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**SOUTHERN WATER SERVICES LIMITED**

**OPERATING AND FINANCIAL REVIEW,**

**ANNUAL REPORT**

**AND**

**FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED**

**31 MARCH 2010**

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**SOUTHERN WATER SERVICES LIMITED**

**OPERATING AND FINANCIAL REVIEW, ANNUAL REPORT AND FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 31 MARCH 2010**

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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 13,658 kilometres of mains, 95 water treatment works and numerous pumping stations and service reservoirs.

During 2009/10 we put, on average, some 560 MI/d into supply, with a peak output of some 651 MI/d during the summer. Of the households served 39% have a meter and pay by reference to the amount of water supplied. Of our business customers 88% 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 21,712 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 from these processes are used to produce agricultural fertilisers / soil conditioners and to generate renewable electricity using anaerobic digestion and CHP plants.

**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 102,000 (2008-9 99,000) residential searches were sold.

**Regulation of the Water Industry**

The economic regulator for England & Wales is the Water Services Regulation Authority, referred to as '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 for the period 2010-11 to 2014-15 were determined by Ofwat in November 2009. The allowed increases for Southern Water are shown in Figure 1 below. Associated with these price limits is a set of required outputs and efficiency targets.

Figure 1 Price limits

	2010-11	2011-12	2012-13	2013-14	2014-15
Allowed price increase ('K' factor)	-0.7%	0.0%	3.6%	3.3%	-0.1%

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

Price limits are set to ensure that an efficiently managed company can finance its functions, deliver the best value for water consumers and allow water companies to provide a sustainable service into the future.

The setting of price limits by Ofwat is the culmination of a process that began with each company 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, draft and final Business Plans were submitted to Ofwat to support the PR09 process.

Companies have the right to ask Ofwat to refer the price limits to the Competition Commission if they do not believe they will allow them to deliver the expected outputs and finance their functions. While the price limits and output expectations contained within Ofwat's determination represent a significant challenge to the Company, the Board took the view that they were on balance achievable and so did not choose to appeal.

**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 just one customer (in another company's supply area) has switched under the regime.

Competition is also possible through cross-border supplies and inset appointments, where the incumbent's licensed area of supply is altered. To date there have been 24 inset appointments, 13 of which have been made since 2007. Of these, 11 have been granted to five new entrants to the industry. During the year, one inset appointment in Southern Water's area took effect, with Albion Water providing sewerage services to a new development of 700 homes in Hampshire.

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. The Government published its response to the review in September 2009, setting out proposed legislative changes required to implement the key aspects of Professor Cave's recommendations. However, there is currently no timetable for introducing this legislation.

Ofwat have this year also introduced new requirements to report costs for different parts of the value chain – composed of nine 'business units'. This is part of its accounting separation project, which aims to improve the understanding of costs in the water sector. Ofwat sees this as another important step towards developing future competitive frameworks.

**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  | RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations) accidents to be at or below the rolling average of 13               |
| 2  | Service Incentive Mechanism (Quantitative element) score to be no more than 500  |
| 3  | For the calendar year 2010 - No more than 6 Wastewater Treatment Sites listed on the EA (Environment Agency) MD109 as a numeric compliance failure |
| 4  | The number of properties internally flooded as a result of overloaded sewers and other causes (excluding severe weather) to be less than 300       |
| 5  | For the calendar year 2010 - No more than 150 pollution incidents (categories 1, 2 & 3) arising from foul sewers, rising mains and CSO's           |
| 6  | For the calendar year 2010 - Water treatment works coliform non compliance to be 0.08% or better (= no more than 7 failed works).                  |
| 7  | The number of properties experiencing Unplanned Interruptions for greater than 12 hrs to be no more than 390                                       |
| 8  | Leakage to be no more than 83 Ml/d   |
| 9  | Retain ISO 14001 compliance  |
| 10 | Energy generated from sewage sludge to be at least 20% greater than 2009/10  |

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Headline KPIs**

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

**Financial KPIs**

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

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

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

<b>Net debt: RCV</b>	
2007-08 performance	77%
2008-09 performance	81%
2009-10 performance	79%
Covenanted lock-up level	<85%
<b>Senior cash interest cover</b>	
2007-08 performance	1.4 times
2008-09 performance	1.7 times
2009-10 performance	1.4 times
Minimum target trigger level	1.1 times

**Customer Services**

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.

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, with the aim of achieving an incremental improvement in the score each year.

We are continuing to show improvement within Customer Services and recent initiatives are keeping us on track to achieve our target Customer Services OPA maximum score of 37.5 points.

The table below shows comparable performance.

