviewed regularly by the Executive Management Team.

To ensure ongoing compliance with policies and standards of the company and regulatory and legal requirements, all senior managers are required to sign a six-monthly Letter of Compliance, certifying that the function for which they are responsible, complies with all relevant requirements.

Key risks

Regulatory risk

Southern Water is a highly regulated business. The water sector has three main regulators – Ofwat, the Environment Agency, and the Drinking Water Inspectorate. Not meeting any of the regulatory requirements or failing obligations placed upon the company by regulators could result in financial loss through the price setting mechanism, fines, legal enforcement action and ultimately the loss of the appointment as a water and sewerage undertaker. Any change in regulatory policy could also have a significant impact on the organisation.

The two most prominent examples of these risks currently are

The risk of a fine for historic customer service failures

Ofwat has given notice that it intends to impose fines for failures to achieve standards of customer service set out in the statutory Guaranteed Standards Scheme and mis-reporting of customer services data. It has the power to impose a fine of up to 10% of turnover in the most serious cases.

Ofwat's policy statement on financial penalties makes clear that in determining the level of any fine it will take account of a company's behaviour, the duration of the misdemeanour, the degree to which customers are affected and any other mitigating factors.

Southern Water has fully co-operated with Ofwat's investigation and customers have been reimbursed where it is found that they have suffered loss.

OPERATING AND FINANCIAL REVIEW (continued)

G. Risk management (continued)

The risk of a poor determination at the 2009 periodic review

The process for Ofwat's 2009 periodic review begins in 2007-08. This will determine price limits for the period from 2010 to 2015. Failure to properly present a robust regulatory Business Plan may lead to a shortfall in funding for the regulatory period.

Southern Water has already begun investigatory work for the review and a dedicated project manager to manage the process has been appointed. To ensure that the industry's voice is heard as the methodology for the review is developed the company works closely with Water UK as well as maintaining its own close contact with regulators.

Operational risk

Water and sewerage services are essential to public health and the safeguarding of the environment. Whether arising from a failure to maintain and invest in assets or operational issues, any failures could lead to interruptions to public water supplies, risk to health through supply of unfit water or severe environmental damage from the failure of our wastewater assets. These are ongoing risks which are managed as part of the everyday business. But the impact of failure is potentially significant for both customers and the environment.

The key risks in this area are currently

The risk of a further prolonged period of dry weather affecting the ability to maintain supplies

Exceptionally dry winters in 2004-05 and 2005-06 left the region's reservoirs and underground water resources at record low levels. A wetter winter in 2006-07 restored resources back to normal levels, and most reservoirs were more than 90% full by spring. However, there remains a residual risk that a repeat of the record low rainfall seen during the recent drought, and in particular three consecutive dry winters, would put at risk the ability to maintain supplies without restrictions.

This risk is managed by having a formal drought plan with trigger levels which escalate action. Longer-term Southern Water believes that the regulatory assumptions that underpin water resources planning need to be reviewed to ensure that no restrictions are necessary until three dry winters have been experienced.

The risk of not containing pollution incidents and works compliance targets not being met

Southern Water operates 373 wastewater treatment works and manages 21,000km of sewers across four counties. Whilst one of the key objectives for the company is to minimise the impact of its operations on the environment, the scale of these operations means that some incidents and compliance failures are inevitable. These can occur as a result of poor maintenance, human error or system incapacity.

As well as the risk of damage to the environment, such incidents can lead to prosecutions by the Environment Agency and fines being imposed as well as damage to the reputation of Southern Water. To minimise the risk of such incidents Southern Water is investing around £900m on asset maintenance over the current regulatory period. It also has a pollution incident response team on standby to ensure that where incidents do occur, their impact on the environment is minimised.

OPERATING AND FINANCIAL REVIEW (continued)

G. Risk management (continued)

Financing risk

The Company intends to at least maintain its present risk profile, as measured by its investment grade credit rating. It 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.

Negative cashflows before financing, which have been a feature of the water industry since privatisation as a result of mandatory capital investment requirements, create an ongoing need to maintain access to the capital markets.

The risk of a significant increase in interest rates or closure of the capital markets to water companies in general

Any significant movement in interest rates or reduction in the availability of credit to the water industry might put at risk the company's ability to finance the future capital investment programme.

This risk is managed by ensuring that exposure to interest rate rises on current borrowings is hedged and accordingly 100% of current borrowings are at either fixed rates or index-linked. Good contacts with lenders, including bondholders, are maintained through an annual update programme with key investors.

A stable regulatory regime is vital to ensuring ongoing access and Southern Water works with the rest of the industry through Water UK to ensure that Ofwat appreciates the importance of this stability.

Capital Investment

Over the current regulatory period a capital investment programme of £1.8bn is required to be delivered, the largest ever for Southern Water. An excellent start to the programme has been made and £834m has been delivered to date. However, around £1.0bn of capital investment must still be delivered before 2010.

Failure to deliver significant elements of the capital programme risks adjustments to the regulatory capital value at the next review, the risk of enforcement action by the Environment Agency, DWI or Ofwat and threats to the integrity of services.

