

SOUTHERN WATER SERVICES LIMITED

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

**FOR THE YEAR ENDED
31 MARCH 2009**

Registered No. 02366670

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SOUTHERN WATER SERVICES LIMITED

Operating and Financial Review, Report of the Directors and Accounts for the year ended 31 March 2009

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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 kilometres of mains, 99 water treatment works and numerous pumping stations and service reservoirs.

The average daily volume supplied in 2008-09 was 555 million litres a day. Of the households served, 38% 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 800 million litres of wastewater from 1.8 million domestic and business properties. Wastewater is transported through a network of 21,638 kilometres of sewers and 2,296 pumping stations to 371 Wastewater Treatment Works where it undergoes a number of treatment processes. Once treated the water is recycled safely back to the environment. Recycled bi-products of these processes are used to produce organic-based fertilisers, soil conditioners and to generate electricity.

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 99,000 searches were sold.

Regulation of the Water Industry

The Water Services Regulation Authority (WSRA) replaced the Office of the Director General of Water Services on 1 April 2006. However, the WSRA has continued to operate under the organisation's former name 'Ofwat'. Ofwat's main duties are ensuring companies can finance their functions, protecting customers' interests and promoting competition. It is also responsible for setting price limits for all appointed water and sewerage undertakers. These price limits apply to the weighted average of water and wastewater charges.

Price limits were last set in 2004 for the period 2005-06 to 2009-10. The allowed increases for Southern Water 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.

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 each periodic review 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, started this process with each developing and publishing a strategic direction statement in October 2007. This sets out our approach to delivering a sustainable water and wastewater service for our customers in the long term. Subsequently we submitted to Ofwat our draft and final Business Plans to support the PR09 process.

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

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. To date no customers have switched under the regime.

A review of competition in the water industry was recently undertaken by Professor Martin Cave on behalf of the Government. The conclusions of this review were published in Spring 2009. The key findings of Professor Cave's report were to recommend that the Government introduce legislation to allow over 162,000 large public and private sector organisations in England and Wales to choose their water and sewerage retailer for the first time. The report also suggested that retail divisions of water companies be made legally independent from their network business.

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.

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

1. Maintain wastewater treatment compliance at the high levels achieved in 2007-08 and 2008-09.
2. For the financial year 2009/10, minimise the number of properties internally flooded as a result of overloaded sewers.
3. Minimise pollution incidents, particularly those in the most serious categories 1 and 2.
4. Improve the high level of water treatment compliance achieved in 2008-09.
5. Deliver the capital programme outputs to the agreed business plan profile of £235m for 2009-10.
6. Deliver further customer service improvements by reducing the number of occasions that customers have to contact the company by 10%.
7. Reduce customer debt.
8. Reduce accidents by increasing near miss reporting leading to the number of accidents reportable to the Health & Safety Executive being less than the low numbers achieved in 2008-09.
9. Further improve employee welfare by targeted Health & Safety training.
10. Set up an energy reduction team to enable proposed energy / carbon reduction schemes to be commenced in 2010-11.

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.

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

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.

Net debt: RCV	
2007-08 performance:	77%
2008-09 performance:	81%
Covenanted lock-up level:	<85%
Senior cash interest cover	
2007-08 performance:	1.4 times
2008-09 performance:	1.7 times
Minimum target trigger level:	1.1 times

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.

Since 2006, we have shown continued improvement within Customer Services and recent initiatives have ensured that the 2008-09 outturn has maintained the forward movement. The comparative Customer Services OPA scores, out of a maximum of 37.5 points, are shown in the table below along with the target for 2009-10.

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 and in recent years, the overall OPA score has been adversely affected by earlier customer service issues. The Board continues to monitor performance against this overall measure and aims to achieve an incremental improvement in the score each year.

Customer services	
Ofwat Improvement plan achieved.	
Overall Performance Assessment	
2007-08 performance:	11.2 points
2008-09 performance:	35.6 points
2009-10 target:	37.5 points

OPERATING AND FINANCIAL REVIEW (continued)**A. OUR BUSINESS (continued)****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.

Drinking water compliance (based on calendar years)

2005 performance:	99.96%
2006 performance:	99.95%
2007 performance:	99.95%
2008 performance:	99.97%
2009 target:	99.98%

Leakage (based on financial years)

2005-06 performance:	93 MI/d
2006-07 performance:	82 MI/d
2007-08 performance:	83 MI/d
2008-09 performance:	87 MI/d
2009-10 target:	85 MI/d

Wastewater Services

The operation of wastewater infrastructure has the potential to cause adverse effects on the natural environment. Southern Water's goal is to minimise these potential impacts by ensuring that 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 and this step change was further improved in 2008.

Our performance highlights are summarised below:

- Dramatic reduction in the most serious pollution incidents in 2007 and further improvement in 2008
- Dramatic improvement in Wastewater Treatment Works compliance in 2007 sustained in 2008

The drivers behind our improved performance were:

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

**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 performance:	4 Category 1&2 pollution incidents
2009 target:	5 Category 1&2 pollution incidents

Wastewater treatment works compliance (failures of numeric consents)

2005 performance:	14
2006 performance:	15
2007 performance:	3
2008 performance:	3
2009 target:	5

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 27.

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
	2009 £m	2008 £m	%
Turnover	677.8	618.7	9.6
Cost of sales and admin. expenses	(363.9)	(361.4)	(0.7)
Exceptional items	-	(20.3)	100.0
Other income	0.3	0.4	(25.0)
Operating profit before exceptional items	314.2	257.7	21.9
Operating profit	314.2	237.4	32.4
Profit on disposal of fixed assets	7.6	9.5	(20.0)
Net interest	(172.4)	(145.0)	(18.9)
Profit before tax	149.4	101.9	46.6
Tax	(52.0)	(14.5)	(258.6)
Profit after tax	97.4	87.4	11.4
Dividends	(120.1)	(67.8)	(77.1)
Retained profit	(22.7)	19.6	(215.8)

Operating profit for 2008-09 increased by 32.4% to £314.2m (2007-08: £237.4m). This increase was largely due to the 9.6% increase in turnover and the impact of exceptional administration expenditure during the prior year of £20.3m. Operating profit before exceptional items increased by 21.9% compared with the previous year.

Turnover increased by 9.6% to £677.8m (2007-08: £618.7m). 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 £2bn. Whilst the majority of customers are not charged according to the volume consumed, the wet summer and economic climate has had a negative effect on metered water sales.

Costs, excluding exceptional items, increased by 0.7% to £363.9m (2007-08: £361.4m). This increase resulted mainly from the impact of inflation and higher depreciation partially offset by operating efficiencies.

The profit on disposals of £7.6m (2007-08: £9.5m) relates mainly to the sale of land and buildings.

The profit after taxation for the year amounted to £97.4m (2007-08: £87.4m). In the prior year the directors recommended a final dividend of £378.57 per ordinary share, which was paid in the current financial year. Interim dividends of £1,766.18 per ordinary share (2007-08: £710.82 per share), totalling £98.9m (2007-08: £39.8m) were also paid during the year, resulting in total dividends paid and charged in the current financial year of £120.1m (2007-08: £67.8m). The directors do not propose payment of a final dividend for 2008-09.

Cash Flow statement

Net cash inflow from operating activities increased to £443.3m for 2008-09 from £365.0m in 2007-08. 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 decreased to £106.8m for 2008-09 from £115.3m in 2007-08, due to lower interest paid and in particular the timing of interest payments at the year end.

The outflow of cash relating to the purchase of tangible fixed assets was £330.6m (2007-08: £428.5m) and net cash outflow before financing in 2008-09 was £117.1m (2007-08: £217.6m).

During the year borrowings were increased by £298.3m in order to help meet the ongoing requirements of the capital investment programme less amounts charged for depreciation.

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

At the end of the year to 31 March 2009, Southern Water had fixed assets of £3,645.8m (2007-08: £3,546.6m) an increase of £99.2m from March 2008. This increase results from the capital investment programme.

