

**SOUTHERN WATER SERVICES LIMITED**

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

**FOR THE YEAR ENDED  
31 MARCH 2008**

Registered No 2366670

**TUESDAY**



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**SOUTHERN WATER SERVICES LIMITED**

**Operating and Financial Review, Report of the Directors and Accounts  
for the year ended 31 March 2008**

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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 below as the non-appointed activities.

#### **Water Services**

Southern Water supplies high quality drinking water to more than one million properties across the region, through a network of more than 13,500 km of mains, 99 water treatment works and numerous pumping stations and service reservoirs.

The average daily volume supplied in 2007-08 was 492 million litres a day. Of the households served, 35% have a meter and pay by reference to the amount of water supplied. 88% of business customers are metered.

#### **Wastewater Services**

Every day we treat 798 million litres of wastewater from 1.9 million domestic and business properties. Wastewater is transported through a network of 21,545 kilometres of sewers and 2276 pumping stations to one of 370 works where it undergoes a series of treatment processes. Recycled products of these processes are used to make organic-based fertilisers, soil conditioners and to generate power to help run the works.

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

Of the total water and wastewater services turnover, 18% 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 109,000 searches were sold. The implementation of Home Improvement Packs is increasing the demand for this service.

During the year the sale of the leisure facilities at Bewl Water reservoir was completed. The laboratory and sampling services business was also disposed of in the year. The policy of disposal of non-core activities continues with the goal being to enable the business to focus on delivering the best services for water and wastewater customers.

#### **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.

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Regulation of the Water Industry (continued)**

Price limits were last set in 2004 for the period 2005-06 to 2009-10. The allowed increases are shown in Figure 1 below. 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 price increase ('K' factor)	12.6%	3.9%	3.5%	5.8%	2.6%

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

The next price review (PR09) covers the five years from April 2010. The main objective of PR09 is to set price limits that deliver the best value for water consumers and allow efficient water companies to provide a sustainable service into the future.

For water and wastewater companies to meet the challenges of the future and be responsive to changing consumer expectations, companies must take ownership of their own long-term plans. Water companies, including Southern Water, have started this process with each one developing and publishing a strategic direction statement. This sets out its approach to delivering a sustainable water and wastewater service for its customers in the long term. It is already clear that this innovation was a success – stakeholders have commented that they found the statements useful and companies have agreed that it has enabled them to put the price review in a longer-term context.

**Competition**

The Water Act 2003 set out a framework for the development of competition within the water industry. On 1 December 2005, a new water supply licensing regime was launched by Ofwat. This signals a clear drive to develop competition in the water sector.

Our customers want to have reliable water services at an efficient price. Competition needs to offer customers choice of service and price, together with a secure, resilient service, otherwise the benefits to customers will be negligible. Southern Water is committed to improve clarity of our accounting for each part of the supply chain. This will aid transparency in costs and charges to new entrants.

**Strategic Goals**

Southern Water aims to provide resilient, sustainable and value for money services to current and future customers. This means we will need to continually review the needs of our customers and the service levels provided. 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, Human Resources and Finance.

To ensure that regulatory goals are met and the business delivers to customers effectively and efficiently, the Board has endorsed a comprehensive set of performance targets for all areas of the business. In addition, to ensure focus on key issues, the Top 10 targets for the organisation are set out annually for all staff.

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Strategic Goals (continued)**

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

- |    |  |
|----|--|
| 1  | Deliver the Capital Programme investment and outputs to the agreed business plan profile for 2008-09   |
| 2  | Minimise the number of properties internally flooded due to overloaded sewers and maintain wastewater treatment compliance at the record levels achieved in 2007-08  |
| 3  | Minimising pollution incidents, particularly those in the most serious categories 1 and 2  |
| 4  | Improving the quality of drinking water supplies on at least two key parameters  |
| 5  | Delivering customer services improvements respond to billing enquiries within four working days on 98.5% of occasions, respond to written complaints within eight working days on 99% of occasions and no more than 4% of telephone calls to be abandoned by customers |
| 6  | Deliver further customer service improvements by reducing the number of occasions that customers have to contact the company by 30%  |
| 7  | Delivering a series of software applications that will improve efficiency and compliance in Operations, Finance, Procurement and Human Resources by the end of 2008  |
| 8  | Maintain our leading position in the water industry in terms of leakage  |
| 9  | Reduce Customer Debt   |
| 10 | Reduce the number of accidents reportable to the Health & Safety Executive to be less than 2006-2007 performance and the number of accidents leading to time off work to be less than 2007-08  |

**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. Of these, 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 senior 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 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.

<b>Net debt: RCV</b>	
2006-07 performance	78%
2007-08 performance	77%
Covenanted lock-up level	<85%
<b>Senior cash interest cover</b>	
2006-07 performance	1.3 times
2007-08 performance	1.4 times
Covenanted trigger level	1.1 times

**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.

The focus during the year has been on clearing backlogs associated with implementation of the new billing system, stabilising performance and achievement of the customer services improvement plan agreed with Ofwat (as described in section D). This improvement plan was developed as a consequence of the reporting irregularities identified by Southern Water in October 2005 and reported to Ofwat. The plan covered measures for 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 and pollution incidents. Price limits can be adjusted for comparatively good or poor performance on the OPA index at price reviews. The overall OPA score has been adversely affected by the customer service issues over the last three years. The Board continues to monitor performance against this overall measure and aims to achieve an incremental improvement in the score each year. The OPA scores, out of a maximum of 437.5 points, are shown below along with the target for 2008-09.

<b>Customer services</b>	
2007-08 performance	Improvement plan achieved
<b>Overall Performance Assessment</b>	
2006-07 performance	341.0 points
2007-08 performance	384.6 points
2008-09 target	416.2 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. Southern Water's aim is to beat annual leakage targets set by Ofwat (92 MI/d for 2007-08 and 2008-09) maintaining its position as the water and sewerage company with the lowest leakage levels in the industry, measured on a per property basis.

<b>Drinking water compliance (based on calendar years)</b>	
2005 performance	99.96%
2006 performance	99.95%
2007 performance	99.95%
2008 target	99.97%
<b>Leakage</b>	
2005-06 performance	93 MI/d
2006-07 performance	82 MI/d
2007-08 performance	83 MI/d
2008-09 target	82.5 MI/d

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Wastewater Services**

The provision of wastewater services can have significant effects on the natural environment. Southern Water's goal is to minimise these potential impacts by ensuring that any pollution incidents are kept to a minimum and treated wastewater is appropriately recycled back into the environment. We are committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice.

2007 was our best year ever in terms of improved environmental performance.

Our performance highlights are summarised below:

- A significant improvement in our prosecution record compared with previous years
- A 50% reduction in the most serious categories of pollution incidents (refer to Pollution Incidents table below)
- A dramatic improvement in compliance at our wastewater treatment works (refer to WTW Compliance table below)

The drivers behind our improved performance were:

- Targeted investment
- Management focus
- Cultural change
- Working with the Regulator

***Pollution incidents (based on calendar years)  
(Category 1 'Major', Category 2 'Significant')***

2005 performance	13 Category 1 & 2 pollution incidents
2006 performance	15 Category 1 & 2 pollution incidents
2007 performance	7 Category 1 & 2 pollution incidents
2008 target	6 Category 1 & 2 pollution incidents

***Wastewater treatment works compliance (failures of numeric consents)***

2005 performance	14
2006 performance	15
2007 performance	3
2008 target	3

SOUTHERN WATER SERVICES LIMITED

**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 28

**Profit and Loss Account**

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

Table 1	Years ended 31 March		Change
	2008 £m	2007 £m	%
Turnover	618.7	575.8	7.5
Cost of sales and admin expenses	(361.4)	(332.2)	8.8
Exceptional items	(20.3)	-	N/A
Other income	0.4	1.0	(60.0)
Operating profit before exceptional items	257.7	244.6	5.4
Operating profit	237.4	244.6	(2.9)
Profit on disposal of fixed assets	9.5	20.2	(53.0)
Net interest	(145.0)	(129.4)	12.1
Profit before tax	101.9	135.4	(24.7)
Tax	(14.5)	(41.3)	(64.9)
Profit after tax	87.4	94.1	(7.1)
Dividends	(67.8)	(61.8)	9.7
Retained profit	19.6	32.3	(39.3)

Operating profit for 2007-08 reduced by 2.9% to £237.4m (2006-07 £244.6m). A significant factor in this reduction is the impact of exceptional administration expenditure for the year of £20.3m. The exceptional item relates to a fine levied by the regulator Ofwat and accepted by the company for the misreporting of customer services statistics and for failing to make guaranteed standard payments to customers up until October 2005. Operating profit before this exceptional charge was £257.7m which represented an increase of 5.4% compared with the previous year.