Brighton & Hove secondary wastewater treatment scheme

The largest single scheme in the capital programme is provision of secondary sewage treatment for Brighton & Hove. Ofwat provided funding in the order of £200m in price limits for the scheme which involves the construction of a new wastewater treatment and sludge recycling works at Peacehaven, new pumping stations and underground sewers.

An enforcement notice has been served on Southern Water by the Environment Agency requiring completion of the scheme by 31 March 2010.

OPERATING AND FINANCIAL REVIEW (continued)

G. Risk management (continued)

Brighton & Hove secondary wastewater treatment scheme (continued)

Approval has been received by Brighton & Hove City Council for the elements of the scheme which fall within its jurisdiction. In relation to those parts of the scheme within East Sussex County Council's jurisdiction, a five-week long public inquiry was held last summer and a final decision is expected from the Secretary of State for Communities & Local Government imminently.

Failure to achieve planning permission would mean that the enforcement notice issued on us by the EA could not be met. Even if planning approval is received the execution risks of such a major project remain significant. However, the tendering process for the scheme is well advanced so that a rapid start can be made as soon as consent is received.

OPERATING AND FINANCIAL REVIEW (continued)

H. CUSTOMER SERVICE GENERAL LEVELS OF PERFORMANCE

General Levels of Service

In October 2005, Southern Water brought to the attention of Ofwat certain inconsistencies relating to the reporting of response levels to, and handling of, customer enquiries and complaints. These were discovered in the course of the Customer Services Transformation Project, which involved the installation of a new SAP-based billing system.

It became evident that as a result of these irregularities, some customers had not received compensation they were due under the statutory Guaranteed Standards Scheme (GSS) and data reported to Ofwat had been inaccurate. A specialist team was appointed jointly with Ofwat to investigate these irregularities and work was also instigated to make the payments due under the GSS. The matter was also reported to the Serious Fraud Office (SFO) by Southern Water.

On 31 March 2006, the company was notified by Ofwat that it intends to impose a fine for the failures since April 2005.

The SFO has subsequently announced that it does not intend to pursue an investigation into the matter. Ofwat is now free to finalise its own investigations and impose fines on Southern Water for the failures.

Southern Water has fully co-operated with the investigation since discovery of the irregularities and taken significant steps to ensure that customers are reimbursed for any financial loss and that regulatory reporting and control systems are improved to avoid the risk of a re-occurrence.

To complement these system improvements, regulatory reporting has now been certified to ISO 9001 standard.

Customer services improvement plan

As a result of the investigation, it became evident that the actual customer service performance levels were well below those that had been historically reported to Ofwat and below the industry norms. In February 2006 an improvement plan was agreed with Ofwat to improve the levels of service provided to customers and bring them back into line with industry norms.

Regrettably, the first improvement plan agreed with Ofwat was not met. After significant improvements during the first half of the year initial teething problems with the new SAP billing system meant that performance declined materially in the second half of 2006-07. A second improvement plan, up to March 2008, is under review by Ofwat, to ensure that 'good' levels of performance, as defined by Ofwat in its annual customer service publications, are achieved. This will be achieved through increases in personnel, increased (offshore) back-office support, improvements to IT systems and productivity improvements as staff become accustomed to the new billing system and ongoing refinements are made to the system user interface.

Southern Water deeply regrets that it has not been providing customers with the level of service that they expect over the last few months and is determined to recover its position as rapidly as possible.

OPERATING AND FINANCIAL REVIEW (continued)

I. CORPORATE RESPONSIBILITY

Environmental policy

Southern Water 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

Environmental performance is reported in an annual Sustainability Report. Responsibility for operating within a framework that supports sustainable development is fully recognised by Southern Water and where possible, targets for measurable indicators have been established. Performance against these targets is monitored and reported regularly.

Health & Safety

The Health and Safety of all employees, customers and contractors is of paramount importance.

Every employee receives a copy of the corporate policy statement on health and safety. There are regular meetings of employee representatives to consider all aspects of health and safety. During 2006-07 an 'Aim for Zero' campaign has been running to raise awareness of all employees' collective and individual responsibilities for the prevention of accidents. A Health and Safety Conference was also held, attended by 150 people, including Southern Water staff, contractors and guests.

The number of reportable accidents reduced further over that recorded for 2005-2006, highlighting the continuing improvement in health and safety at Southern Water. This achievement is supported by the award of a ninth successive year when we have been recognised in the RoSPA Occupational Safety Awards. This year a third consecutive Gold Medal - the highest category of general award - was awarded.

An internal occupational health service, including the provision of physiotherapy, is provided for all employees, along with a confidential guidance and counselling service. These services are continually being reviewed and developed to meet the changing needs of the business and employees at work.

Community programme

Southern Water plays an active role in the community under the company's Bringing Water to Life programme, supporting a series of community initiatives to build links and understanding with the communities served.