<b>Customer services</b>	
<b>Overall Performance Assessment</b>	
2008-09 performance	35.6 points
2009-10 target	37.5 points
2009-10 performance	37.5 points

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

The OPA score is made up of six Ofwat-defined measures relating to customer service, as set out in the table below

<b>Customer Services Overall Performance Assessment components</b>	<b>Target</b>	<b>Actual</b>
DG6 – Percentage of billing contacts dealt with in 5 days	99.5%	99.9%
DG7 – Percentage of written complaints dealt with in 10 days	99.8%	99.8%
DG8 – Proportion of meters read	99.8%	99.8%
DG9(i) – Percentage of calls not abandoned	94.2%	94.8%
DG9(ii) – All lines busy – percentage not engaged	99.2%	99.5%
DG9 (iii) – Customer satisfaction score (out of 5)	4.45	4.38

From 1 April 2010 Ofwat will be replacing the OPA measure with a new Service Incentive Mechanism (SIM). This new mechanism will compare, across all water companies, the ease of customer telephone contact, the number of unwanted contacts, complaints and customer satisfaction. Companies' scores on the new measure from 2011-12 will be taken into account in setting prices at the next price review.

The Board will be monitoring closely our performance on the measure with the goal of securing a positive price adjustment at the next price review.

**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 2009-10) maintaining its position as the water and sewerage company with the lowest leakage levels in the industry, measured on a per property basis.

<b>Drinking water compliance (based on calendar years)</b>	
2005 performance	99.96%
2006 performance	99.95%
2007 performance	99.95%
2008 performance	99.97%
2009 performance	99.98%
2010 target	99.99%
<b>Leakage (based on financial years)</b>	
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 performance	95 MI/d
2010-11 target	83 MI/d

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Wastewater Services**

The operation of such an extensive 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 and safely recycled back into the environment. We are committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice.

In 2007 we produced a step change in our environmental performance and this improved position has been largely maintained in 2008 and 2009.

Our performance highlights are summarised below:

- Reduction in the most serious pollution incidents since 2006
- Step change in Wastewater Treatment Works compliance in 2007 sustained in 2008 and 2009
- Described by the Environment Agency as one of the water industry's 'best performers' in 2008

***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 performance	9 Category 1&2 pollution incidents
2010 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 performance	4
2010 target	No more than 6

**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 29

**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 %
	2010 £m	2009 £m	
Turnover	679 1	677 8	0 2
Cost of sales and admin expenses	(375 4)	(363 9)	(3 2)
Other income	0 2	0 3	(33 3)
Operating profit	303 9	314 2	(3 3)
Profit on disposal of fixed assets	1 4	7 6	(81 6)
Net interest	(115 2)	(172 4)	33 2
Profit before tax	190 1	149 4	27 2
Tax	(60 8)	(52 0)	(16 9)
Profit after tax	129 3	97 4	32 8
Dividends	(40 9)	(120 1)	65 9
Retained (loss)/profit	88 4	(22 7)	489 4

Operating profit for 2009-10 decreased by 3.3% to £303.9m (2008-09 £314.2m). This decrease was largely due to the 3.2% increase in cost of sales and administrative expenses.

Turnover increased by 0.2% to £679.1m (2008-09 £677.8m) compared with an average tariff increase on measured and unmeasured income of 5.8%. The tariff increase is offset by a decline in demand for water from measured domestic and business customers resulting from the economic downturn together with the impact of continued high levels of customers switching to measured supplies and the inclusion in the prior year's turnover of non-recurring revenue resulting from our Income Maximisation project.

Costs increased by 3.2% to £375.4m (2008-09 £363.9m). This increase resulted mainly from the impact of higher depreciation charges and bad debt provision costs partially offset by operating efficiencies.

The profit on disposals of £1.4m (2008-09 £7.6m) relates mainly to the sale of land and buildings.

Net interest payable of £115.2m decreased by 33.2% (2008-09 £172.4m). Of this decrease £42.8m related to non-cash interest associated with inflation on index linked bonds. The remaining movement results from a net reduction in the level of interest payable on bonds following the repayment of the Mezzanine Debt in April 2009, offset by a reduction in interest receivable on cash deposits and a non-cash financing charge on the pension deficit.

The profit after taxation for the year amounted to £129.3m (2008-09 £97.4m).

On 28 April 2010 the directors declared a final dividend for 2009-10 of £35.0m, equivalent to £625 per ordinary share to be paid during 2010-11. No final dividend was paid in relation to 2008-09. The dividends charged to the profit and loss account in the year totalling £40.9m represent interim dividends of £731.13 per ordinary share (2008-09 the total charge of £120.1m comprised an interim dividend of £98.9m, £1,776.18 per ordinary share together with the final dividend for 2007-08 of £21.2m, £378.57 per ordinary share).

**OPERATING AND FINANCIAL REVIEW (continued)****B. FINANCIAL PERFORMANCE (continued)****Cash Flow statement**

Net cash inflow from operating activities decreased to £389.4m for 2009-10 from £443.3m in 2008-09. This decrease is principally the result of an exceptional one off lump sum payment of £56.1m made by the company into the Southern Water Pension Scheme.