Turnover increased by 7.5% to £618.7m (2006-07 £575.8m). This resulted principally from the impact of inflation and an increase in the K factor (the annual price movement as set by Ofwat) which was required to secure and service the ongoing finance for the continual investment programme for the current regulatory review period which totals approximately £2 billion. 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 continued to have a negative effect on measured water sales.

Costs, excluding exceptionals, increased by 8.8% to £361.4m (2006-07 £332.2m). This increase resulted mainly from higher electricity prices, the impact of inflation, higher depreciation and an increase in the bad debt provision, partially offset by operating efficiencies. The profit on disposals of £9.5m (2006-07 £20.2m) relates mainly to the sale of land and buildings.

The profit after taxation for the year amounted to £87.4m (2007 £94.1m). In the prior year the directors recommended a final dividend of £500.00 per ordinary share, which was paid in the current financial year. Interim dividends of £710.82 per ordinary share (2007 £1,014.39 per share), totalling £39.8m were also paid during the year, resulting in total dividends paid and charged in the current financial year of £67.8m. At the year end the final dividend for 2007-08 had not been approved by the Board of Directors.

**OPERATING AND FINANCIAL REVIEW (continued)**

**B. FINANCIAL PERFORMANCE (continued)**

**Cash Flow statement**

Net cash inflow from operating activities increased to £365 0m for 2007-08 from £339 7m in 2006-07 This reflects the impact of increased turnover being higher than the increase in cash costs

The net cash outflow from returns on investment and servicing of finance increased to £115 3m for 2007-08 from £77 8m in 2006-07, due to higher interest paid and in particular the timing of interest payments at the year end

There was a decrease in outflow of cash relating to the purchase of tangible fixed assets of £428 5m (2006-07 £505 3m) and a net cash outflow before financing in 2007-08 of £217 6m (2006-07. £303 9m)

During the year borrowings were increased by £298 3m in order to help meet the ongoing requirements of the capital investment programme

**Balance Sheet**

At the end of the year to 31 March 2008, Southern Water had fixed assets of £3,546 6m (2006-07 £3,319 5m) an increase of £227 1m from March 2007 This increase results from the large capital investment programme Overall net assets increased from £781 3m to £811 4m

**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.

**Current cost profit and loss account (appointed business)**

Profit before tax was £119 5m (2006-07 £159 0m) The principal differences from the historical profit and loss account arise from the inclusion of the following adjustments, which are explained in greater detail in note 1 to the Current Cost Accounts

Depreciation adjustment – an increased charge of £69 6m (2006-07 £64 2m)

Working capital adjustment – a credit of £2 8m (2006-07 £4 5m)

Financing adjustment – a credit of £88 9m (2006-07 £97 2m)

Non appointed profit before tax extracted of £4 2m (2006-07 £3 8m)

Profit on disposal of fixed assets – an increased cost of £0 3m (2006-07 £10 1m)

**Current cost cashflow (appointed business)**

Net cash flow from operating activities increased to £362 4m for 2007-08 from £335 8m in 2006-07 Net cashflow from investing activities decreased from £486 9m to £383 1m, reflecting the capital investment programme which reached a peak during 2006-07 and reduced in 2007-08 As a result net cash outflow before financing fell to £217 6m in 2007-08 (2006-07 £303 9m)

**Current cost balance sheet (appointed business)**

At the end of the period to 31 March 2008, Southern Water had current cost fixed assets of £15,636m (2006-07 £14,917m) an increase of £719m from March 2007 This increase results from the effects of inflation and the large capital investment programme Overall net assets increased from £12,504m to £13,031m

Net debt at the year end, as per the regulatory accounts and including preference shares and mezzanine debt, was £3,014 0m (2006-07 £2,749 9m) The net debt to RCV ratio, a key performance indicator for the company and Ofwat on the above basis, decreased from 94% to 93% (The definition of net debt for the purposes of financial covenants does not include preference shares and junior debt such as the mezzanine debt )

The Regulatory Capital Value, the capital value used by Ofwat for price setting purposes, was £3,248m at 31 March 2008

**OPERATING AND FINANCIAL REVIEW (continued)**

**B. FINANCIAL PERFORMANCE (continued)**

**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 2007-08 reflected the cashflow from the sale of income rights relating to aerial masts in 2006-07.

Following the change in ownership in October 2007, the dividend policy is under review. Any dividend policy will be subject to ensuring that any distribution will not impair the ability of the appointed business to finance its functions and ensuring that the requirements of the Common Terms Agreement that underpins our financial structure are met.

**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. At the same time a Common Terms Agreement (the CTA) between the members of the Southern Water Financing Group 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**

82% 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 wastewater 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 with that assumed in the setting of price limits, may provide grounds for an interim determination of K by Ofwat.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE**

**Water services**

Water companies across the South East have outlined how they will keep taps flowing with water in the future. The plans look at three key ways of making more water available:

- Making better use of existing resources
- Managing customers' demand for water
- Developing new resources

In all the draft Water Resource Management Plans there are a range of options contained within these three headings. Every water company believes it must be able to deliver these three requirements over the 25-year-period from 2010, to make sure there is enough water for customers, now and in the future.

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 2007 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 2007 calendar year compliance with Water Resources Act "look-up table" discharge consents (which represent the vast majority of current consents) was 100% 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. Both minimising the number of pollution incidents and ensuring compliance with discharge consents continue to be part of the company's 'Top 10' targets for 2008-09.

**Bathing water quality**

During the 2007 bathing water season (1 May to 30 September) the Environment Agency tested 81 beaches in the region for compliance with the EU Bathing Water Directive standards. For the third year running all 81 beaches met the mandatory standards and 79% met the much stricter guideline standards.

**Customer service**

Following the implementation of our new SAP billing system in February 2007 and the continued scrutiny by Ofwat of our standards of customer service, the 2007-08 financial year has been one of continuous transformation and improvement.

Regulatory performance during this period has been closely monitored by the Board by reference to targets defined in our improvement programme, which was formulated and agreed with Ofwat. All the key customer service indicators were monitored and reported monthly throughout the period, with steady improvement being seen on all measures, culminating in Ofwat "good" service levels being achieved in March 2008 on all key metrics. This is further illustrated by the progress in the Overall Performance Assessment (OPA) index which is set out in section A above.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE (continued)**

**Customer service (continued)**

In addition to the increases in resources consistent with our improvement plan we have also significantly enhanced our web site and e-mail facilities and established additional Interactive Voice Recognition (IVR) facilities, including payment self-service, greatly increasing and improving our customer contact channels and options. Agent productivity and performance has improved throughout the year as familiarity and confidence in the new processes and systems improved.

We have worked continually with our key service providers throughout this period to ensure our back-office activities are consistent in terms of quality and performance with the needs of our customers. The progress and improvements made in 2007-08 provided us with a robust and stable platform to enable us to continue to improve our service to customers in 2008-09.

In February 2008 Ofwat fined Southern Water £20.3m for the mis-reporting of customer service performance levels over a number of years prior to 2006. Southern Water deeply regrets this unfortunate period in its history and we have apologised to all of our customers.

**Customer services improvement plan**

The targets to achieve Ofwat "good" levels of customer service against key metrics in 2007-08 were met. However, there is still much work to do to further stabilise performance and to continue to improve levels of service. In agreeing to an improvement plan in 2007-08, the Board also committed to an improvement plan for 2008-09 and discussions are currently underway with Ofwat to determine the appropriate targets to set in next year's plan.