As at 31 March 2009 Creditors falling due within one year totalled £311.2m and included the mezzanine debt of £146.0m, since this was repaid in April 09. Creditors falling due after one year increased by £189.2m to £3,393.2m as at 31 March 2009. This principally resulted from an additional new loan agreement entered into on the 5 March 2009 of £300.0m and an increase in indexation of £56.5m, offset by the transfer of the mezzanine debt (£146.0m) to short term and the repayment of £20.0m of mezzanine debt. The net pension deficit increased to £83.3m following the latest actuarial valuation, as described in note 22.

Overall net assets decreased from £811.4m to £761.0m.

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 £57.5m (2007-08: £119.5m). 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 – a charge of £75.7m (2007-08: £69.6m)
 Working capital adjustment – a charge of £0.1m (2007-08: credit of £2.8m)
 Financing adjustment – a charge of £10.3m (2007-08: credit of £88.9m)
 Non-appointed profit before tax extracted of £5.6m (2007-08: £4.2m)
 Profit on disposal of fixed assets – a charge of £0.2m (2007-08: £0.3m)

Current cost cashflow (appointed business)

Net cash flow from operating activities increased to £437.7m for 2008-09 from £362.4m in 2007-08. Net cashflow from investing activities decreased from £383.1m to £312.5m, reflecting the capital investment programme which reached a peak during 2006-07 and reduced in 2007-08 and 2008-09. As a result net cash outflow before financing fell to £117.1m in 2008-09 (2007-08: £217.6m).

Current cost balance sheet (appointed business)

At the end of the period to 31 March 2009, Southern Water had current cost fixed assets of £15,599.2m (2007-08: £15,636.1m) a decrease of £36.9m from 31 March 2008. This small decrease was primarily the result of a negative RPI adjustment offsetting the additions from the capital investment programme. Overall net assets decreased from £13,031.0m to £12,842.1m.

Net debt at the year end, as per the regulatory accounts and including preference shares and mezzanine debt, was £3,189.8m (2007-08: £3,014.0m). The net debt to RCV ratio, a key performance indicator for the company and Ofwat on the above basis, increased from 93% to 94.8%. (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 £3,364m at 31 March 2009.

Dividend policy

Distributions may comprise normal dividends, special dividends and shareholder loan payments. Board decisions in respect of annual distributions will reflect consideration relevant to directors' duties at law and under the Ofwat administered regulatory arrangements.

Distribution proposals submitted to the board will include an assessment of the proposed distribution on the company's credit rating, headroom under debt covenants, potential impact on the financial flexibility and the ability of the company to deliver its capital programme.

Distribution proposals submitted to the board will include an assessment of the company's performance against business plan including expected performance over the balance of the regulatory period.

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 21 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 in England have all now drafted and consulted on their water resources plans and are awaiting decision from DEFRA before they can publish their final plans. The Water Resource plans set out how the company intends to meet its anticipated demands over the next 25 years. The plans are reviewed and consulted on in detail every 5 years or when there has been a material change in circumstances. In the South East of England an additional layer of interaction occurs as each of the companies, Ofwat, the Environment Agency and the Consumers Council for Water work together to find the best regional solution for customers.

The core aspect of the plan is to meet the anticipated demand in the most cost effective and sustainable way and this could be achieved through demand management measures, leakage reduction or developing new resources. Following consultation the company summarises the responses it has received in its statement of response and based on this DEFRA then decide whether the plans can be published.

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 99.97% for the 2008 calendar year. To maintain these high standards each year over 640,000 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 two 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 2008 calendar year only three of our 371 Wastewater Treatment Works failed to comply with their consent conditions. This performance sustained the performance achieved in 2007 which was a dramatic improvement on the 15 failures in 2006.

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.

Bathing water quality

During the 2008 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. 80 of the 81 beaches met the mandatory standards and 70% met the much stricter guideline standards.

Customer service

In accordance with our continuous improvement plan, we have made a significant advancement during 2008-09.

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. Our forward momentum has continued with an exceptional improvement throughout 2008-09, as illustrated by the Overall Performance Assessment (OPA) index which is set out in section A above.

Following the introduction of a new billing system and new telephony system in early 2007, we have improved and enhanced our processes and procedures, redesigned and improved our web site, and recruited a significant number of people. We have also undertaken comprehensive training and development of new and existing staff and enhanced data and reporting systems. These improvements will continue to enhance customer service through a reduction in the need for customers to contact us, increased first time resolution, improved service in terms of both wait times and customer experience and a significantly increased choice of service channels and the convenience of 24 hour "self-service" options. This year our website was awarded the "best in the utility industry" for usability by an independent survey carried out by Utility Week.

OPERATING AND FINANCIAL REVIEW (continued)

D. OPERATIONAL PERFORMANCE (continued)

Customer service (continued)

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. We have enjoyed continuous improvement throughout 2008-09, resulting in a reduction in the level of repeat contacts and complaints.

Moving forward into 2009-10, we plan to further enhance our customer experience with more improvements to our web-site and a number of initiatives designed to increase the level of first-time resolution of customer enquiries and reduce the need for repeat contact.

Energy use

Energy Management

Energy management has always been key and an integral part of Southern Water's Asset Management but with the increasing awareness of climate change and the requirement to report and reduce our carbon emissions we have recognised the increasing importance of Energy Management. To this end we have 're-aligned' our Asset Management structure to provide greater focus on Energy and Carbon to ensure that opportunities for energy and carbon saving are identified, explored and delivered. A recently established 'Energy Panel', attended by directors, also provides strategic direction and ensures that key decisions such as Energy Purchasing are given the attention they require.

Generation

Southern Water completed the installation of their eleventh Combined Heat & Power (CHP) plant in April 2008. During the year the company has generated over 36 GWh of electricity from these renewable sources which is an increase of over 180% on the previous year. Further investment in CHP is planned during the next 5 year price review period which will contribute to our target of generating 20% of our electricity demand from renewable sources by 2020. Southern Water has also maximised the use of its diesel fuelled standby generators throughout the winter months to minimise the impact of peak winter tariffs known as 'Triads'. The generators were also used throughout the year to support the National Grid during periods of high demand by participating in a scheme known as Short Term Operating Reserve (STOR) whereby Southern Water receive payment for making the generators available for National Grid to call upon 24 hours per day 365 days per year.

Energy Usage

Southern Water has continued with its Optimisation programme throughout the year to reduce consumption through process optimisation and to mitigate the affect of peak winter tariffs by optimising site load profiles to consume less electricity during these peak periods. During the year we have also finalised our plans for further investment in energy efficiency improvements for 2010 onwards. These plans include improved power consumption monitoring at our top 20 power consuming sites, improved efficiency monitoring of our pumps and the roll out of Automatic Meter Reading (AMR) devices at 2,000 sites to provide accurate detailed consumption data.

Carbon footprint

Southern Water is now calculating its Carbon footprint each quarter in readiness for the introduction of the Carbon Reduction Commitment (CRC) in 2010 when we will have to purchase carbon vouchers in proportion to our emissions. We have continued to work with the Carbon Trust and consultants to review opportunities to reduce our operational emissions and as part of our PR09 business plan submission to OFWAT we have carried out a detailed assessment of the anticipated emissions to construct and operate all the schemes put forward in our business plan and we have a range of 'Carbon mitigation' schemes included in our submission for delivery 2010 onwards.

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 four years of AMP4, £1.5bn of the £2.0bn capital expenditure programme for this regulatory period has been delivered and many of the required outputs have been delivered ahead of schedule.

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. Subsequent to 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 prepared new proposals which responded to the comments made by two Secretaries of State. The new design combined 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. Planning permission was granted by East Sussex County Council in October 2008, however a Judicial Review application, which challenges the Planning Committee decision was then lodged in January 2009. The Judicial Review is effectively over and the scheme now has no further impediment to a reasonable commencement. As a result of the delays caused by the rejection of the initial planning application, some £200.0m of expenditure on this scheme has been deferred into the next regulatory period. Effectively therefore, taking account of this delay, the expenditure of £1.5bn in the first four years of AMP4 compares with an adjusted five year programme of £1.8bn.