These initiatives are headlined by the long-running 'Learn to Swim' scheme for children between the ages of 4 and 12. Now in its 15th year of operation, the programme, supported by Olympic gold medallist Duncan Goodhew, has taught nearly 500,000 children to swim and was highly commended in the national Hollis Sponsorship Awards.

As part of an ongoing water efficiency campaign, an award-winning play and street theatre show featuring the wasteful Drip family is staged in schools and local events with the Facepack Theatre Company. In particular, "Are you a Drip?" and "Drips Ahoy" encourages water conservation for Key Stage 2 pupils. A range of educational resources for Key stages 1-4 is also provided, including a new online service.

SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW (continued)

I. CORPORATE RESPONSIBILITY (continued)

Community programme (continued)

Southern Water sponsors the local regions of Britain in Bloom and during 2006/7 ran a region-wide Schools in Bloom competition as part of this nationwide event. The company also agreed sponsorship of the Brighton Festival Children's Parade, one of the largest community events in the south of England.

Overseas, Southern Water is a long-standing supporter of the independent charity WaterAid, which works in regions such as Africa and Asia to help people gain improvements to their water, sanitation and hygiene. An annual customer appeal is run along with general fundraising activities and media publicity activities. During 2007 a record sum of almost £155,000 was raised for WaterAid from a James Bond-themed ball held for staff and Southern Water's key partner organisations. Further fundraising events, including a raceday and golf day, are planned for the current year.

To back the company's community support initiatives all employees are entitled to take two days paid leave each year to carry out community activities.

SOUTHERN WATER SERVICES LIMITED

REPORT OF THE DIRECTORS

The directors present their report and the audited accounts for the year ended 31 March 2007

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 4.3 million people.

BUSINESS REVIEW

The information that fulfils the requirement of the business review can be found in the Operating and Financial Review (OFR) on pages 1 to 24, which are incorporated in this report by reference.

RESULTS AND DIVIDENDS

The profit and loss account on page 29 shows the Company's results, dividends and profit for the year. Further details are also available in the OFR on pages 1 to 24.

The final dividend for 2007 of £500 per ordinary share (£28.0m in total) was declared in April 2007 and paid in May 2007.

POST BALANCE SHEET EVENTS

During June 2007, the owners of the Southern Water group of companies indicated that they would be looking to dispose of their interest in the group and are actively seeking buyers.

DIRECTORS AND THEIR INTERESTS

The directors who held office during the year ended 31 March 2007 were as follows:

Robert Thian	(Chairman)
Leslie Dawson	
Howard Goodbourn	
Donald Workman	(Non-Executive Director)
David Golden	(Independent Non-Executive Director)
Simon MacDonagh	(Independent Non-Executive Director)
Steven Marshall	(Independent Non-Executive Director)
Barrie Delacour	<i>(resigned 25 April 2007)</i>
John O'Brien	<i>(resigned 10 April 2006)</i>
David Alexander	<i>(resigned 10 April 2006)</i>
Paul de Rosen	<i>(resigned 10 April 2006)</i>

None of the directors who held office during the financial year had any disclosable interests in the shares of the Company.

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.

REPORT OF THE DIRECTORS (continued)

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 £1.3m (2006: £1.4m).

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.

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.

SOUTHERN WATER SERVICES LIMITED

REPORT OF THE DIRECTORS (continued)

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. Copies of the Code may be obtained from the Department of Trade and Industry or from the website www.payontime.co.uk

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 2007 were 35 days (2006 22 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 £19,000 (2006 £21,000) 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

SOUTHERN WATER SERVICES LIMITED

STATEMENT OF 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), and that reasonable and prudent judgements and estimates have been made in preparing the accounts for the year ended 31 March 2007. They also confirm that the financial statements have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice 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

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

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



Kevin Hall

Secretary

27 June 2007

SOUTHERN WATER SERVICES LIMITED

PROFIT AND LOSS ACCOUNT

For the year ended 31 March 2007

	Notes	2007 £m	2007 £m	2006 £m	2006 £m
Turnover	1,2,3		575.8		541.5
Cost of sales	3		(303.7)		(285.2)
Gross profit			<u>272.1</u>		<u>256.3</u>
Administrative expenses					
- before exceptional items	3	(28.5)		(28.8)	
- exceptional items	4	-		<u>(14.1)</u>	
Administrative expenses			(28.5)		(42.9)
Other operating income	3		1.0		1.7
Operating profit			<u>244.6</u>		<u>215.1</u>
Profit on disposal of fixed assets			20.2		5.0
Net interest and similar charges	6		(129.4)		(126.1)
Profit on ordinary activities before taxation	4		<u>135.4</u>		<u>94.0</u>
Tax on profit on ordinary activities	7		(41.3)		(32.6)
Profit on ordinary activities after taxation	19		<u>94.1</u>		<u>61.4</u>
Dividends	8,19		(61.8)		(44.8)
Retained profit for the financial year			<u>32.3</u>		<u>16.6</u>