**Energy use**

Southern Water is continuing to expand its Combined Heat and Power (CHP) systems and in April 2008 the eleventh unit was commissioned. Southern Water now has the capacity to generate approximately 10% of the company's electricity consumption from renewable sources and further CHP is planned in the forthcoming year and beyond out to 2015.

Southern Water has set a target of 20% of energy generated by renewable sources by 2020. Other forms of generating renewable energy including energy recovery from drinking water and wastewater networks using hydro recovery turbines and wind generation are being considered to achieve this target.

**Energy efficiency**

The company has adopted a number of energy efficient practices to optimise its working practices. Consultants have been employed to continue to provide advice on methods of optimising the efficiency of water and wastewater treatment works and pumping stations. Southern Water has also been working with the Carbon Trust to develop a Carbon Management Strategy. As a result of this a target of 10% CO<sub>2</sub> reduction by 2015 from a base line of 2008-09 has been set.

**OPERATING AND FINANCIAL REVIEW (continued)**

**E. LOOKING AHEAD**

**The Remainder of AMP4**

2008-09 is the fourth year of the current five year regulatory period (AMP4)

In the first three years of AMP4, £1.2bn 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 the capital programme is for 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 EU Urban Wastewater Directive. Following a five-week planning inquiry held in the summer of 2006, the company's proposals were rejected by the Government in July 2007 following a public inquiry. Southern Water has now prepared new proposals which responded to the comments made by two Secretaries of State. The new design combines new features, land shaping and planting to blend the proposals into the surrounding landscape. A new planning application was made to East Sussex County Council, the planning authority in January 2008. As a result of the rejection of the initial planning application, completion of the scheme will now be delayed into the next regulatory period.

The second major objective for AMP4 is to ensure stable 'serviceability' is achieved on above-ground wastewater assets by 2007-08. This will be assessed by Ofwat on the basis of our annual June Return data submission. Southern Water is confident that the overall level of compliance improvement shown during the year 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 undertaken by 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.

**The 2009 Periodic Review**

One of Ofwat's main tasks is to set price limits for the water and sewerage companies in England and Wales. Ofwat reviews price limits every five years. Prices were set at the price review in 2004 for 2005-2010. The next price review (PR09) covers the five years from April 2010.

PR09 is organised for review in four phases, which commenced in October 2007.

A Strategic Direction Statement was published in December 2007, representing the first milestone in the price review, and setting out our 25-year vision, reflecting customers' views on the standards they expect from Southern Water and the company's delivery plans. Our objectives are:

- Provision of resilient services to customers in a changing environment
- Facilitate sustainable growth
- Recognised as best value for money

The water industry faces numerous challenges over the next 25 years, some of which are more apparent than others.

**OPERATING AND FINANCIAL REVIEW (continued)**

**E. LOOKING AHEAD (continued)**

**The 2009 Periodic Review (continued)**

Climate change will inevitably be a key influencing factor in the company's strategy going forward. Our fundamental role of balancing flows of water to and from the environment is put under additional strain from the effects of climate variability. Our carbon footprint, the amount of carbon we emit into the atmosphere each year through our operations, can contribute to the effects of climate change thus compounding this problem. Minimising it is a significant challenge and a key consideration in all our future proposals. Future challenges may constrain our options, but taking account of them now will ensure a sustainable service for future generations.

The key investment driver for the next regulatory period from 2010 to 2015 (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. Our recent research has shown that customers support the need for further service improvements in a number of areas and we will identify how we intend to deliver these improvements through our business planning process.

Customers in particular were very supportive of our proposals to improve

- Resilience of our assets
- Security of supply
- Our performance on sewer flooding

We will continue to recognise that the needs of our business customers may differ considerably from the needs of our domestic customers, and we will ensure fairness to both groups of customers by developing our tariff strategy to reflect the different customer needs.

The nature of the current regulatory regime provides a strong incentive for us to continue to become more efficient in our operations and investments and deliver value to customers. To enhance these incentives, a new water supply licensing regime was launched on 1 December 2005 creating a framework for competition to develop in the industry. Although this has been slow to move forward, Ofwat has shown a clear will to accelerate competition in the water sector. At Southern Water, we are keen to work with the regulators to ensure that a system of competition, delivered in the right way and serving the interests of all customers, can be developed. The Government may also take a view on how it wishes to see competition develop in the water industry and we will need to take account of these views. For many years water companies have produced plans that detail how they should manage water supplies to ensure customers have clean, fresh drinking water on demand. These plans for the first time are being put out for public consultation.

The documents can be downloaded from the Southern Water website at the following URL

[www.southernwater.co.uk/environment/managingresources/publicconsultation.asp](http://www.southernwater.co.uk/environment/managingresources/publicconsultation.asp)

Inside the main report are consultation questions and a comments form that can be sent directly to Defra

Alternatively an online form can be filled out at the following URL

[www.southernwater.co.uk/environment/managingresources/questionnaire.asp](http://www.southernwater.co.uk/environment/managingresources/questionnaire.asp)

and submitted directly to The Secretary of State for Environment, Food and Rural Affairs

**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 two executive directors – the Chief Executive Officer and the Finance Director – 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, Revenue, Corporate Strategy, Commercial, Legal and Communications.

**People**

At the year end, Southern Water had 1,523 full-time-equivalent staff (2006-07 1,784) across the region. The decrease in employee numbers reflected 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 staff development continued to be a key component for the organisation. The company is committed to improving its employees' skills through continued learning and in February 2008 Southern Water gained the prestigious Investor in People Award.

During the year over 300 employees from across the organisation attended Leadership conferences designed to engage people and develop business solutions to further improve services to customers. 2007-08 saw the launch of 'Rocketing Performance', a series of structured development modules designed to improve leadership and organisational skills at all levels in the business. The development of the skill base was further enhanced in the year with the launch of the graduate scheme and a new intake of apprentices to the business.

**Key Partners**

Southern Water spent £1.2bn of the £1.8bn capital programme in the first three years of AMP4. This was delivered through a number of contractual mechanisms such as the Single Entity Contract with 4D which concentrated on the major capital schemes. Other contracts include Mechanical and Electrical (Morrison Utility Services), Sewers (Hollerans Mouchel Parkman JV), and Water Networks (Clancy Docwra).

Southern Water is currently working on its sourcing strategy to deliver its capital and operational obligations, including its current Utility Services Contracts. The new mechanisms will be in place in early 2009 in readiness to deliver throughout AMP5 (2010 - 2015).

Southern Water continued its implementation of its Master Framework Agreements to deliver a variety of 'back office' services. These include correspondence handling (RR Donnelley), IT Infrastructure management (Wipro Technologies), Finance and Accounting (Wipro BPO) and Engineering Solution and Design (WS Atkins and TCS). These continue to deliver high quality and high value services to support Southern Water in meeting its obligations to its customers.

**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 Officer 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 most prominent of these risks currently is

**The Risk of a poor determination at the 2009 Periodic Review**

The process for Ofwat's 2009 periodic review began 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 done an extensive amount of preparatory work for the review, which will culminate in the submission of a draft Business Plan to Ofwat in August 2008. We are working with expert partner organisations to ensure the robustness of the asset plan which underpins the Business Plan.

We have responded to all of Ofwat's consultations on the price review methodology and the company works closely with Water UK as well as maintaining its own close contact with regulators to ensure that its views are heard.

**OPERATING AND FINANCIAL REVIEW (continued)**

**G. RISK MANAGEMENT (continued)**

**KEY RISKS (continued)**

**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 seasonal levels where they have remained and all reservoirs were greater than 95% full by spring 2008. 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 370 wastewater treatment works and manages more than 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.

**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 cash flows 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.

**OPERATING AND FINANCIAL REVIEW (continued)**

**G. RISK MANAGEMENT (continued)**

**KEY RISKS (continued)**

**Financing Risk (continued)**

This risk is managed by ensuring that exposure to interest rate rises on current borrowings is hedged by a subsidiary company, Southern Water Services (Finance) Limited, and accordingly 100% of current borrowings are at either fixed rates or index-linked. This risk is further mitigated by the regulatory pricing mechanism whereby prices are increased annually by movements in the retail price index. Good contacts with lenders, including bondholders, are maintained through an annual update programme with key investors.