The second major objective for AMP4 was to ensure that stable 'serviceability' was achieved on above-ground wastewater assets by 2007-08. This was confirmed by Ofwat during 2008-09.

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 – was targeted to be achieved by 2008-09. It is expected that achievement of this target will be confirmed by Ofwat following submission of the company's 2009 June Return to Ofwat.

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 current price review (PR09) covers the five years from April 2010.

PR09 is organised for review in four phases, which commenced in October 2007. We have now started phase 3 by publishing our Business Plan. Phase 3 will also cover the discussions around this plan with Draft and Final determinations provided by Ofwat in July and November respectively. Phase 4 focuses on delivering the plan.

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

In August 2008 Southern Water published its draft business plan which set out what could be achieved during the period 2010-2015. We consulted widely on this draft plan and subsequently made revisions and refinements before publishing our Final Business Plan on 7th April 2009. This plan sets out in detail our investment proposals to maintain and enhance services to customers.

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

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. Our Final Business Plan includes measures to address both these risks and many other risks. Our Company strategy can be found at:

http://www.southernwater.co.uk/pdf/aboutUs/businessPlan/SW_BusinessPlan_09v4.pdf

OPERATING AND FINANCIAL REVIEW (continued)

E. LOOKING AHEAD (continued)

The 2009 Periodic Review (continued)

The key investment driver for the next regulatory period from 2010 to 2015 (AMP5) will be meeting the requirements of European legislation. For example, the Water Framework Directive (WFD) 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.

The proposed capital investment programme continues to be very substantial at £2.2bn of which over 30% is for meeting European legislation. Our recent research has shown that customers support the need for further service improvements in preventing sewer flooding, odour control from sewage treatment works and improvements to drinking water quality in addition to large parts of the Environmental Quality improvement programme.

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.

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 1,543 full time equivalent staff across the region. This number has increased by 20 from last year. This reflects a normal level of attrition that has been offset by recruitment into our Customer Services function as we continue to enhance service delivery to our customers.

The company is committed to improving our employees' skills through continued learning and our strategic investment in staff development continued through the year. A number of development programmes were completed including: 160 people attending 'Rocketing Performance' - a series of structured development modules designed to improve leadership and the delivery of a successful pilot training programme designed to increase the skill base of operational staff. During the year 300 individuals from across the organisation attended Leadership Conferences designed to engage people and develop business solutions to further improve services to customers.

The development of the skill base was further enhanced during the year with a new intake of apprentices and graduates to the business, the sponsorship of an innovative engineering Masters degree in conjunction with the University of Brighton and an award winning scheme through the RBLI which assists disadvantaged and disabled people back into work.

Southern Water continues to support and encourage staff to fully participate in the organisation. This increases motivation and enthusiasm which was demonstrated this year by significantly improved results in the annual staff opinion survey.

Key Partners

Southern Water has continued to deliver its five year capital investment programme ahead of targets. The Commercial mechanisms and strategic partnerships established through the Single Entity Contract with 4Delivery and the Utility Services Contracts with Morrison Utility Services (Mechanical and Electrical), Holleran Mouchel Parkman JV (Sewers), and Clancy Docwra (Water Networks) have continued to ensure delivery of high quality, value for money outputs.

Throughout this period Southern Water has been developing and implementing its sourcing strategy to maintain and improve the delivery of operational and capital outputs for the AMP5 period. The primary focus has been to establish new Multi Service Framework agreements for all core Utility Services. Arrangements for the major capital delivery programmes will also be reviewed to align with final AMP5 programme.

The Master Framework Agreements which Southern Water established to deliver a variety of 'back office' services including correspondence handling (RR Donnelley), IT Infrastructure management (Wipro Technologies), Finance and Accounting (Wipro BPO) and Engineering Solution and Design (WS Atkins and TCS) have continued to show impressive improvements in both quality of service and value for money. These agreements are due for renewal in 2010 and Southern Water will be reviewing the nature and scope of current service provision in order to finalise a commercial strategy for these services moving forward.

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. Southern Water submitted its final Business Plan to Ofwat in April 2009. Failure by Ofwat to recognise significant investment needs or other major issues included within that plan may lead to a shortfall in funding for the regulatory period.

Southern Water has carried out extensive preparatory work for the review, culminating in the submission of our final Business Plan to Ofwat. We have worked 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. We will continue our dialogue with Ofwat on key issues, leading up to their Final Determination of price limits in December 2009.

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 risk in this area is currently as follows:

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

Southern Water operates 371 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 AMP4. 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.

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 takes 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.

OPERATING AND FINANCIAL REVIEW (continued)**G. RISK MANAGEMENT (continued)****KEY RISKS (continued)****Financing Risk (continued)****The risk of a sustained period of negative inflation**

Regulation of the water industry is based on the RPI-X model used across utilities in the UK. Both revenues and capital values are linked to RPI. This means that the industry is particularly affected by movements in that index.

Over the last few months the prospect of sustained deflation has become a very real risk to the economy. As part of our PR09 Business Plan, we modelled scenarios of deflation over the period 2010-2015 to understand the extent of this risk to Southern Water.

Deflation would reduce the RPI indexation of our Regulatory Capital Value and, therefore, lead to strain on the debt/RCV ratio included in our debt covenants. If it persisted there is the possibility of dividend 'lock up' to protect bond holders in accordance with the terms of our financing. The perception of this on the financial markets will make us less attractive to issuers of new bonds. If this scenario were to materialise, whilst the maintenance of existing services would always be ensured, there would possibly be consequences for funding the delivery of the enhancement programme included in the Business Plan.

We will keep the position under close review and maintain an ongoing dialogue with Ofwat on this key issue as we move through the price setting period and beyond.

Capital investment risk

Over the current regulatory period, AMP4, a capital investment programme of £2.0bn is required to be delivered, the largest ever for Southern Water. 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.

By March 2009, approximately £1.5bn of the £2.0bn programme has been delivered. This significantly reduces the risk of regulatory action.

However, the company accepts that following significant planning difficulties it will not be able to complete the largest scheme in the programme, the provision of a new wastewater treatment works to serve Brighton & Hove by the end of AMP4.

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.

In January 2008 Southern Water submitted a new planning application to East Sussex County Council, the planning authority, for project proposals which responded to the comments made by two Secretaries of State. The new design combined new features, landscaping and planting to blend the proposals into the surrounding landscape. Planning permission was granted by East Sussex County Council in October 2008, however a Judicial Review application, which challenges the Planning Committee decision was then lodged in January 2009. The Judicial Review is effectively over and the scheme now has no further impediment to a reasonable commencement.

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 now late in 2012.

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 formally received.

OPERATING AND FINANCIAL REVIEW (continued)

H. CORPORATE RESPONSIBILITY

Environmental Policy

Southern Water's management is committed to the development and execution of its Environmental 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.

In 2008 Southern Water was certified to ISO14001, the international standard for environmental management.

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 2008-09, a range of Health and Safety initiatives have been run by the company and many of our main contractors under the corporate 'Aim for Zero Injuries' brand.

We have been awarded a RoSPA President's Award in their International Occupational Health and Safety Awards, given to companies who have achieved 10 years of excellent Health and Safety performance. 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 Health and Safety Conferences for more than 450 operational staff and key contractors. Another initiative, to show that potentially hazardous activities can be run safely, was to hire a mobile climbing tower for a day at one of main offices. Staff and contractors were then invited to try it out. The key message was that you can have fun...safely.

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

In December, we ran a campaign that linked safety and Christmas, highlighting issues such as safe driving at that time of year.

Community Programme

We recognise that not only are our activities important to the environment of the South East and its sustainable development but that we also have a social responsibility within the community. Therefore, we continued to support a number of successful and long-running initiatives and developed some new activities during 2008/09.

For the past 17 years, we have sponsored the Learn to Swim scheme across the Southern Water region for children aged between four and 12 years. More than 500,000 children have been given the opportunity to learn to swim under this scheme so far. It runs at more than 70 centres across the region with 1,000 Amateur Swimming Association-qualified instructors passing on vital swimming skills to youngsters.