The above results relate to continuing operations

The Notes on pages 33 to 55 form part of these accounts

SOUTHERN WATER SERVICES LIMITED

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 March 2007

	Notes	2007 £m	2006 £m
Profit on ordinary activities after taxation		94.1	61.4
Actuarial gain/(loss) recognised in the pension fund	19,21	27.4	(2.0)
Movement on deferred tax relating to pension deficit		(8.2)	0.6
Total recognised gains for the year		113.3	60.0
Prior year adjustment		-	(96.9)
Total gains/(losses) recognised since last annual report		113.3	(36.9)

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

SOUTHERN WATER SERVICES LIMITED

BALANCE SHEET

As at 31 March 2007

	Notes	2007 £m	2006 £m
Fixed assets			
Tangible assets	9	3,290.3	2,923.7
Investments	10	<u>29.2</u>	<u>29.2</u>
		3,319.5	2,952.9
Current assets			
Stocks	11	2.2	1.1
Debtors amounts falling due within one year	12	181.5	119.3
Debtors amounts falling due after one year	13	812.3	812.3
Cash and deposits		<u>130.9</u>	<u>240.9</u>
		1,126.9	1,173.6
Creditors: amounts falling due within one year	14	<u>(261.3)</u>	<u>(242.3)</u>
Net current assets		865.6	931.3
Total assets less current liabilities		<u>4,185.1</u>	<u>3,884.2</u>
Creditors amounts falling due after more than one year	15	(2,859.5)	(2,611.4)
Provision for liabilities and charges	16	(423.6)	(400.2)
Grants and contributions	17	(47.9)	(46.2)
Net assets excluding pension deficit		<u>854.1</u>	<u>826.4</u>
Pension deficit	21	(72.8)	(96.6)
Net assets including pension deficit		<u>781.3</u>	<u>729.8</u>
Capital and reserves			
Called up share capital	18	0.1	0.1
Share premium	19	46.3	46.3
Profit and loss account	19	734.9	683.4
Total shareholders' funds		<u>781.3</u>	<u>729.8</u>

The accounts on pages 29 to 55 were approved by the Board and authorised for issue on 27 June 2007 and signed on its behalf by:



Howard Goodbourn
Finance Director

SOUTHERN WATER SERVICES LIMITED

CASH FLOW STATEMENT
for the year ended 31 March 2007

	Notes	2007 £m	2006 £m
Net cash inflow from operating activities	20	339.7	331.6
Returns on investments and servicing of finance			
Interest received		72.2	78.0
Interest paid		(136.3)	(162.4)
Issue costs of new loans/redemption premium		(1.6)	(8.6)
Preference share dividends		(13.7)	(13.7)
Net cash outflow from returns on investments and servicing of finance		(79.4)	(106.7)
Taxation		(17.1)	(17.1)
Capital expenditure and financial investment			
Purchase of tangible fixed assets		(505.3)	(272.4)
Receipt of grants and contributions		10.2	13.8
Sale of tangible assets		8.2	5.5
Net cash outflow for capital expenditure and financial investment		(486.9)	(253.1)
Equity dividends paid		(61.8)	(44.8)
Net cash outflow before financing		(305.5)	(90.1)
Financing			
Increase in borrowings		198.5	499.5
Repayment of borrowings		-	(420.0)
Net cash inflow from financing		198.5	79.5
Decrease in net cash		(107.0)	(10.6)
Reconciliation to net debt			
Net debt at beginning of year		(2,412.3)	(2,307.3)
Decrease in net cash		(107.0)	(10.6)
Movements in borrowings		(198.5)	(79.5)
Debt issue costs/redemption premium		1.6	8.6
Other non cash changes		(33.7)	(23.5)
Net debt at end of year		(2,749.9)	(2,412.3)

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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

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

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

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

1 Accounting policies (continued)

Research and development

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

Preference shares

Preference shares are classified as debt in accordance with FRS 25 'Financial instruments disclosure and presentation'. 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.

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 above ground assets, plant and equipment) are stated at cost less accumulated depreciation. These assets are depreciated on a straight-line basis over their estimated operating lives which are principally as follows

	<u>Years</u>
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 2007

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.

In line with SSAP 21, the sale of income rights relating to aerials masts and sites owned by the company to third parties is treated as an operating lease. Income received from such sales is received entirely in advance and is therefore taken to deferred revenue and will be credited to the profit and loss account over the life of the lease.

Sale and leaseback transactions occur when an asset is sold but use is immediately re-acquired by entering into a lease with the buyer. Where the new lease is an operating lease, the transaction is treated as the disposal of an asset and the operating lease accounted for in accordance with existing policies.

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.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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 a defined benefit pension scheme. An independent actuary normally conducts a valuation of this pension scheme every three years.

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.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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.