The company ensures that sufficient funds are available for its operational and capital investment programme through ongoing monitoring and forecasting of cash flow and take steps accordingly.

A stable regulatory regime is vital to ensuring ongoing access to capital 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 risk**

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 £1.2bn has been delivered to date. Around £0.6bn 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**

Southern Water has submitted new plans to bring significant environmental improvements to the East Sussex coastline. The company wants to build a £300 million wastewater treatment works and sludge recycling centre on land at Lower Hoddern Farm in Peacehaven. It will deliver modern wastewater treatment facilities to serve the communities between Hove and Peacehaven and will ensure that the effluent discharges meet the requirements of the EU Urban Wastewater Directive. The company's original proposal was rejected by the Government in July 2007 following a public inquiry.

Southern Water has now prepared new proposals which respond to the comments made by two Secretaries of State. The new design combines new features, landscaping and planting to blend the proposals into the surrounding landscape. The new planning application was made to East Sussex County Council, the planning authority, in January 2008.

Following the public inquiry ruling into Southern Water's first proposals for Peacehaven in 2007, both the Planning Inspector and Secretaries of State highlighted the now "urgent and pressing need" to meet these European standards.

There is an urgent and pressing national need for a new wastewater treatment works to serve the area. However, Southern Water needs to obtain the necessary planning permissions and consents before any construction work can start. The scheme would take three to four years to build and the earliest operational date is 2011.

Failure to achieve planning permission would mean that the enforcement notice issued on the company 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. CORPORATE RESPONSIBILITY**

**Environmental Policy**

Southern Water's management is committed to the development and execution of its Environment Policy with the aim of continually improving our environmental performance. The Southern Water Environmental Policy Advisory Committee (SWEPAC) is responsible for this policy and its implementation.

The responsibility for environmental management and performance rests with all employees throughout the company. Environmental performance is reported in our annual Stakeholder 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 continues to be a priority for the company. Every employee can see and comment on the corporate policy statement on Health and Safety. There are regular meetings of employee representatives to consider all aspects of Health and Safety.

During 2007-08, our Health and Safety initiatives have run under the 'Aim for Zero Injuries' brand and this was awarded 'Best Employee Communications' at the 2007 CorpComms Awards. This achievement is complimented with the award of RoSPA Gold Medal. This is our fifth consecutive Gold Medal and our 11<sup>th</sup> RoSPA award in succession. Several of our key contractors were also recognised by RoSPA with a range of awards during the year.

As part of a range of activities to support the European Week of Safety and Health, we ran three separate regional Behavioural Safety events for more than 450 operational staff and key contractors. Other events included displays from Sussex Police and the Sussex Safer Roads partnership. This popular event concentrated upon driving risks and as a part of this initiative, we invited a Sussex Fire and Rescue team from Brighton to practically demonstrate how they extricate the injured from a crashed car by cutting the roof off a vehicle at one of our sites.

We also actively supported campaigns held by the UK Health and Safety Executive and the European Agency for Safety and Health 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.

This year Southern Water won a hat-trick of awards at a prestigious public relations awards ceremony.

- Southern Water's Communications department was named Outstanding In-House Public Relations Team and the company picked up the Community Relations gold award for its Learn To Swim campaign, which has taught more than half a million children to swim in the last 16 years.
- The company's Aim For Zero Injuries campaign, which has been successful in reducing accidents in the workplace, won a silver award in the Internal Communications category and its Water Efficiency campaign, which last summer helped save 43 million litres of water a day - enough to meet the needs of a city the size of Brighton and Hove - was a finalist in the Corporate Communications section.
- The 2008 Hollis Sponsorship Awards gave a coveted trophy to the company for its Achiever of the Year Awards, part of its life-saving Learn to Swim Programme. This award is the latest in a rapidly growing string of accolades for Southern Water which, in the past six months, includes the Brighton Business Awards, New Pride Awards, Corporate Communications Awards and the Utility Achievement Awards.

**OPERATING AND FINANCIAL REVIEW (continued)**

**H. CORPORATE RESPONSIBILITY (continued)**

**Community Programme (continued)**

Woodland located behind Heyworth Primary School in Haywards Heath can now be properly surveyed thanks to a grant given to the school by Southern Water. Extensive work has been carried out within the wood to develop a nature trail for the children's use, as well as an outdoor classroom. Using the funds provided by the water company, the school hopes an arboricultural survey will confirm the future of the woodland and help them preserve the beautiful trees that shape it.

An Arabian Nights themed ball organised by Southern Water in March 2008 raised more than £130,000 for WaterAid - an international charity dedicated to helping people escape poverty and disease caused by living without safe water and sanitation. More than one billion people around the world do not have access to clean water. Just £15 can provide one person with safe water, sanitation and hygiene education. Southern Water raised more than £200,000 for WaterAid in 2007-08 and this money is enough to help 13,000 people living in countries without safe water and sanitation.

Southern Water has renewed its partnership with the Sussex Otters and Rivers Project (SORP), which promotes the sustainable management of river catchments and their landscapes, and the restoration of wetland habitats for the benefit of both people and wildlife.

During 2007-2008 Southern Water has provided grants amounting to about £19,000 towards the Community and Environmental schemes. This activity is carried as a part of our ongoing initiatives through community chest programmes.

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 FOR THE YEAR ENDED 31 MARCH 2008

The directors present their report and the audited accounts for the year ended 31 March 2008

#### 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 19, which are incorporated in this report by reference.

#### RESULTS AND DIVIDENDS

The profit and loss account on page 24 shows the Company's results, dividends and profit for the year. Further details are also available in the OFR on pages 1 to 19.

The final dividend for 2008 of £378.57 per ordinary share (£21.2m in total) was declared and paid on 30 May 2008.

#### DIRECTORS AND THEIR INTERESTS

The directors who held office during the year ended 31 March 2008 were as follows:

Michael Welton	(Chairman) ( <i>Appointed 24 April 2008</i> )
Leslie Dawson	
Howard Goodbourn	
David Golden	(Independent Non-Executive Director)
Steven Marshall	(Independent Non-Executive Director)
Phillip Peters	(Non-Executive Director) ( <i>Appointed 22 October 2007</i> )
Jason Zibarras	(Non-Executive Director) ( <i>Appointed 22 October 2007</i> )
Robert Armstrong	(Independent Non-Executive Director) ( <i>Appointed 23 May 2008</i> )
Cheryl Black	(Independent Non-Executive Director) ( <i>Appointed 23 May 2008</i> )
Simon MacDonagh	(Independent Non-Executive Director) ( <i>Resigned 22 April 2008</i> )
Robert Thian	(Chairman) ( <i>Resigned 23 January 2008</i> )
Donald Workman	(Non-Executive Director) ( <i>Resigned 15 October 2007</i> )
Barrie Delacour	( <i>Resigned 25 April 2007</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.

#### 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 (2007: £1.3m).

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**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 a functional and company-wide level. An employee survey is also completed on an annual basis to seek input from employees.

The Company recognises the rights of every employee to join a trade union and participate in its activities. Southern Water 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 Company takes full account of the needs of people with disabilities and follows set policies and procedures to support reasonable adjustments in the workplace.

***Health and safety***

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

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

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

**CREDITOR PAYMENT POLICY AND PRACTICE**

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

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 2008 were 40 days (2007: 35 days).

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**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 Stakeholder 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 £770,000 (2007 £19,000) to a variety of charities over the year. Donations in the year comprised of £750,000 to the Southern Water Trust Fund, a charitable trust set up to assist customers who are suffering hardship, poverty or a poor quality of life by providing grants to help them pay their water bills, and a further £20,000 of donations to other charities within the region.

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.

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period.

In preparing those financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements,
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business, in which case there should be supporting assumptions or qualifications as necessary.