We have sponsored the prestigious South and South East in Bloom competition, organised by the Royal Horticultural Society for the past eight years. During the year, there were nearly 200 entries in 16 categories ranging from neighbourhoods to cities and small villages to coastal resorts.

Students from 14 junior schools in Sussex, Kent, Hampshire, the Isle of Wight and Surrey participated in the Southern Water 2008 Tea Towel Competition. Entrants were asked to design a tea towel with a water efficiency message and the winner received a VIP tour of a water supply works, a £100 donation to school projects, a framed copy of their tea towel and a Southern Water goody bag. The winning design will feature on tea towels being given away to thousands of customers during our water café roadshows.

On our behalf, the Facepack Theatre Company performed an entertaining and educational show using puppetry and songs to deliver water efficiency messages into schools. The show featured the 'the Drips family' and was staged 24 times at 21 schools across the region. The production has now been redeveloped to incorporate messages about water for health and climate change and will be performed again to key stage 2 pupils across the region in 2009.

OPERATING AND FINANCIAL REVIEW (continued)

H. CORPORATE RESPONSIBILITY (continued)

Community Programme (continued)

We sponsored the Brighton Fringe City and Brighton Festival Children's Parade which attracted more than 100,000 people. More than 100 guests attended a stakeholder reception at the children's parade, in which 4,000 children took part.

We worked in partnership with Worthing Thunder basketball team to deliver water for health and good nutrition messages into 16 schools in West Sussex.

We are a long-standing supporter of WaterAid and raised more than £250,000 during the year for the charity, which provides clean water and sanitation for some of the world's poorest people. Our major fund-raising events for WaterAid included a charity ball, race day and golf day.

We also donated more than £16,000 to community and environment schemes across our region, while our health and safety charity challenge in which we make charity donations for hazards and near misses reported in the workplace raised £12,000 for children's charity the NSPCC.

Awards and Achievements

We gained recognition for many of our achievements in 2008-2009:

1. We won the Chartered Institute of Public Relations (CIPR) President's Grand Prix Award in the Community Relations category for our We're Backing Brighton campaign, which included support of the Brighton Festival Children's Parade and the Brighton Festival Fringe.
2. We achieved the Wessex CIPR Best Use of News Media Award for our Spotlight on the Solent scheme. The Cross Solent Mains Replacement scheme involved an interactive multimedia project, which included live webcams and podcasts.
3. We gained a Utility Industry Achievement Award for IT Initiative of the Year. The award recognised the success of our initiative which revolutionised the mobile phone based system used by our field staff.
4. For the second consecutive year we won a CorpsComms award for Best Employee Communications
5. Our website, which highlights our project to replace water pipes under the Solent, won the New Media, Digital and Broadcast Award from the Public Relations Consultants Association (PRCA).
6. We won gold awards in three categories at the CIPR Pride Awards for the Home Counties (South region):
 - a. Outstanding In-House Public Relations Team
 - b. Community Relations category for our We're Backing Brighton campaign
 - c. Internal Communications.
7. Three of our capital schemes received recognition from the Institution of Civil Engineers (ICE) at the Annual South East England Engineering Awards 2008:
 - a. Water and Environment Project Award in the Kent and East Sussex Brassey Awards for our Margate and Broadstairs Urban Wastewater Treatment Scheme
 - b. Environment Award in the South Branch Construction Awards for nutrient removal at our Budds Farm and Peel Common sites
 - c. Major Scheme Award in the South Branch Construction Awards for our Cross Solent Mains Replacement scheme.
8. We won an award for our Single Entity Contract and its sustainable approach to capital delivery at the Procurement Leaders Awards.
9. Our staff newspaper was named best in its class in the Communicators in Business Awards and also won the overall Gold Award.

OPERATING AND FINANCIAL REVIEW (continued)

H. CORPORATE RESPONSIBILITY (continued)

Awards and Achievements (continued)

10. We achieved three successes at the Water Industry Achievement Awards:
 - a. Customer Care Initiative of the Year for the Brighton & Hove Mains Replacement Scheme and avoidance of unplanned interruptions
 - b. Partnership of the Year for the relationship between our four key partners – 4Delivery, Clancy Docwra, Holleran Mouchel Parkman and Morrison Utility Services
 - c. Community Campaign of the Year for our involvement with the Learn to Swim programme.
11. We won the Employment Solutions Award in the Sussex Business Awards for our operations-led scheme to support disadvantaged people.
12. Southern Water was the winner of The Single Subject Category in the Communicators in Business Communication Strategy Awards.

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2009

The directors present their report and the audited accounts for the year ended 31 March 2009.

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 18, which are incorporated in this report by reference.

RESULTS AND DIVIDENDS

The profit and loss account on page 23 shows the Company's results, dividends and profit for the year. Further details are also available in the OFR on pages 5 to 6.

Interim dividends of £1,766.18 per ordinary share (2007-08: £710.82 per share), totalling £98.9m (2007-08: £39.8m) were also paid during the year, resulting in total dividends paid and charged in the current financial year of £120.1m (2007-08: £67.8m). The directors do not recommend payment of a final dividend for 2009 (2008: £21.2m).

DIRECTORS AND THEIR INTERESTS

The directors who held office during the year ended 31 March 2009 were as follows:

Michael Welton	(Chairman)
Leslie Dawson	
Howard Goodbourn	
David Golden	(Independent Non-Executive Director)
Steven Marshall	(Independent Non-Executive Director)
Phillip Peters	(Non-Executive Director)
Jason Zibarras	(Non-Executive Director)
Surinder Toor	(Alternate Non-Executive Director) (<i>Appointed 9 February 2009</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>)

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 £1.1m (2008: £1.3m).

FINANCIAL RISK MANAGEMENT

The Financial Risk Management policy is included in the OFR on pages 1 to 18.

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2009 (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. SWS has a single union agreement with Unison.

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

Equal opportunity

The Company's policy is to promote equality of opportunity in recruitment, employment continuity, training and career development. The 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.

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 2009 were 40 days (2008: 40 days).

ENVIRONMENTAL ISSUES

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

The Company's environmental performance is reported in its annual 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.

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

CHARITABLE DONATIONS

The Company made donations of £1,028,599 (2008: £770,000) to a variety of charities over the year. Donations in the year comprised £1,000,000 (2008: £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 £28,599 (2008: £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.

POST BALANCE SHEET EVENTS

In April 2009, the Company repaid £146.0m to Southern Water Services (Finance) Limited (SWSF), made up of £106.0m in full settlement of the Junior Mezzanine debt and £40.0m in part settlement of the Senior Mezzanine debt.

Following this transaction, the directors of SWSF waived £61.4m of the remaining Senior Mezzanine debt with the Company, in exchange for taking certain negative value swaps passed down to SWSF from Southern Water Capital Limited.

GOING CONCERN

The directors believe, after due and careful enquiry, that the Company has sufficient resources for its present requirements and, therefore, consider it appropriate to adopt the going concern basis in preparing the financial statements to 31 March 2009. Further information is set out in note 1 'Basis of accounting' on page 27.

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2009 (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
24 June 2009

SOUTHERN WATER SERVICES LIMITED

PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2009

	Notes	2009 £m	2009 £m	2008 £m	2008 £m
Turnover	1,2,3		677.8		618.7
Cost of sales	3		(337.1)		(334.2)
Gross profit			<u>340.7</u>		<u>284.5</u>
Administrative expenses					
- before exceptional items	3	(26.8)		(27.2)	
- exceptional item	4	-		(20.3)	
Administrative expenses total			<u>(26.8)</u>	<u>(20.3)</u>	(47.5)
Other operating income	3		<u>0.3</u>		<u>0.4</u>
Operating profit before exceptional item			314.2		257.7
Exceptional item			-		(20.3)
Operating profit			314.2		237.4
Profit on disposal of fixed assets			7.6		9.5
Profit on ordinary activities before interest and taxation			<u>321.8</u>		<u>246.9</u>
Interest payable	7		(240.1)		(221.8)
Interest receivable	7		67.7		76.8
Profit on ordinary activities before taxation	4		<u>149.4</u>		<u>101.9</u>
Tax on profit on ordinary activities	8		(52.0)		(14.5)
Profit on ordinary activities after taxation	20		<u>97.4</u>		<u>87.4</u>
Dividends	9,20		(120.1)		(67.8)
Retained (loss)/profit for the financial year			<u>(22.7)</u>		<u>19.6</u>

The above results relate to continuing operations.