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)	2007 £m	2006 £m
Staff costs (note 5a)	48.5	47.6
Depreciation on		
- owned assets	140.0	138.6
- assets held under finance leases	0.4	0.4
	<u>140.4</u>	<u>139.0</u>
Rentals under operating leases	3.8	3.7
Research and development expenditure	1.3	1.4
Release of grants and contributions (note 17)	(2.4)	(2.2)
Exceptional item	-	14.1
Auditors' remuneration for audit work	0.3	0.3
Auditors' remuneration for non-audit services to the company	0.2	1.7

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

5 Employee information

	2007 £m	2006 £m
(a) Employee costs (including directors' emoluments):		
Wages and salaries	51.7	49.1
Social security costs	4.2	3.9
Pension costs	6.1	7.6
Total employee costs	62.0	60.6
Less charged as capital expenditure	(13.5)	(13.0)
Charged to the profit and loss account	48.5	47.6

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

	2007 No.	2006 No.
(b) Average number of persons employed		
Operations	1,157	1,234
Customer Services	289	279
Corporate Centre	452	388
	1,898	1,901

6 Net interest and similar charges

	2007 £m	2006 £m
Interest payable on other loans	(0.2)	(0.1)
Interest paid to group companies	(151.5)	(161.6)
Indexation	(32.0)	(19.8)
Amortisation of issue costs	(2.5)	(4.4)
Amortisation of bond premium	0.7	0.6
Other finance expense (note 21)	-	(2.6)
Interest on preference shares	(13.7)	(13.7)
Total interest payable	(199.2)	(201.6)
Interest receivable from Southern Water Services Group Limited	56.9	56.9
Other interest receivable	12.9	18.6
Net interest charge	(129.4)	(126.1)

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

7 Tax on profit on ordinary activities

	2007 £m	2006 £m
Current tax:		
UK corporation tax on profits for the year at 30% (2006 30%)	16.7	16.7
Adjustment in respect of prior years	(1.0)	-
	15.7	16.7
Deferred tax:		
Origination and reversal of timing differences	22.5	14.7
Prior year adjustment	1.0	-
Pension cost relief in excess of pension cost charge	2.1	1.2
Total deferred tax	25.6	15.9
 Total tax on profit on ordinary activities	41.3	32.6

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

	2007 £m	2006 £m
Profit on ordinary activities before tax	135.4	94.0
Current tax:		
UK corporation tax on profits for the year at 30% (2006 30%)	40.6	28.2
Adjustments in respect of prior years	(1.0)	-
Other differences	-	0.8
Permanent differences	0.7	3.6
Tax charge on ordinary activities	40.3	32.6
Effect of deferred tax	(24.6)	(15.9)
Current tax charge for year	15.7	16.7

Factors that may affect future tax charges

In March 2007 the Chancellor of the Exchequer proposed several changes to the tax regime, including a reduction of the overall rate of UK corporation tax from 30% to 28% and revisions to the rate at which tax deductions are available for capital expenditure

The changes are not proposed to take effect until 1st April 2008 at the earliest and, for some of the changes, no tax legislation has yet been put forward. As such, quantification of the impact of the changes is not possible.

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 2007

8 Dividends per share

	2007 £ per ordinary share	2006 £ per ordinary share	2007 £m	2006 £m
Ordinary shares				
Interim dividend – 30 June	177.70	177.70	9.9	9.9
Interim dividend – 30 Sept	177.70	177.70	9.9	9.9
Interim dividend – 31 Dec	177.71	177.70	10.0	10.0
Interim dividend – 05 Jan	303.57	-	17.0	-
Interim dividend – 31 Mar	177.71	177.70	10.0	10.0
Total interim dividend	1,014.39	710.80	56.8	39.8
Final dividend – prior year	89.29	89.29	5.0	5.0
Total ordinary dividend	1,103.68	800.09	61.8	44.8

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

9 Tangible 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
Cost						
At 1 April 2006	977 6	1,096 9	1,374 0	321 2	312 3	4,082 0
Additions	15 9	21 9	15 0	469 9	2 7	525 4
Transfers	60 4	93 4	51 5	(227 3)	22 0	-
Grants & contributions	-	-	(6 1)	-	-	(6 1)
Disposals	(21 0)	(3 6)	(1 8)	-	(3 5)	(29 9)
At 31 March 2007	1,032 9	1,208 6	1,432 6	563 8	333 5	4,571 4
Depreciation						
At 1 April 2006	263 3	353 0	344 2	-	197 8	1,158 3
Charge for the year	27 8	42 9	41 5	-	28 2	140 4
Disposals	(8 8)	(3 6)	(1 8)	-	(3 4)	(17 6)
At 31 March 2007	282 3	392 3	383 9	-	222 6	1,281 1
Net book value						
At 31 March 2007	750.6	816.3	1,048.7	563 8	110 9	3,290 3
At 31 March 2006	714 3	743 9	1,029 8	321 2	114 5	2,923 7

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals during the years ended 31 March 2007 and 31 March 2006 was £63 9m and £45 9m, respectively. Of the grants and contributions set against infrastructure assets during the years ended 31 March 2007 and 31 March 2006, £2 7m and £5 1m respectively relates to infrastructure renewals.

For the years ended 31 March 2007 and 31 March 2006, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £154 2m and £148 1m, respectively.