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

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

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

**PROVISION OF INFORMATION TO AUDITORS**

Each of the persons who is a director at the date of approval of this report confirms that

- (1) so far as the director is aware, there is no relevant audit information of which the Company's auditors are unaware, and
- (2) each director has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s234ZA of the Companies Act 1985.

**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  
Date 26 June 2008

## SOUTHERN WATER SERVICES LIMITED

**PROFIT AND LOSS ACCOUNT**

For the year ended 31 March 2008

	Notes	2008 £m	2008 £m	2007 £m	2007 £m
<b>Turnover</b>	1,2,3		<b>618.7</b>		575.8
Cost of sales	3		<b>(334.2)</b>		(303.7)
<b>Gross profit</b>			<u>284.5</u>		<u>272.1</u>
Administrative expenses					
- before exceptional items	3	(27.2)		(28.5)	
- exceptional item	4	<u>(20.3)</u>		<u>-</u>	
Administrative expenses total			<b>(47.5)</b>		(28.5)
Other operating income	3		<u>0.4</u>		<u>1.0</u>
<b>Operating profit before exceptional item</b>			<b>257.7</b>		244.6
<b>Exceptional item</b>			<b>(20.3)</b>		-
<b>Operating profit</b>			<b>237.4</b>		244.6
Profit on disposal of fixed assets			<b>9.5</b>		20.2
Net interest and similar charges					
- interest payable	6		<b>(221.8)</b>		(199.2)
- interest receivable	6		<b>76.8</b>		69.8
<b>Profit on ordinary activities before taxation</b>	4		<b>101.9</b>		135.4
Tax on profit on ordinary activities	7		<b>(14.5)</b>		(41.3)
<b>Profit on ordinary activities after taxation</b>	19		<b>87.4</b>		94.1
Dividends	8,19		<b>(67.8)</b>		(61.8)
<b>Retained profit for the financial year</b>			<u><b>19.6</b></u>		<u>32.3</u>

The above results relate to continuing operations

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

The Notes on pages 28 to 49 form part of these accounts

SOUTHERN WATER SERVICES LIMITED

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**

For the year ended 31 March 2008

	Notes	2008 £m	2007 £m
<b>Profit on ordinary activities after taxation</b>		<b>87.4</b>	<b>94.1</b>
Actuarial gain recognised in the pension scheme	19,21	13.7	27.4
Movement on deferred tax relating to pension deficit		(3.2)	(8.2)
<b>Total recognised gains for the year</b>		<b>97.9</b>	<b>113.3</b>

SOUTHERN WATER SERVICES LIMITED

**BALANCE SHEET**

As at 31 March 2008

	Notes	2008 £m	2007 £m
<b>Fixed assets</b>			
Tangible assets	9	3,517.4	3,290 3
Investments	10	<u>29.2</u>	<u>29 2</u>
		<b>3,546.6</b>	<b>3,319 5</b>
<b>Current assets</b>			
Stocks	11	2.2	2 2
Debtors amounts falling due within one year	12	203.3	181 5
Debtors amounts falling due after one year	13	812.3	812 3
Cash at bank and in hand		<u>201.8</u>	<u>130 9</u>
		<b>1,219.6</b>	<b>1,126 9</b>
<b>Creditors: amounts falling due within one year</b>	14	<u>(236.2)</u>	<u>(261 3)</u>
<b>Net current assets</b>		<b>983.4</b>	<b>865 6</b>
<b>Total assets less current liabilities</b>		<b>4,530.0</b>	<b>4,185 1</b>
<b>Creditors amounts falling due after more than one year</b>	15	<b>(3,204.0)</b>	<b>(2,859 5)</b>
<b>Provision for liabilities and charges</b>	16		
Environmental obligations		(0.9)	(1 0)
Deferred taxation		(405.1)	(422.6)
<b>Grants and contributions</b>	17	<b>(50.3)</b>	<b>(47 9)</b>
<b>Net assets excluding pension deficit</b>		<b>869.7</b>	<b>854 1</b>
<b>Pension deficit</b>	21	<b>(58.3)</b>	<b>(72 8)</b>
<b>Net assets including pension deficit</b>		<b>811.4</b>	<b>781 3</b>
<b>Capital and reserves</b>			
Called up share capital	18	0.1	0 1
Share premium	19	46.3	46 3
Profit and loss account	19	765.0	734 9
<b>Total shareholders' funds</b>		<b>811.4</b>	<b>781 3</b>

The accounts on pages 24 to 49 were approved by the Board and authorised for issue on 26.6.08 and signed on its behalf by



**Howard Goodbourn**  
Finance Director

## SOUTHERN WATER SERVICES LIMITED

**CASH FLOW STATEMENT**

for the year ended 31 March 2008

	Notes	2008 £m	2007 £m
<b>Net cash inflow from operating activities</b>	20	<b>365.0</b>	339 7
<b>Returns on investments and servicing of finance</b>			
Interest received		72.9	72 2
Interest paid		(174.5)	(136 3)
Preference share dividends		(13.7)	(13 7)
<b>Net cash outflow from returns on investments and servicing of finance</b>		<b>(115.3)</b>	(77 8)
<b>Taxation</b>		<b>(18.0)</b>	(17 1)
<b>Capital expenditure and financial investment</b>			
Purchase of tangible fixed assets		(428.5)	(505 3)
Receipt of grants and contributions		13.6	10 2
Sale of tangible assets		33.4	8 2
<b>Net cash outflow for capital expenditure and financial investment</b>		<b>(381.5)</b>	(486 9)
<b>Equity dividends paid</b>		<b>(67.8)</b>	(61.8)
<b>Net cash outflow before financing</b>		<b>(217.6)</b>	(303 9)
<b>Financing</b>			
Increase in borrowings		294.0	198 5
Issue costs of new loans/redemption premium /gilt lock receipts		4.3	(1 6)
<b>Net cash inflow from financing</b>		<b>298.3</b>	196 9
<b>Increase/(decrease) in net cash</b>		<b>80.7</b>	(107 0)
<b>Reconciliation to net debt</b>			
Net debt at beginning of year		(2,749.9)	(2,412 3)
Increase/(decrease) in net cash		80.7	(107 0)
Movements in borrowings		(294.0)	(198 5)
Debt issue costs/redemption premium/gilt lock receipts		(4.3)	1 6
Other non cash changes		(46.5)	(33 7)
<b>Net debt at end of year</b>		<b>(3,014.0)</b>	(2,749 9)

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008**

**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 Southern Water Services Limited ("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, Greensands Holdings 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 metered and unmetered income

Metered income is based on actual or estimated water consumption. Unmetered 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 and proceeds from gilt lock agreements 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

**Research and development**

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

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)****1 Accounting policies (continued)****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 down to their residual values 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.

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**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.

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 other operating income in 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 2008 (continued)**

**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 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

The Company also operates a defined contribution pension scheme Company contributions to the scheme are charged to the profit and loss account in the period to which they relate

**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 2008 (continued)**

**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 UK.

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

**4 Profit on ordinary activities before taxation**

Profit on ordinary activities before taxation is stated after charging/(crediting)	<b>2008 £m</b>	2007 £m
Employee costs (note 5a)	<b>42.4</b>	48.5
Depreciation on		
- owned assets	<b>159.4</b>	140.0
- assets held under finance leases	<b>0.4</b>	0.4
	<b>159.8</b>	140.4
Rentals under operating leases	<b>3.6</b>	3.8
Research and development expenditure	<b>1.3</b>	1.3
Release of grants and contributions (note 17)	<b>(2.5)</b>	(2.4)
Exceptional item (see note (a) below)	<b>20.3</b>	-
Fees receivable by the Company's auditors in respect of		
- Statutory audit of the Company's financial statements	<b>0.3</b>	0.3
- Other services pursuant to legislation	<b>0.1</b>	0.1
- Auditing of financial statements of the Company's associates pursuant to legislation	<b>0.2</b>	0.1

(a) The exceptional item relates to a fine of £20.3m imposed on the Company by the regulator Ofwat for the misreporting of customer services statistics and for failing to make guaranteed standard payments to customers up until October 2005.