The Notes on pages 27 to 50 form part of these accounts.

SOUTHERN WATER SERVICES LIMITED

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

For the year ended 31 March 2009

	Notes	2009 £m	2008 £m
Profit on ordinary activities after taxation		97.4	87.4
Actuarial (loss)/gain recognised in the pension scheme	20,22	(38.5)	13.7
Movement on deferred tax relating to pension deficit	17	10.8	(3.2)
Total recognised gains for the year		<u>69.7</u>	<u>97.9</u>

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

SOUTHERN WATER SERVICES LIMITED

BALANCE SHEET

As at 31 March 2009

	Notes	2009 £m	2008 £m
Fixed assets			
Tangible assets	10	3,616.6	3,517.4
Investments	11	29.2	29.2
		<u>3,645.8</u>	<u>3,546.6</u>
Current assets			
Stocks	12	1.6	2.2
Debtors: amounts falling due within one year	13	212.6	203.3
Debtors: amounts falling due after one year	14	820.3	812.3
Cash at bank and in hand		360.4	201.8
		<u>1,394.9</u>	<u>1,219.6</u>
Creditors: amounts falling due within one year	15	<u>(311.2)</u>	<u>(236.2)</u>
Net current assets		1,083.7	983.4
Total assets less current liabilities		<u>4,729.5</u>	<u>4,530.0</u>
Creditors: amounts falling due after more than one year	16	(3,393.2)	(3,204.0)
Provision for liabilities and charges			
Environmental obligations	17	(0.4)	(0.9)
Deferred taxation	17	(440.1)	(405.1)
Grants and contributions	18	(51.5)	(50.3)
Net assets excluding pension deficit		<u>844.3</u>	<u>869.7</u>
Pension deficit	22	(83.3)	(58.3)
Net assets including pension deficit		<u>761.0</u>	<u>811.4</u>
Capital and reserves			
Called up share capital	19	0.1	0.1
Share premium	20	46.3	46.3
Profit and loss account	20	714.6	765.0
Total shareholders' funds		<u>761.0</u>	<u>811.4</u>

The accounts on pages 23 to 50 were approved by the Board and authorised for issue on 24 June 2009 and signed on its behalf by:



Howard Goodbourn
Finance Director

SOUTHERN WATER SERVICES LIMITED

CASH FLOW STATEMENT

for the year ended 31 March 2009

	Notes	2009 £m	2008 £m
Net cash inflow from operating activities	21	443.3	365.0
Returns on investments and servicing of finance			
Interest received		70.7	72.9
Interest paid		(163.8)	(174.5)
Preference share dividends		(13.7)	(13.7)
Net cash outflow from returns on investments and servicing of finance		(106.8)	(115.3)
Taxation		(21.0)	(18.0)
Capital expenditure and financial investment			
Purchase of tangible fixed assets		(330.6)	(428.5)
Receipt of grants and contributions		9.6	13.6
Sale of tangible assets		8.5	33.4
Net cash outflow for capital expenditure and financial investment		(312.5)	(381.5)
Equity dividends paid		(120.1)	(67.8)
Net cash outflow before financing		(117.1)	(217.6)
Financing			
Increase in borrowings		298.3	294.0
Repayment of loans		(20.0)	-
Issue costs of new loans		(2.1)	(2.0)
Gilt lock receipts			6.3
Net cash inflow from financing		276.2	298.3
Increase in net cash		159.1	80.7
Reconciliation to net debt			
Net debt at beginning of year		(3,014.0)	(2,749.9)
Increase in net cash		159.1	80.7
Movements in borrowings		(278.3)	(294.0)
Debt issue costs		2.1	(2.0)
Gilt lock receipts		-	6.3
Other non cash changes		(58.7)	(46.5)
Net debt at end of year		(3,189.8)	(3,014.0)

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009

1 Accounting policies

Basis of accounting

The accounts have been prepared on the going concern basis, 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 228A 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.

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 16.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)**1 Accounting policies (continued)****Tangible fixed assets**

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

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

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

- ii) Other tangible fixed assets (including 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.

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 10.

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

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

1 Accounting policies (continued)

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 the profit and loss account as incurred.

The sale of income rights relating to aerial 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.

Where the company enters into a lease which entails taking substantially all the risks and rewards of ownership of an asset, the lease is treated as a "finance lease". The asset is recorded in the balance sheet as a tangible fixed asset and is depreciated over its estimated useful life or the term of the lease, whichever is shorter. Future instalments under such leases, net of finance charges, are included within creditors. Rentals payable are apportioned between the finance element, which is charged to the profit and loss account, and the capital element which reduces the outstanding obligation for future instalments.

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.

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.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

1 Accounting policies (continued)

Pensions

SWS operates a defined benefit pension scheme, the assets of which are held separately from those of the company in independently administered funds. 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.

Pension scheme assets are measured using market value. Pension scheme liabilities are measured using the projected unit actuarial method and are discounted at the current rate of return on a high quality corporate bond of equivalent terms and currency to the liability. The increase in the present value of the liabilities of the Group's defined benefit pension schemes expected to arise from employee service in the period is charged to operating profit. The expected return on the schemes' assets and the increase during the year in the present value of the schemes' liabilities arising from the passage of time are included in other finance income. Actuarial gains and losses are recognised in the consolidated statement of total recognised gains and losses.

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. The assets of the scheme are held separately from those of the company in an independently administered fund. 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 affect its final value.

2 Segmental analysis

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

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.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

4 Profit on ordinary activities before taxation

Profit on ordinary activities before taxation is stated after charging/(crediting):	2009 £m	2008 £m
Employee costs (note 5a)	43.9	42.1
Depreciation on		
- owned assets	165.4	159.4
- assets held under finance leases	0.4	0.4
	165.8	159.8
Rentals under operating leases	3.6	3.6
Research and development expenditure	1.1	1.3
Release of grants and contributions (note 18)	(2.6)	(2.5)
Exceptional item (see note (a) below)	-	20.3
Fees receivable by the Company's auditors in respect of:		
- Statutory audit of the Company's financial statements	0.3	0.3
- Other services pursuant to legislation	0.1	0.1
- All other services	0.5	0.2

(a) The exceptional item in 2008 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

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

5 Employee information

	2009 £m	2008 £m
(a) Employee costs (including directors' emoluments):		
Wages and salaries	50.6	47.6
Social security costs	4.0	4.0
Pension costs	5.1	5.2
Total employee costs	<u>59.7</u>	<u>56.8</u>
Less: charged as capital expenditure	<u>(15.8)</u>	<u>(14.7)</u>
Charged to the profit and loss account	<u>43.9</u>	<u>42.1</u>

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

(b) Average number of persons employed by activity

The average monthly numbers of persons (including executive directors) employed by the company during the year was:

	2009 No.	2008 No.
Operations	997	1,071
Customer Services	254	224
Corporate Centre	267	316
	<u>1,518</u>	<u>1,611</u>

6 Directors' emoluments

	2009 £000	2008 £000
Aggregate emoluments (including benefits in kind)	1,410	1,185
Aggregate emoluments under the Long Term Incentive Plan	285	nil

No retirement benefits accrued to directors (2008: one) under a Southern Water defined benefit scheme. Retirement benefits accrued to two directors (2008: two) under a Southern Water defined contribution scheme.

Details of emoluments and benefits for the highest paid director:

	2009 £000	2008 £000
Aggregate highest paid director's emoluments and benefits	748	629
Aggregate highest paid director's emoluments under the Long Term Incentive Plan	<u>210</u>	<u>nil</u>

During the year the company made contributions of £80,000 (2008: £30,000) to a money purchase pension scheme in respect of the highest paid director's qualifying services.