Freehold land is stated at a cost of £45 8m and £44 7m (restated) at 31 March 2007 and 31 March 2006, 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 2007

9 Tangible fixed assets and capital commitments (continued)

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

	2007	2006
	£m	£m
Cost	11.7	11.7
Aggregate depreciation	<u>(8.6)</u>	<u>(8.2)</u>
Net book amount	<u>3.1</u>	<u>3.5</u>

(b) Capital commitments

	2007	2006
	£m	£m
In respect of contracts placed	<u>417.1</u>	<u>741.0</u>

10 Fixed asset investments

	2007	2006
	£m	£m
Shares in group undertakings		
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

	2007	2006
	£m	£m
Raw materials	0.9	0.8
Work in progress	1.3	0.3
	<u>2.2</u>	<u>1.1</u>

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

12 Debtors: amounts falling due within one year

	2007 £m	2006 £m
Trade debtors	87.5	62.3
Unbilled income	53.2	40.6
Amounts owed by group undertakings	4.5	0.6
Group relief receivable	0.7	-
Prepayments	3.7	2.8
Other debtors	31.9	13.0
	181.5	119.3

13 Debtors: amounts falling due after one year

	2007 £m	2006 £m
Loan to Southern Water Services Group Limited	812.3	812.3

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

	2007 £m	2006 £m
Bank overdraft	10.3	13.3
Trade creditors	17.0	16.0
Loans from group undertakings (see below)	30.3	30.3
Capital creditors and capital accruals	134.2	114.0
Amounts owed to group undertakings	1.7	0.6
Corporation tax	-	0.5
Taxation and social security	1.4	1.4
Accruals and deferred revenue	68.2	68.0
Bond premium deferred	0.7	0.6
Debt issue costs (note 15)	(2.5)	(2.4)
	261.3	242.3

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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

	2007 £m	2006 £m
Loans and other borrowings		
Loan from SWSF Limited	2,617.1	2,386.7
Bond premium deferred	16.0	16.7
Debt issue costs (see note iv below)	(51.1)	(52.0)
Class A1 Preference shares (see note v below)	150.0	150.0
Class B Preference shares (see note v below)	110.0	110.0
Total Loans and other borrowings	2,842.0	2,611.4
Deferred revenue (see note vi below)	17.5	-
Total Creditors falling due after more than one year	2,859.5	2,611.4
	2007 £m	2006 £m
Repayments fall due as follows:		
Between two and five years	-	-
After five years not by instalments	2,877.1	2,646.7
	2,877.1	2,646.7

As part of the Southern Water Group refinancing in 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 and redemption premium totalling £8.0m were paid by SWSF and recharged to SWS.

In the year to 31 March 2007, SWSF raised and advanced to SWS further additional debt to the value of £200m.

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 intercompany loan has been separately disclosed.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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

An analysis of the loans is shown below -

	2007	2006
Loans	£m	£m
Class A £350m 6 202% fixed rate 2029	350 0	350 0
Class A £150m 3 716% index linked 2034	167 1	161 8
Class A £35m 3 716% index linked 2034	38.9	37 7
Class A £350m 6 650% fixed rate 2026	350.0	350 0
Class A £150m 3 826% index linked 2023	167.1	161 8
Class A £350m 5 020% fixed rate 2021	349.9	349 9
Class A £150m 2 295% index linked 2041 (note i below)	153.2	149 6
Class A £200m 1 740% index linked 2052 (note i below)	203.8	-
Class B £250m 7 879% fixed rate 2038 (note ii below)	250.0	250 0
Artesian £165m 4 086% index linked 2033	183.8	178 0
Artesian £156 5m 3 645% index linked 2032	170.1	164 7
Senior mezzanine £127 2m 11 97% fixed rate 2038 (note iii below)	127.2	127 2
Junior mezzanine £106m 16 01% fixed rate 2038	106.0	106 0
Debt issue costs (note iv below)	(51.1)	(52 0)
Bond premium deferred	16.0	16 7
Class A1 Preference shares (note v below)	150.0	150 0
Class B Preference shares (note v below)	110.0	110 0
	<u>2,842.0</u>	<u>2,611 4</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 company has entered into swap agreements that have converted its Class A £150m and £200m from fixed rates of 5 0% and 4 5% respectively, to index linked bonds with interest rates of 2 295% plus RPI and 1 740% plus RPI respectively
- (ii) 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%
- (iii) 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%
- (iv) 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 2007 debt issue costs amounted to £53 6m of which £2 5m represents the short-term amount which is disclosed separately in note 14

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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

- (v) The preference shares issued have been classified as loans in the financial statements as required by 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. Class A2 shares are also 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 2006 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. It is anticipated that a dividend will be declared and paid to the A2 preference shareholders in September 2007 for outperformance in the year ending March 2007.

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.