## SOUTHERN WATER SERVICES LIMITED

## NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

## 5 Employee information

	2008 £m	2007 £m
<b>(a) Employee costs (including directors' emoluments):</b>		
Wages and salaries	47.6	51.7
Social security costs	4.0	4.2
Pension costs	5.2	6.1
Total employee costs	<u>56.8</u>	<u>62.0</u>
Less charged as capital expenditure	<u>(14.7)</u>	<u>(13.5)</u>
Charged to the profit and loss account	<u>42.1</u>	<u>48.5</u>

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

	2008 No.	2007 No.
<b>(b) Average number of persons employed</b>		
Operations	1,071	1,157
Customer Services	224	289
Corporate Centre	316	452
	<u>1,611</u>	<u>1,898</u>

## 6 Net interest and similar charges

	2008 £m	2007 £m
Interest payable on other loans	(0.1)	(0.2)
Interest paid to group companies	(163.4)	(151.5)
Indexation	(44.7)	(32.0)
Amortisation of issue costs	(2.5)	(2.5)
Amortisation of gilt lock proceeds	0.1	-
Amortisation of bond premium	0.7	0.7
Other finance expense (note 21)	1.8	-
Interest on preference shares	<u>(13.7)</u>	<u>(13.7)</u>
Total interest payable	<u>(221.8)</u>	<u>(199.2)</u>
Interest receivable from Southern Water Services Group Limited	56.9	56.9
Other interest receivable	<u>19.9</u>	<u>12.9</u>
Net interest charge	<u>(145.0)</u>	<u>(129.4)</u>

## SOUTHERN WATER SERVICES LIMITED

## NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

## 7 Tax on profit on ordinary activities

	2008 £m	2007 £m
<b>Current tax:</b>		
UK corporation tax on profits for the year at 30% (2007 30%)	23.4	16.7
Adjustment in respect of prior years	3.4	(1.0)
	<u>26.8</u>	<u>15.7</u>
<b>Deferred tax:</b>		
Origination and reversal of timing differences	16.0	22.5
Effect of abolition of Industrial Building Allowance ("IBA") related charges	(4.6)	-
Effect of corporation tax rate change	(29.1)	-
Adjustment in respect of prior years	0.2	1.0
Pension cost relief in excess of pension cost charge	2.8	2.1
Change in tax rate – impact on pension deferred tax asset	2.4	-
Total deferred tax	<u>(12.3)</u>	<u>25.6</u>
Total tax on profit on ordinary activities	<u>14.5</u>	<u>41.3</u>

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

	2008 £m	2007 £m
<b>Profit on ordinary activities before tax</b>	<u>101.9</u>	<u>135.4</u>
<b>Current tax:</b>		
UK corporation tax on profits for the year at 30% (2007 30%)	30.6	40.6
Adjustments in respect of prior years	3.4	(1.0)
Permanent differences	11.6	0.7
<b>Tax charge on ordinary activities</b>	<u>45.6</u>	<u>40.3</u>
Timing differences	(18.8)	(24.6)
<b>Current tax charge for year</b>	<u>26.8</u>	<u>15.7</u>

## Factors that may affect future tax charges

In March 2007 the Chancellor of the Exchequer proposed several changes to the tax regime. The effect of the changes to tax legislation coming into effect from 1 April 2008 which were substantively enacted by Parliament before the balance sheet date are disclosed within the above deferred tax charge. These changes are

- Reduction in the rate of corporation tax from 30% to 28% with effect from 1 April 2008
- The withdrawal of the clawback of Industrial Buildings Allowances on the disposal of industrial buildings

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 2008 (continued)

## 8 Dividends per share

	2008 £ per ordinary share	2007 £ per ordinary share	2008 £m	2007 £m
<b>Ordinary shares</b>				
Interim dividend – 29 June	177.70	177 70	9.9	9 9
Interim dividend – 29 Sept	177.70	177 70	9.9	9 9
Interim dividend – 31 Dec	177.71	177 71	10.0	10 0
Interim dividend – 05 Jan	-	303 57	-	17 0
Interim dividend – 31 Mar	177.71	177 71	10.0	10 0
<b>Total interim dividend</b>	<u>710.82</u>	<u>1,014 39</u>	<u>39.8</u>	<u>56 8</u>
Final dividend – prior year	500.00	89 29	28.0	5 0
<b>Total ordinary dividend</b>	<u>1,210.82</u>	<u>1,103 68</u>	<u>67.8</u>	<u>61 8</u>

The final dividend for 2008 of £378 57 per ordinary share (£21 2m in total) was declared and paid on 30 May 2008

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

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
<b>Cost:</b>						
At 1 April 2007	1,032.9	1,208.6	1,432.6	563.8	333.5	4,571.4
Additions	25.0	57.3	49.3	249.3	16.0	396.9
Transfers	149.1	179.6	151.6	(522.2)	41.9	-
Grants & contributions	-	-	(8.0)	-	-	(8.0)
Disposals	(0.5)	(0.1)	(2.0)	-	(9.0)	(11.6)
<b>At 31 March 2008</b>	<b>1,206.5</b>	<b>1,445.4</b>	<b>1,623.5</b>	<b>290.9</b>	<b>382.4</b>	<b>4,948.7</b>
<b>Depreciation:</b>						
At 1 April 2007	282.3	392.3	383.9	-	222.6	1,281.1
Charge for the year	33.0	54.4	44.8	-	27.6	159.8
Disposals	-	(0.1)	(2.0)	-	(7.5)	(9.6)
<b>At 31 March 2008</b>	<b>315.3</b>	<b>446.6</b>	<b>426.7</b>	<b>-</b>	<b>242.7</b>	<b>1,431.3</b>
<b>Net book amount:</b>						
<b>At 31 March 2008</b>	<b>891.2</b>	<b>998.8</b>	<b>1,196.8</b>	<b>290.9</b>	<b>139.7</b>	<b>3,517.4</b>
At 31 March 2007	750.6	816.3	1,048.7	563.8	110.9	3,290.3

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals during the years ended 31 March 2008 and 31 March 2007 was £51.5m and £63.9m, respectively. Of the grants and contributions set against infrastructure assets during the years ended 31 March 2008 and 31 March 2007, £3.6m and £2.7m respectively relates to infrastructure renewals.

For the years ended 31 March 2008 and 31 March 2007, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £162.2m and £154.2m, respectively.

Freehold land is stated at a cost of £46.5m and £45.8m at 31 March 2008 and 31 March 2007, respectively, and is not depreciated.

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

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

	2008 £m	2007 £m
Cost	11.7	11.7
Aggregate depreciation	(9.0)	(8.6)
Net book amount	<u>2.7</u>	<u>3.1</u>

## SOUTHERN WATER SERVICES LIMITED

## NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

## 9 Tangible fixed assets and capital commitments (continued)

(b) Capital commitments	2008 £m	2007 £m
In respect of contracts placed	<u>624.0</u>	<u>417.1</u>

## 10 Fixed asset investments

Shares in group undertakings	2008 £m	2007 £m
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. This investment generated profits of £0.4m in the year (2007: £0.7m) and has net liabilities of £271.5m (2007: £180.3m).

The Directors are satisfied that the carrying value of the investment is supported by the underlying assets and activities of SWSF.

## 11 Stocks

	2008 £m	2007 £m
Raw materials	0.9	0.9
Work in progress	1.3	1.3
	<u>2.2</u>	<u>2.2</u>

## 12 Debtors: amounts falling due within one year

	2008 £m	2007 £m
Trade debtors	112.1	87.5
Accrued income	61.3	53.2
Amounts owed by group undertakings	9.9	4.5
Group relief receivable	-	0.7
Prepayments	6.4	3.7
Other debtors	13.6	31.9
	<u>203.3</u>	<u>181.5</u>

Amounts owed to group undertakings are unsecured, interest-free and settled regularly.