Two directors are eligible for awards under the Southern Water Long Term Incentive Plan. A future award potentially payable in 2010 and 2011 may be made to each participant as a percentage of an incentive pool which is based on three elements, the Company's Operational Performance based on the Company's Overall Performance Assessment (OPA) score as at 31 March 2010, the financial performance against the Final Determination for the period from 1 April 2005 to 31 March 2010 and the outcome of the 2009 Final Determination.

The financial year ending 31 March 2009 is the 4th year of the Long Term Incentive Plan and the amounts disclosed above are the accrued awards attributed to the year ending 31 March 2009. A further accrual of £853,000 has also been applied in the accounts for the year ending 31 March 2009 relating to anticipated awards for the 3 years ended 31 March 2008, of which £630,000 is attributed to the highest paid director.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

7 Interest

	2009 £m	2008 £m
Interest payable and similar charges		
Interest payable on other loans	0.1	0.1
Interest paid to group companies	164.2	163.4
Indexation	56.5	44.7
Amortisation of issue costs	2.5	2.5
Amortisation of gilt lock proceeds	(0.1)	(0.1)
Amortisation of bond premium	(0.6)	(0.7)
Amortisation of discount	0.4	-
Other finance expense (note 22)	3.4	(1.8)
Dividends on preference shares- see note below	13.7	13.7
Total interest payable and similar charges	<u>240.1</u>	<u>221.8</u>
Interest receivable		
Interest receivable from Southern Water Services Group Limited	56.9	56.9
Other interest receivable	10.8	19.9
Total interest receivable	<u>67.7</u>	<u>76.8</u>

The preference share dividends were paid on 30 September 08 and 31 March 09 and Class A1 amounted to £40 per share and Class B £70 per share.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

8 Tax on profit on ordinary activities

	2009 £m	2008 £m
Current tax:		
UK corporation tax on profits for the year at 28% (2008: 30%)	17.2	23.4
Adjustment in respect of prior years	<u>(1.3)</u>	<u>3.4</u>
	15.9	26.8
Deferred tax:		
Origination and reversal of timing differences	29.7	16.0
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	5.3	0.2
Pension cost relief in excess of pension cost charge	1.1	2.8
Change in tax rate – impact on pension deferred tax asset	<u>-</u>	<u>2.4</u>
Total deferred tax	36.1	(12.3)
Total tax on profit on ordinary activities	<u>52.0</u>	<u>14.5</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:

	2009 £m	2008 £m
Profit on ordinary activities before tax	<u>149.4</u>	<u>101.9</u>
Current tax:		
UK corporation tax on profits for the year at 28% (2008: 30%)	41.8	30.6
Adjustments in respect of prior years	(1.3)	3.4
Permanent differences	<u>6.2</u>	<u>11.6</u>
Tax charge on ordinary activities	46.7	45.6
Timing differences	<u>(30.8)</u>	<u>(18.8)</u>
Current tax charge for year	<u>15.9</u>	<u>26.8</u>

There are no factors that may affect future tax charges.

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

Deferred tax liabilities have not been discounted.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

9 Dividends per share

	2009 £ per ordinary share	2008 £ per ordinary share	2009 £m	2008 £m
Ordinary shares				
Interim dividend – 30 Jun	-	177.70	-	9.9
Interim dividend – 30 Sept	355.40	177.70	19.8	9.9
Interim dividend – 28 Nov	1,055.36	-	59.1	-
Interim dividend – 31 Dec	177.71	177.71	10.0	10.0
Interim dividend – 31 Mar	177.71	177.71	10.0	10.0
Total interim dividend	<u>1,766.18</u>	<u>710.82</u>	<u>98.9</u>	<u>39.8</u>
Final dividend – prior year	378.57	500.00	21.2	28.0
Total ordinary dividend	<u>2,144.75</u>	<u>1,210.82</u>	<u>120.1</u>	<u>67.8</u>

The Directors do not recommend payment of a final dividend for 2009 (2008: £378.57 per ordinary share (£21.2m in total)).

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

10 Tangible fixed assets and capital commitments

(a) Tangible assets

	Freehold land & buildings	Plant & Machinery	Infra- structure assets	Assets in the course of construction	Other	Total
	£m	£m	£m	£m	£m	£m
Cost:						
At 1 April 2008	1,206.5	1,445.4	1,623.5	290.9	382.4	4,948.7
Additions	32.2	46.8	46.5	135.1	10.8	271.4
Transfers	95.2	108.7	41.9	(283.9)	38.1	-
Grants & contributions	-	-	(6.5)	-	-	(6.5)
Disposals	(9.3)	(17.4)	(2.3)	-	(0.6)	(29.6)
At 31 March 2009	1,324.6	1,583.5	1,703.1	142.1	430.7	5,184.0
Depreciation:						
At 1 April 2008	315.3	446.6	426.7	-	242.7	1,431.3
Charge for the year	34.7	55.3	46.8	-	29.0	165.8
Disposals	(9.3)	(17.5)	(2.2)	-	(0.7)	(29.7)
At 31 March 2009	340.7	484.4	471.3	-	271.0	1,567.4
Net book amount:						
At 31 March 2009	983.9	1,099.1	1,231.8	142.1	159.7	3,616.6
At 31 March 2008	891.2	998.8	1,196.8	290.9	139.7	3,517.4

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals during the years ended 31 March 2009 and 31 March 2008 was £46.0m and £51.5m, respectively. Of the grants and contributions set against infrastructure assets during the years ended 31 March 2009 and 31 March 2008, £2.8m and £3.6m respectively relates to infrastructure renewals.

For the years ended 31 March 2009 and 31 March 2008, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £168.7m and £162.2m, respectively.

Freehold land is stated at a cost of £47.7m and £46.5m at 31 March 2009 and 31 March 2008, respectively, and is not depreciated.

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

One asset held under a finance lease has been capitalised and included in plant and machinery:

	2009 £m	2008 £m
Cost	11.7	11.7
Aggregate depreciation	(9.4)	(9.0)
Net book amount	<u>2.3</u>	<u>2.7</u>

Outstanding payments and interest associated with this lease are negligible.

(b) Capital commitments	2009 £m	2008 £m
In respect of contracts placed	<u>402.0</u>	<u>624.0</u>

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

11 Fixed asset investments

	2009 £m	2008 £m
Shares in group undertakings		
At 1 April and 31 March	<u>29.2</u>	<u>29.2</u>

The investment represents all the issued shares of Southern Water Services (Finance) Ltd ("SWSF"), a company incorporated in the Cayman Islands. The principal activity of the company is to raise debt finance. This investment generated profits of £0.4m in the year (2008: £0.4m) and has net liabilities of £262.3m (2008: £264.3m). The net liability position largely results from hedge accounting for cash flow hedges.

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

12 Stocks

	2009 £m	2008 £m
Raw materials	1.1	0.9
Work in progress	0.5	1.3
	<u>1.6</u>	<u>2.2</u>

13 Debtors: amounts falling due within one year

	2009 £m	2008 £m
Trade debtors	107.3	112.1
Accrued income	87.4	61.3
Amounts owed by group undertakings	0.6	9.9
Prepayments	9.1	6.4
Other debtors	8.2	13.6
	<u>212.6</u>	<u>203.3</u>

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

14 Debtors: amounts falling due after one year

	2009 £m	2008 £m
Other debtors	8.0	-
Loans owed by group undertakings	812.3	812.3
	<u>820.3</u>	<u>812.3</u>

Loans owed by group undertakings represent a loan to Southern Water Services Group Limited which 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%.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

15 Creditors: amounts falling due within one year

	2009 £m	2008 £m
Bank overdraft	-	0.5
Loans and other borrowings (see note (i) below)	146.0	-
Trade creditors	18.2	17.2
Loans from group undertakings (see note (ii) below)	30.3	30.3
Capital creditors and capital accruals	51.4	102.5
Amounts owed to group undertakings	6.4	7.5
Taxation and social security	1.3	1.2
Accruals and deferred revenue	59.9	78.7
Bond premium deferred	0.3	0.7
Debt issue costs (note 16)	(2.7)	(2.5)
Deferred gilt lock proceeds (note 16)	0.1	0.1
	<u>311.2</u>	<u>236.2</u>

Notes:

- (i) In April 2009 the Company repaid £40.0m of the Senior Mezzanine debt and £106.0m of the Junior Mezzanine debt. Consequently these amounts have been reclassified as due within one year as at the balance sheet date.
- (ii) 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.