- (vi) Deferred revenue relates to the proceeds from the sale of income rights relating to aerial masts and sites owned by SWS. The income will be credited to the profit and loss account evenly over the life of the lease.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

16 Provision for liabilities and charges

	2007 £m	2006 £m
(a) Environmental obligations		
At 1 April	1.1	1.3
Written back	-	-
Utilised in year	<u>(0.1)</u>	<u>(0.2)</u>
At 31 March	<u>1.0</u>	<u>1.1</u>
(b) Deferred taxation		
Accelerated capital allowances	431.0	409.8
Other timing differences	<u>(8.4)</u>	<u>(10.7)</u>
Deferred taxation	<u>422.6</u>	<u>399.1</u>
Total	<u>423.6</u>	<u>400.2</u>

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 affect its final value.

	2007 £m	2006 £m
Movement in deferred tax provision		
Deferred tax provided at 1 April	399.1	384.4
Deferred tax charge in Profit and Loss Account	<u>23.5</u>	<u>14.7</u>
Deferred tax provided at 31 March	<u>422.6</u>	<u>399.1</u>

The deferred tax asset of £31.2m (2006: £41.4m) 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 2006	46.2
Receivable in year	4.1
Released to profit and loss account	<u>(2.4)</u>
At 31 March 2007	<u>47.9</u>

These grants and contributions relate to non-infrastructure assets.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

18 Share capital

	2007 £m	2006 £m
Equity shares		
Authorised		
46,050,000 ordinary shares of £1 each	<u>46.1</u>	<u>46.1</u>
Allotted, called up and fully paid		
56,000 ordinary shares of £1 each	<u>0.1</u>	<u>0.1</u>
Non equity shares		
Authorised and issued		
Preference shares		
150,000 Class A1 shares of £1 each	0.2	0.2
150,000 Class A2 shares of £0.01 each	0.0	0.0
110,000 Class B shares of £1 each	<u>0.1</u>	<u>0.1</u>

The preference shares are classified as debt in line with 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.

19 Reconciliation of movement in shareholders' funds

	Called up share capital £m	Share premium £m	Profit and loss account £m	Total £m
At 1 April 2006	0.1	46.3	683.4	729.8
Profit before dividends paid	-	-	94.1	94.1
Dividends paid	-	-	(61.8)	(61.8)
Actuarial gain on pension scheme	-	-	27.4	27.4
Movement on deferred tax relating to pension asset	-	-	(8.2)	(8.2)
At 31 March 2007	<u>0.1</u>	<u>46.3</u>	<u>734.9</u>	<u>781.3</u>

The profit and loss reserve includes £72.8m (2006: £96.6m) stated after deferred taxation of £31.2m (2006: £41.4m) in respect of pension scheme liabilities of the group pension fund.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

20 (a) Cash Flow from operating activities

	2007 £m	2006 £m
Continuing operations		
Operating profit and profit on ordinary activities before interest and taxation	244.6	215.1
Depreciation charge	140.4	139.0
Difference between pension charge and cash contributions	(6.6)	(6.6)
Amortisation of grants and contributions	(2.4)	(2.2)
Decrease in environmental provision	(0.1)	(0.2)
Increase in deferred revenue due after one year	17.5	-
Increase in stocks	(1.1)	-
Increase in debtors	(39.5)	(15.3)
(Decrease)/ increase in creditors	(13.1)	1.8
Total net cash inflow from operating activities	339.7	331.6

20 (b) Analysis of net debt

	At 31 March 2006 £m	Cash Flow £m	Other non-cash changes £m	At 31 March 2007 £m
Bank overdraft	(13.3)	3.0	-	(10.3)
Cash deposits	240.9	(110.0)	-	130.9
Cash and cash equivalents	227.6	(107.0)	-	120.6
Debt issue costs	54.4	1.6	(2.4)	53.6
Loans due within one year	(30.3)	-	-	(30.3)
Loans due after one year	(2,664.0)	(198.5)	(31.3)	(2,893.8)
	(2,412.3)	(303.9)	(33.7)	(2,749.9)

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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 £72.8m (2006 deficit £96.6m). The deficit has arisen mainly as a result of lower expected future returns on investments and turbulence in the stock market. The movement in the deficit is mainly due to changes in actuarial assumptions (financial and demographic) in the year. These movements are analysed below.

Pension schemes operated

At 1 April 2006 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.

Contributions made to the scheme for the year to 31 March 2007 amounted to £0.2m. No contributions were outstanding at the year end.

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

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:

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

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

21 Pensions (continued)

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, which 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 2007 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.