## SOUTHERN WATER SERVICES LIMITED

## NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

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

	2008 £m	2007 £m
Loan to Southern Water Services Group Limited	<u>812.3</u>	<u>812.3</u>

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**

	2008 £m	2007 £m
Bank overdraft	0.5	10.3
Trade creditors	17.2	17.0
Loans from group undertakings (see below)	30.3	30.3
Capital creditors and capital accruals	102.5	134.2
Amounts owed to group undertakings	6.5	1.7
Taxation and social security	1.2	1.4
Accruals and deferred revenue	78.7	68.2
Bond premium deferred	0.7	0.7
Debt issue costs (note 15)	(2.5)	(2.5)
Deferred gilt lock proceeds (note 15)	0.1	-
	<u>236.2</u>	<u>261.3</u>

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**

	2008 £m	2007 £m
Loans and other borrowings		
Loan from Southern Water Services (Finance) Limited	2,955.8	2,617.1
Bond premium deferred	15.4	16.0
Debt issue costs (see note v below)	(50.6)	(51.1)
Deferred gilt lock proceeds (see note vi below)	6.1	-
Class A1 Preference shares (see note vii below)	150.0	150.0
Class B Preference shares (see note vii below)	110.0	110.0
Total Loans and other borrowings	<u>3,186.7</u>	<u>2,842.0</u>
Deferred revenue (see note viii below)	17.3	17.5
<b>Total Creditors falling due after more than one year</b>	<u><b>3,204.0</b></u>	<u><b>2,859.5</b></u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

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

	2008 £m	2007 £m
<b>Repayments fall due as follows:</b>		
Between two and five years	-	-
After five years not by instalments	3,215.8	2,877.1
	<b>3,215.8</b>	<b>2,877.1</b>

In the year to 31 March 2008, Southern Water Services (Finance) Limited ("SWSF") raised and advanced to SWS further additional debt to the value of £300m

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

An analysis of the loans is shown below -

	2008 £m	2007 £m
<b>Loans</b>		
Class A £350m 6 202% fixed rate 2029	350.0	350.0
Class A £150m 3 716% index linked 2034	173.5	167.1
Class A £35m 3 716% index linked 2034	40.4	38.9
Class A £350m 6 650% fixed rate 2026	350.0	350.0
Class A £150m 3 826% index linked 2023	173.5	167.1
Class A £350m 5 010% fixed rate 2021	349.9	349.9
Class A £150m 2 295% index linked 2041 (note i below)	159.2	153.2
Class A £200m 1 533% index linked 2052 (note i below)	211.6	203.8
Class A £300m 1 740% index linked 2056 (note ii below)	297.0	-
Class B £250m 7 879% fixed rate 2038 (note iii below)	250.0	250.0
Artesian £165m 4 086% index linked 2033	190.9	183.8
Artesian £156.5m 3 645% index linked 2032	176.6	170.1
Senior mezzanine £127.2m 11 97% fixed rate 2038 (note iv below)	127.2	127.2
Junior mezzanine £106m 16.01% fixed rate 2038	106.0	106.0
Debt issue costs (note v below)	(50.6)	(51.1)
Deferred gilt lock proceeds (note vi below)	6.1	-
Bond premium deferred	15.4	16.0
Class A1 Preference shares (note vii below)	150.0	150.0
Class B Preference shares (note viii below)	110.0	110.0
	<b>3,186.7</b>	<b>2,842.0</b>

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.

In respect of the specific instruments above

- (i) SWSF 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) SWSF has entered into a swap agreement that has converted £250m of its Class A £300m from a fixed rate of 5.135% to an index linked bond with an interest rate of 1.533% plus RPI. The interest rate on the remaining £50m continues to be fixed at 5.135%.

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

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

- (iii) 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%
- (iv) 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%
- (v) 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 2008 debt issue costs amounted to £53.1m of which £2.5m represents the short-term amount which is disclosed separately in note 14.
- (vi) Prior to the issue of the new £300m bond, SWSF entered into a gilt lock agreement, resulting in the receipt of £6.3m, which was advanced to SWS along with the proceeds of the bond issue. The proceeds have been deferred in the financial statements of SWS and are being released to the profit and loss account over the life of the loan.
- (vii) 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 2007 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 share holders in September 2008 for outperformance in the year ending March 2008.

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.

- (viii) 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 2008 (continued)

**16 Provision for liabilities and charges**

	2008 £m	2007 £m
<b>(a) Environmental obligations</b>		
At 1 April	1.0	1.1
Utilised in year	<u>(0.1)</u>	<u>(0.1)</u>
At 31 March	<u>0.9</u>	<u>1.0</u>
<b>(b) Deferred taxation</b>		
Accelerated capital allowances	425.4	431.0
Other timing differences	<u>(20.3)</u>	<u>(8.4)</u>
<b>Deferred taxation</b>	<u>405.1</u>	<u>422.6</u>
<b>Total</b>	<u>406.0</u>	<u>423.6</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.

	2008 £m	2007 £m
<b>Movement in deferred tax provision</b>		
Deferred tax provided at 1 April	422.6	399.1
Deferred tax charge in Profit and Loss Account		
- Effect of abolition of IBA related charges	(4.6)	-
- Effect of corporation tax charge	(29.1)	-
- Other timing differences	<u>16.2</u>	<u>23.5</u>
<b>Deferred tax provided at 31 March</b>	<u>405.1</u>	<u>422.6</u>

The Finance Act 2007 announced a reduction in the main stream corporation tax rate from 30% to 28% from 1 April 2008 and also removed the requirement for balancing adjustments on sale of industrial buildings.

As a result, £29.1m has been credited to the profit and loss account for the year to reflect the changes in respect of the rate change and £4.6m has been credited to reflect the changes in respect of industrial buildings.

The deferred tax asset of £22.7m (2007: £31.2m) 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 2007	47.9
Receivable in year	4.9
Released to profit and loss account	<u>(2.5)</u>
<b>At 31 March 2008</b>	<u>50.3</u>

These grants and contributions relate to non-infrastructure assets.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

18 Share capital

	2008 £m	2007 £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 2007	0.1	46.3	734.9	781.3
Profit after tax	-	-	87.4	87.4
Dividends paid	-	-	(67.8)	(67.8)
Actuarial gain on pension scheme	-	-	13.7	13.7
Movement on deferred tax relating to pension asset	-	-	(3.2)	(3.2)
<b>At 31 March 2008</b>	<u><b>0.1</b></u>	<u><b>46.3</b></u>	<u><b>765.0</b></u>	<u><b>811.4</b></u>

The profit and loss reserve includes £58.3m (2007: £72.8m) stated after deferred taxation of £22.7m (2007: £31.2m) 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 2008 (continued)**

**20 (a) Cash flow from operating activities**

	2008 £m	2007 £m
<b>Continuing operations</b>		
Operating profit	237.4	244.6
Depreciation charge	159.8	140.4
Difference between pension charge and cash contributions	(9.5)	(6.6)
Amortisation of grants and contributions	(2.5)	(2.4)
Decrease in environmental provision	(0.1)	(0.1)
(Decrease)/increase in deferred revenue due after one year	(0.2)	17.5
Increase in stocks	-	(1.1)
Increase in debtors	(44.9)	(39.5)
Increase/(decrease) in creditors	25.0	(13.1)
<b>Total net cash inflow from operating activities</b>	<b>365.0</b>	<b>339.7</b>

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

	At 31 March 2007 £m	Cash Flow £m	Other non-cash changes £m	At 31 March 2008 £m
Bank overdraft	(10.3)	9.8	-	(0.5)
Cash deposits	130.9	70.9	-	201.8
Cash and cash equivalents	120.6	80.7	-	201.3
Debt issue costs	53.6	2.0	(2.5)	53.1
Gilt lock proceeds	-	(6.3)	0.1	(6.2)
Loans due within one year	(30.3)	-	-	(30.3)
Loans due after one year	(2,893.8)	(294.0)	(44.1)	(3,231.9)
	<b>(2,749.9)</b>	<b>(217.6)</b>	<b>(46.5)</b>	<b>(3,014.0)</b>

The non-cash movement of £44.1m relates to an increase in debt as a result of indexation less the amortisation of bond premiums

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**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 £58.3m (2007 deficit £72.8m). 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**

The Company principally operates 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. On 1 April 2005 Southern Water Services Executive Pension Scheme (SWEPS) was also closed to new entrants and merged with the SWPS.