16 Creditors: amounts falling due after more than one year

	2009 £m	2008 £m
Loans and other borrowings:		
Loan from Southern Water Services (Finance) Limited	3,154.5	2,955.8
Bond premium deferred	5.6	15.4
Debt issue costs (see note v below)	(49.8)	(50.6)
Deferred gilt lock proceeds (see note vi below)	5.9	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>3,376.2</u>	<u>3,186.7</u>
Deferred revenue (see note viii below)	17.0	17.3
Total Creditors falling due after more than one year	<u>3,393.2</u>	<u>3,204.0</u>

	2009 £m	2008 £m
Repayments fall due as follows:		
Between two and five years	-	-
After five years not by instalments	3,414.5	3,215.8
	<u>3,414.5</u>	<u>3,215.8</u>

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

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

In the year to 31 March 2009, 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: -

	2009	2008
	£m	£m
Loans		
Class A £350m 6.202% fixed rate 2029	350.0	350.0
Class A £150m 3.716% index linked 2034	182.2	173.5
Class A £35m 3.716% index linked 2034	42.5	40.4
Class A £350m 6.650% fixed rate 2026	350.0	350.0
Class A £150m 3.826% index linked 2023	182.2	173.5
Class A £350m 5.010% fixed rate 2021	350.0	349.9
Class A £150m 2.295% index linked 2041 (note i below)	166.4	159.2
Class A £200m 1.740% index linked 2052 (note i below)	220.2	211.6
Class A £300m 1.533% index linked 2056 (note ii below)	307.7	297.0
Class A £300m 6.135% fixed rate 2019	300.0	-
Class B £250m 7.879% fixed rate 2038 (note iii below)	250.0	250.0
Artesian £165m 4.086% index linked 2033	200.5	190.9
Artesian £156.5m 3.645% index linked 2032	185.6	176.6
Senior mezzanine £127.2m 11.97% fixed rate 2038 (note iv below)	67.2	127.2
Junior mezzanine £106m 16.01% fixed rate 2038 (note iv below)	-	106.0
Debt issue costs (note v below)	(49.8)	(50.6)
Deferred gilt lock proceeds (note vi below)	5.9	6.1
Bond premium deferred	5.6	15.4
Class A1 Preference shares (note vii below)	150.0	150.0
Class B Preference shares (note vii below)	110.0	110.0
	<u>3,376.2</u>	<u>3,186.7</u>

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

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%.
- (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%.

In April 2009, the Company repaid £40.0m of the Senior Mezzanine debt and £106.0m of the Junior Mezzanine debt. Consequently these amounts have been reclassified as due within one year as at the balance sheet date (see note 15).

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

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

- (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 2009 debt issue costs amounted to £52.5m of which £2.7m represents the short-term amount which is disclosed separately in note 15.
- (vi) Prior to the issue of the Class A £300m bond in the year to 31 March 2008, 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, which do not carry voting rights, 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 2009 for outperformance in the year ending March 2009.

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.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

17 Provision for liabilities and charges

(a) Environmental obligations	2009 £m	2008 £m
At 1 April	0.9	1.0
Utilised in year	<u>(0.5)</u>	<u>(0.1)</u>
At 31 March	<u>0.4</u>	<u>0.9</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.

(b) Deferred taxation	2009 £m	2008 £m
Accelerated capital allowances	460.7	425.4
Other timing differences	<u>(20.6)</u>	<u>(20.3)</u>
Deferred taxation	<u>440.1</u>	<u>405.1</u>

Movement in deferred tax provision:	2009 £m	2008 £m
Deferred tax provided at 1 April	405.1	422.6
Prior year adjustment	5.3	0.2
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>29.7</u>	<u>16.0</u>
Deferred tax provided at 31 March	<u>440.1</u>	<u>405.1</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 was credited to the profit and loss account in the year ended 31 March 2008 to reflect the changes in respect of the rate change and £4.6m was credited to reflect the changes in respect of industrial buildings.

Deferred tax asset relating to pension deficit	2009 £m	2008 £m
At 1 April	22.7	31.2
Deferred tax charge in profit and loss account	(1.1)	(5.3)
Deferred tax charged to the statement total recognised gains and losses	<u>10.8</u>	<u>(3.2)</u>
At 31 March	<u>32.4</u>	<u>22.7</u>

The deferred tax asset of £32.4m (2008: £22.7m) relating to the pension deficit has been deducted from the pension deficit and so has not been included in this balance.

18 Grants and contributions

	£m
At 1 April 2008	50.3
Receivable in year	3.8
Released to profit and loss account	<u>(2.6)</u>
At 31 March 2009	<u>51.5</u>

These grants and contributions relate to non-infrastructure assets.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

19 Share capital

	2009 £m	2008 £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 16 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.

20 Reconciliation of movement in shareholders' funds

	Called up share capital £m	Share premium £m	Profit and loss account £m	Total £m
At 1 April 2008	0.1	46.3	765.0	811.4
Profit after tax	-	-	97.4	97.4
Dividends paid	-	-	(120.1)	(120.1)
Actuarial gain on pension scheme	-	-	(38.5)	(38.5)
Movement on deferred tax relating to pension asset	-	-	10.8	10.8
At 31 March 2009	<u>0.1</u>	<u>46.3</u>	<u>714.6</u>	<u>761.0</u>

The profit and loss reserve includes recognised losses of £115.7m (2008: £81.0m) less deferred taxation of £32.4m (2008: £22.7m) in respect of pension scheme liabilities of the group pension fund.

	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)
At 31 March 2008	<u>0.1</u>	<u>46.3</u>	<u>765.0</u>	<u>811.4</u>

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

21 (a) Cash flow from operating activities

	2009 £m	2008 £m
Continuing operations		
Operating profit	314.2	237.4
Depreciation charge	165.8	159.8
Difference between pension charge and cash contributions	(7.2)	(9.5)
Amortisation of grants and contributions	(2.6)	(2.5)
Decrease in environmental provision	(0.5)	(0.1)
Decrease in deferred revenue due after one year	(0.3)	(0.2)
Decrease in stocks	0.6	-
Increase in debtors	(8.6)	(44.9)
(Decrease)/Increase in creditors	(18.1)	25.0
Total net cash inflow from operating activities	<u>443.3</u>	<u>365.0</u>

21 (b) Analysis of net debt

	At 31 March 2008 £m	Cash Flow £m	Other non- cash changes £m	At 31 March 2009 £m
Bank overdraft	(0.5)	0.5	-	-
Cash deposits	<u>201.8</u>	158.6	-	<u>360.4</u>
Cash and cash equivalents	<u>201.3</u>	159.1	-	<u>360.4</u>
Debt issue costs	53.1	2.1	(2.7)	52.5
Gilt lock proceeds	(6.2)	-	0.2	(6.0)
Loans due within one year	(30.3)	-	(146.0)	(176.3)
Loans due after one year	(3,231.9)	(278.3)	89.8	(3,420.4)
	<u>(3,014.0)</u>	<u>(117.1)</u>	<u>(58.7)</u>	<u>(3,189.8)</u>

Included within Other non-cash changes is a transfer between loan categories of £146.0m (see note 15).

The non-cash movement of £58.7m relates to an increase in debt as a result of indexation plus the amortisation of loan issue costs and gilt lock proceeds.

Loans due within one year relate to loans from group undertakings that are repayable on demand (see note 15).

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)**22 Pensions**

The Company accounted for pension costs during the year under FRS17. These disclosures show a net FRS 17 deficit (after deferred tax) of £83.3m (2008 deficit: £58.3m). 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 ended 31 March 2009 amounted to £0.3m (2008: £0.3m). No contributions were outstanding at the year end.

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

The latest actuarial valuation of the combined SWPS was carried out as at 31 March 2007 using the projected unit method. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, the rate of future pensionable salary increases and the level of pension increases.