	2007	2006	2005
	% pa	% pa	% pa
Price inflation	3.2	3.0	2.9
Rate of increase in salaries (plus an age-related promotional scale)	4.5	4.3	4.4
Rate of increase of pensions in payment	3.2	3.0	2.9
Rate of increase for deferred pensions	3.2	3.0	2.9
Discount rate	5.4	5.0	5.5
Expected return on assets	7.2	6.8	7.0

The assets and liabilities in the schemes and the expected rates of return at 31 March 2007, 31 March 2006 and 31 March 2005 were

	Rate of return 2007 %	Rate of return 2006 %	Rate of return 2005 %	Value at 2007 £m	Value at 2006 £m	Value at 2005 £m
Equities	8.0%	7.9%	8.1%	309.4	273.3	223.5
Bonds	4.7%	4.2%	4.7%	97.4	108.7	94.1
Cash	5.1%	4.0%	3.9%	3.1	5.5	7.5
Total market value of Plan assets				409.9	387.5	325.1
Total value of Plan liabilities				(513.9)	(525.5)	(465.1)
Accrued deficit in the Plan				(104.0)	(138.0)	(140.0)
Related deferred tax asset				31.2	41.4	42.0
Net pension liability				(72.8)	(96.6)	(98.0)

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

21 Pensions (continued)

Analysis of amounts charged to operating profit:

	2007 £m	2006 £m
Employer's current service cost	7.8	7.1
Employer's past service costs	0.3	0.5
Total charged to operating profit	8.1	7.6

Analysis of other amounts credited to operating profit:

	2007 £m	2006 £m
Gain on curtailment	(2.3)	(2.5)
Net gain credited to operating profit	(2.3)	(2.5)

Analysis of the amount charged to other finance expense:

	2007 £m	2006 £m
Interest on pension scheme liabilities	26.2	25.5
Expected return on pension scheme assets	(26.2)	(22.9)
Net charge to other finance expense	-	2.6
Total charge before tax	5.8	7.7

Analysis of the amounts recognised in STRGL:

	2007 £m	2006 £m
Actuarial return less expected return on pension scheme assets	(3.2)	39.7
Experience gain arising on scheme liabilities	7.1	4.6
Gain/(loss) on change of assumptions (financial and demographic)	23.5	(46.3)
Total gain/(loss) recognised in STRGL before adjustment for tax	27.4	(2.0)

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

21 Pensions (continued)

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

	2007 £m	2006 £m
Deficit in the scheme at 1 April	(138.0)	(140.0)
Employer's contributions	12.4	11.7
Employer's current service cost	(7.8)	(7.1)
Employer's past service cost	(0.3)	(0.5)
Curtailment gain	2.3	2.5
Other finance expense	-	(2.6)
Actuarial gain/(loss)	27.4	(2.0)
Deficit in the scheme at end of year	<u>(104.0)</u>	<u>(138.0)</u>

Details of gains and losses for the year to 31 March 2007 are as follows:

	2007	2006	2005	2004
a. Actuarial (gain)/loss on scheme assets				
Amount (£m)	3.2	(39.7)	(19.2)	(34.0)
Percentage of the scheme assets	<u>0.8%</u>	<u>10.2%</u>	<u>5.9%</u>	<u>11.9%</u>
b. Experience (gain)/loss on scheme liabilities				
Amount (£m)	(7.1)	(4.6)	(1.8)	6.8
Percentage of the present value of the scheme liabilities	<u>1.4%</u>	<u>0.9%</u>	<u>0.4%</u>	<u>1.6%</u>
c. Total actuarial (gain)/loss recognised in STRGL				
Amount (£m)	(27.4)	2.0	(13.1)	0.3
Percentage of the present value of the scheme liabilities	<u>5.3%</u>	<u>0.4%</u>	<u>2.9%</u>	<u>0.1%</u>

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

22 Contingent liabilities

	2007 £m	2006 £m
Capital claims	<u>1.9</u>	<u>1.9</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 30 March 2006 the company received a notice from its regulator, Ofwat, that it will be fined for failing to meet customer service standards. The company has responded to an information requirement which may lead to the issuance by Ofwat of a further notice. The notice enables Ofwat to fine the company up to a maximum of 10% of turnover.

23 Financial commitments

As at 31 March 2007, 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:

	2007 £m	2006 £m
Expiring within one year	0.4	0.4
Expiring between two and five years	<u>2.2</u>	<u>2.7</u>
	<u>2.6</u>	<u>3.1</u>

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

24 Directors' emoluments

	2007 £000	2006 £000
Aggregate emoluments (including benefits in kind)	1,078	942
Compensation for loss of office	<u>-</u>	<u>137</u>

Retirement benefits accrued to one director (2006: two) under a Southern Water defined benefit scheme.

Details of emoluments and benefits for the highest paid director:

	2007 £000	2006 £000
Aggregate highest paid director's emoluments and benefits	<u>480</u>	<u>203</u>

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2007

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 2006 SWC owned 75% of the share capital of Southern Water Investments Limited (SWIL), the other 25% being owned by Veolia Water Investment Limited (VWIL) On 10 April 2006 VWIL sold its entire shareholding to SWC The major shareholders in SWC 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

The company has taken advantage of the exemption in FRS 8 paragraph 3(c) from disclosing related party transactions on the basis that the consolidated financial statements in which the company is included are publicly available

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 2007 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

The directors' responsibilities for preparing the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

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

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Report of the Directors is consistent with the financial statements.

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

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This information comprises only the Report of the Directors and the Operating and Financial Review. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and 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 2007 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 Report of the Directors is consistent with the financial statements

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Gatwick

29 June 2007