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

- 2 A second company stakeholder scheme, which is a defined contribution scheme, is also available to all employees.

Contributions made to the defined contribution scheme for the year to 31 March 2008 amounted to £0.3m (2007 £0.2m). No contributions were outstanding at the year end.

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

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 valuation of the combined scheme as at 31 March 2007 is currently being finalised. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, the rate of future pensionable salary increases and the level of pension increases.

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

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

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

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

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

21 Pensions (continued)

FRS 17 - assumptions, asset, liability and reserves disclosures

The formal actuarial funding valuations were carried out at 1 April 2004 and updated to 31 March 2008 by a qualified independent actuary. Formal actuarial funding valuations as at 31 March 2007 are currently being carried out, the results of which have yet to be finalised. The following disclosures are combined for the SWPS and SWEPS. The major assumptions used by the actuary are set out in the table below.

	2008 % pa	2007 % pa	2006 % pa
Price inflation	3.7	3.2	3.0
Rate of increase in salaries (plus an age-related promotional scale)	5.0	4.5	4.3
Rate of increase of pensions in payment	3.7	3.2	3.0
Rate of increase for deferred pensions	3.7	3.2	3.0
Discount rate	6.6	5.4	5.0
Expected return on assets	7.1	7.2	6.8

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. In 2008, the company has used the post-retirement mortality assumptions comprising the '92' series based medium cohort mortality tables modified for appropriate assumptions.

The assets and liabilities in the schemes and the expected rates of return at 31 March 2008, 31 March 2007 and 31 March 2006 were

	Rate of return 2008 %	Rate of return 2007 %	Rate of return 2006 %	Value at 2008 £m	Value at 2007 £m	Value at 2006 £m
Equities	8.4%	8.0%	7.9%	260.5	309.4	273.3
Bonds	4.5%	4.7%	4.2%	133.0	97.4	108.7
Cash	5.6%	5.1%	4.0%	4.9	3.1	5.5
Total market value of Plan assets				398.4	409.9	387.5
Total value of Plan liabilities				(479.4)	(513.9)	(525.5)
Accrued deficit in the Plan				(81.0)	(104.0)	(138.0)
Related deferred tax asset				22.7	31.2	41.4
Net pension liability				(58.3)	(72.8)	(96.6)

## SOUTHERN WATER SERVICES LIMITED

## NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

## 21 Pensions (continued)

## Analysis of amounts charged to operating profit:

	2008 £m	2007 £m
Employer's current service cost	6.4	7.8
Employer's past service costs	-	0.3
Total charged to operating profit	<u>6.4</u>	<u>8.1</u>

## Analysis of other amounts credited to operating profit:

	2008 £m	2007 £m
Gain on curtailment	(2.2)	(2.3)
Net gain credited to operating profit	<u>(2.2)</u>	<u>(2.3)</u>

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

	2008 £m	2007 £m
Interest on pension scheme liabilities	27.4	26.2
Expected return on pension scheme assets	(29.2)	(26.2)
Net charge to other finance expense	<u>(1.8)</u>	<u>-</u>
<b>Total charge before tax</b>	<u>2.4</u>	<u>5.8</u>

## Analysis of the amounts recognised in STRGL:

	2008 £m	2007 £m
Actuarial return less expected return on pension scheme assets	(37.5)	(3.2)
Experience (loss)/gain arising on scheme liabilities	(7.1)	7.1
Gain on change of assumptions (financial and demographic)	<u>58.3</u>	<u>23.5</u>
Total gain recognised in STRGL before adjustment for tax	<u>13.7</u>	<u>27.4</u>

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)

21 Pensions (continued)

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

	2008 £m	2007 £m
Deficit in the scheme at 1 April	(104.0)	(138 0)
Employer's contributions	11.7	12 4
Employer's current service cost	(6.4)	(7 8)
Employer's past service cost	-	(0 3)
Curtailment gain	2.2	2 3
Other finance expense	1.8	-
Actuarial gain	13.7	27 4
Deficit in the scheme at end of year	<u>(81.0)</u>	<u>(104 0)</u>
Deferred tax	22.7	31 2
Net deficit at end of year	<u>(58.3)</u>	<u>(72 8)</u>

Details of gains and losses for the year to 31 March 2008 are as follows:

	2008	2007	2006	2005	2004
<b>a. Actuarial gain/(loss) on scheme assets</b>					
Amount (£m)	37.5	3 2	(39 7)	(19 2)	(34 0)
Percentage of the scheme assets	9.4%	0 8%	10 2%	5 9%	11 9%
<b>b. Experience (gain)/loss on scheme liabilities</b>					
Amount (£m)	7.1	(7 1)	(4 6)	(1 8)	6 8
Percentage of the present value of the scheme liabilities	1.6%	1 4%	0 9%	0 4%	1 6%
<b>c. Total actuarial (gain)/loss recognised in STRGL</b>					
Amount (£m)	(13.7)	(27 4)	2 0	(13 1)	0 3
Percentage of the present value of the scheme liabilities	2.9%	5 3%	0 4%	2 9%	0 1%

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**22 Contingent liabilities**

	<b>2008</b>	<b>2007</b>
	<b>£m</b>	<b>£m</b>
Capital claims	<u>1.0</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.

**23 Financial commitments**

As at 31 March 2008, the Company had annual commitments under non-cancellable operating lease agreements in respect of vehicles and land and buildings for which the payment extends over a number of years as follows:

	<b>Land and Buildings</b>		<b>Other</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Expiring within one year	-	-	0.6	0.4
Expiring between two and five years	-	-	1.4	2.2
Expiring after more than five years	1.3	-	0.1	-
	<u>1.3</u>	-	<u>2.1</u>	<u>2.6</u>

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

**24 Directors' emoluments**

	<b>2008</b>	<b>2007</b>
	<b>£000</b>	<b>£000</b>
Aggregate emoluments (including benefits in kind)	<b>1,185</b>	<b>1,078</b>

Retirement benefits accrued to one director (2007: one) under a Southern Water defined benefit scheme.  
 Retirement benefits accrued to two directors (2007: one) under a Southern Water defined contribution scheme.

Details of emoluments and benefits for the highest paid director

	<b>2008</b>	<b>2007</b>
	<b>£000</b>	<b>£000</b>
Aggregate highest paid director's emoluments and benefits	<u>629</u>	<u>480</u>

**NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

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

The immediate parent undertaking is SWS Holdings Limited

Prior to 15 October 2007, the directors considered Southern Water Capital Limited to be the ultimate parent and controlling party. The major shareholder in Southern Water Capital as at 15 October 2007 was Royal Bank Investments Limited (RBIL) who held 97.9% of the voting shares, increased from a shareholding of 48.9% following the purchase of the entire shareholding of PPI Investments SP Inc and DE Shaw on 5 July 2007.

On 15 October 2007, RBIL sold their entire interest to Greensands Investments Limited, a company incorporated in the UK whose ultimate parent company and ultimate controlling party is Greensands Holdings Limited, a company incorporated in Jersey.

The major shareholders in Greensands Holdings Limited as at 31 March 2008 are IIF International SW UK Investments Limited (advised by JP Morgan Investments Inc), Challenger Infrastructure Fund via its ownership of Challenger Harbourmaster Holdings Jersey Limited and UBS AG.

Greensands Holdings is the only group company to prepare consolidated accounts, copies of which may be obtained from the Company Secretary of Greensands Holdings Limited at Whiteley Chambers, Don Street, St Helier, JE4 9WG.

The Company has taken advantage of the exemption in FRS 8 paragraph 3(c) from disclosing related party transactions with 90% subsidiaries 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 FOR THE YEAR ENDED 31 MARCH 2008**

We have audited the financial statements of Southern Water Services Limited for the year ended 31 March 2008 which comprise the Profit and Loss Account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, the Cash Flow Statement 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 FOR THE YEAR ENDED 31 MARCH 2008 (continued)**

**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 2008 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  
26 June 2008*