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

Expected employer and employee contributions to the defined benefit scheme for 2009/10 are £13.7m and £2.4m respectively.

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

	2007
	SWPS
	% pa
Return on investments: pre-retirement	6.6
Return on investments: post-retirement	5.2
Salary growth	4.5
Pension increases on the excess over guaranteed minimum pensions	3.2

The assets of the scheme had a market value of £410.6m at 31 March 2007. This was sufficient to cover 81% of the scheme's benefits.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

22 Pensions (continued)

FRS 17 - assumptions, asset, liability and reserves disclosures

The formal actuarial funding valuations were carried out as at 31 March 2007 and updated to 31 March 2009 by a qualified independent actuary. The following disclosures are combined for the SWPS and SWEPS. The major assumptions used by the actuary are set out in the table below.

	2009	2008	2007
	% pa	% pa	% pa
Price inflation	3.2	3.7	3.2
Rate of increase in salaries (plus an age-related promotional scale)	4.5	5.0	4.5
Rate of increase of pensions in payment	3.2	3.7	3.2
Rate of increase for deferred pensions	3.2	3.7	3.2
Discount rate	6.9	6.6	5.4
Expected return on assets	7.2	7.1	7.2

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. In 2009, the company has used the post-retirement mortality assumptions comprising the '92' series based medium cohort mortality tables modified for appropriate assumptions.

	2009	2008
	years	years
Longevity at age 65 for current pensioners		
Male	21.6	21.6
Female	24.6	24.5
Longevity at age 65 for future pensioners		
Male	23.1	23.1
Female	26.1	26.0

The assets and liabilities in the schemes and the expected rates of return at 31 March 2009 and 31 March 2008 were:

	Rate of return	Rate of return	Value at	Value at
	2009	2008	2009	2008
	%	%	£m	£m
Equities	8.4%	8.4%	190.6	260.5
Government bonds	4.2%	4.5%	62.2	133.0
Non-Government bonds	6.9%	6.6%	57.6	-
Cash	4.0%	5.6%	8.4	4.9
Total market value of Plan assets			318.8	398.4
Total value of Plan liabilities			(434.5)	(479.4)
Accrued deficit in the Plan			(115.7)	(81.0)
Related deferred tax asset			32.4	22.7
Net pension liability			(83.3)	(58.3)

The equity investments and bonds which are held in plan assets are quoted and are valued at the current bid price following the adoption of the amendment to FRS17. Previously these were valued at mid price.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

22 Pensions (continued)

Reconciliation of the present value of the scheme liabilities

	2009	2008
	£m	£m
Scheme liabilities at start of year	479.4	513.9
Current service cost	5.0	6.4
Interest cost	31.2	27.4
Member contributions	2.5	2.6
Actuarial gain on liabilities	(65.7)	(51.2)
Actual benefit payments	(17.9)	(17.5)
Curtailments	-	(2.2)
Scheme liabilities at end of year	<u>434.5</u>	<u>479.4</u>

Sensitivity analysis of scheme liabilities

The sensitivity of the present value of the scheme liabilities to changes in the principle assumptions used is set out below.

	Change in assumption	Impact on scheme liabilities (%)
Discount rate	+/- 1%	-/+ 15
Rate of inflation*	+/- 1%	+/- 13
Rate of increase in salaries	+/- 1%	+/- 3
Rate of increase in pensions in payment	+/- 1%	+/- 9
Mortality	+/- 1 yr	+/- 2

*A change in inflation is assumed to be reflected in a change in the assumed rates of deferment revaluation, salary increase and pension increase (on pension in excess of GMP).

Reconciliation of the fair value of the scheme assets

	2009	2008
	£m	£m
At 1 April	398.4	409.9
Expected return on assets	27.8	29.2
Loss on assets	(104.2)	(37.5)
Company contributions	12.2	11.7
Member contributions	2.5	2.6
Benefit payments	(17.9)	(17.5)
Bid value of scheme assets at 31 March	<u>318.8</u>	<u>398.4</u>

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

22 Pensions (continued)

Analysis of amounts charged to operating profit are as follows:

	2009 £m	2008 £m
Employer's current service cost	5.0	6.4
Employer's past service cost	-	-
Expected return on pension scheme assets	(27.8)	(29.2)
Interest on pension scheme liabilities	31.2	27.4
Gain on curtailment	-	(2.2)
Total P&L expense before deduction for tax	8.4	2.4

Analysis of the amounts recognised in STRGL:

	2009 £m	2008 £m
Actuarial return less expected return on pension scheme assets	(104.3)	(37.5)
Experience gain/(loss) arising on scheme liabilities	13.1	(7.1)
Gain on change of assumptions (financial and demographic)	52.7	58.3
Total (loss)/gain recognised in STRGL before adjustment for tax	(38.5)	13.7

The cumulative amount of actuarial losses recognised in the statement of recognised gains and losses is £86.6m (2008: £48.1m).

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

	2009 £m	2008 £m
Deficit in the scheme at 1 April	(81.0)	(104.0)
Employer's contributions	12.2	11.7
Employer's current service cost	(5.0)	(6.4)
Employer's past service cost	-	-
Curtailment gain	-	2.2
Other finance expense	(3.4)	1.8
Actuarial (loss)/gain	(38.5)	13.7
Deficit in the scheme at end of year	(115.7)	(81.0)
Deferred tax	32.4	22.7
Net deficit at end of year	(83.3)	(58.3)

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

22 Pensions (continued)

History of gains and losses for the year to 31 March 2009 are as follows:

	2009	2008	2007	2006	2005
a. Experience adjustment on planned assets					
Amount (£m)	104.3	37.5	3.2	(39.7)	(19.2)
b. Experience adjustment on scheme liabilities					
Amount (£m)	(13.1)	7.1	(7.1)	(4.6)	(1.8)
c. Total amount recognised in the STRGL					
Fair value of assets at year end (£m)	318.8	398.4	409.9	387.5	325.1
Actuarial value of liabilities at year end (£m)	(434.5)	(479.4)	(513.9)	(525.5)	(465.1)
Deficit in scheme at year end (£m)	(115.7)	(81.0)	(104.0)	(138.0)	(140.0)

The current year has been valued at bid value as per FRS 17 amendment. Southern Water has taken advantage of an exemption in FRS 17 amendment, not to restate the prior years at bid value for the year ended 31 March 2009.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

23 Contingent liabilities

	2009 £m	2008 £m
Capital claims	<u>-</u>	<u>1.0</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.

24 Financial commitments

As at 31 March 2009, 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:

	Land and Buildings		Other	
	2009 £m	2008 £m	2009 £m	2008 £m
Expiring within one year	-	-	0.3	0.6
Expiring between two and five years	-	-	0.8	1.4
Expiring after more than five years	1.3	1.3	0.1	0.1
	<u>1.3</u>	<u>1.3</u>	<u>1.2</u>	<u>2.1</u>

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

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 2009 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.

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2009 (continued)

26 Post Balance Sheet Events

In April 2009, the Company repaid £146.0m to Southern Water Services (Finance) Limited (SWSF), made up of £106.0m in full settlement of the Junior Mezzanine debt and £40.0m in part settlement of the Senior Mezzanine debt.

Following this transaction, the directors of SWSF waived £61.4m of the remaining Senior Mezzanine debt with the Company, in exchange for taking certain negative value swaps passed down to SWSF from Southern Water Capital Limited.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOUTHERN WATER SERVICES LIMITED FOR THE YEAR ENDED 31 MARCH 2009

We have audited the financial statements of Southern Water Services Limited for the year ended 31 March 2009 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 Annual Report and 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 Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referred from the Business Review section of the Directors' Report.

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

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only the Directors' Report and the Operating and Financial Review and all of the other information listed on the contents page. 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

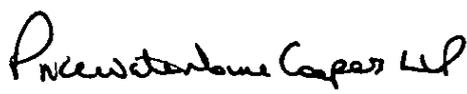
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the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

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 2009 and of its profit and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.



PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Gatwick
25 June 2009