The net cash outflow from returns on investment and servicing of finance decreased to £96.6m for 2009-10 from £106.8m in 2008-09, due to lower interest paid following the repayment of the Mezzanine debt in April 2009. This saving has been partially offset by lower interest receivable on cash deposits as a result of the reduction in Bank of England base rates.

The outflow of cash relating to the purchase of tangible fixed assets was £226.7m (2008-09 £330.6m) and the net cash inflow before financing in 2009-10 was £12.8m (2008-09 £117.1m outflow).

During the year net cash outflow from financing was £84.5m mainly as a result of the repayment of the Mezzanine debt and the issuance of a new £50.0m loan facility, as part of the overall company financing strategy.

**Balance Sheet**

At the end of the year to 31 March 2010, Southern Water had fixed assets of £3,695.8m (2008-09 £3,645.8m) an increase of £50.0m from March 2009. This increase results from the capital investment programme offset by depreciation.

Debtors falling due within one year increased to £234.5m at 31 March 2010, from £212.6m. This increase is as a result of an increase in prepaid expenses and an amount of £17.4m owed by group undertakings.

As at 31 March 2010 Creditors falling due within one year totalled £194.4m, the reduction from £311.2m at 31 March 2009 results from the repayment of the Mezzanine debt in April 2009. Creditors falling due after one year increased by £66.8m to £3,460.0m as at 31 March 2010, this increase principally resulted from inflation on index linked bonds of £13.7m and the receipt of a deferred swap credit of £38.3m and an inter-company creditor of £14.4m as part of the restructuring of the Mezzanine debt as described in note 16.

The net pension deficit decreased to £65.9m following the latest actuarial valuation, as described in note 22.

Overall net assets increased from £761.0m to £810.3m.

**Regulatory Accounts**

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

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

Profit before tax was £162.1m (2008-09 restated £63.0m). The principal differences from the historical profit and loss account arise from the inclusion of the following adjustments, which are explained in greater detail in note 1 to the Current Cost Accounts:

Depreciation adjustment – a charge of £77.9m (2008-09 £75.7m)

Working capital adjustment – a charge of £2.8m (2008-09 charge of £0.1m)

Financing adjustment – a credit of £60.9m (2008-09 restated charge of £4.8m)

Non-appointed profit before tax extracted of £4.8m (2008-09 £5.6m)

Profit on disposal of fixed assets – a charge of £3.4m (2008-09 £0.2m)

The Infrastructure Renewals Charge (IRC) has been further increased by £2.0m to £48.8m this year, reflecting the forecast higher levels of infrastructure renewals activity in AMP5 and beyond and the need to maintain a long-term balance between the IRC and IRE.

The current cost depreciation charge has increased from £194.7m in 2008-09 to £206.0m in 2009-10. This includes the impact of the revised MEA values which we have incorporated in this year's Regulatory Accounts. These result in an uplift of the CCD charge of £5.6m.

**OPERATING AND FINANCIAL REVIEW (continued)**

**B. FINANCIAL PERFORMANCE (continued)**

**Current cost cashflow (appointed business)**

Net cash flow from operating activities decreased to £384.4m for 2009-10 from £437.7m in 2008-09 principally as a result of an exceptional contribution to the pension deficit of £56.1m made in March 2010. Net cashflow from investing activities decreased from £312.5m to £213.4m, reflecting the capital investment programme which reached a peak during 2006-07 and reduced in 2008-09 and 2009-10. As a result there was a net cash inflow before financing of £12.8m in 2009-10 (2008-09 outflow £117.1m).

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

At the end of the period to 31 March 2010, Southern Water had current cost fixed assets of £23,100.8m (2008-09 £15,599.2m) an increase of £7,501.6m from 31 March 2009. This increase was primarily the result of an Ofwat requirement to revalue the current cost fixed assets as part of the price review process. Overall the revaluation resulted in an increase to the net fixed asset value of £6,541.2m, which together with the impact of the RPI adjustment £983.4m accounted for the majority of the movement in the year. Overall net assets increased from £12,842.1m to £20,325.5m.

Net debt at the year end, as per the regulatory accounts and including preference shares and mezzanine debt, was £3,188.8m (2008-09 £3,189.8m). The net debt to RCV ratio, a key performance indicator for the Company and Ofwat on the above basis, decreased from 94.8% to 89.4%. (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 £3,567m at 31 March 2010.

**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 also include an assessment of the Company's performance against the 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 financial statements.

**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 Southern Water's plan was approved by DEFRA and our final plan was published in October 2009. The Water Resources plan set out how the Company intends to meet its anticipated demands over the next 25 years. The plans are reviewed every year 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 will be achieved through leakage reductions, universal metering and developing new resources.

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 99.98% for the 2009 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 2009 calendar year only 4 of our 371 Wastewater Treatment Works failed to comply with their consent conditions. This performance sustained the performance achieved in 2007 and 2008 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 2009 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. All 81 beaches met the mandatory EU standard whilst 77% also met the much stricter (twenty times tighter) guideline standard. This is the water quality standard required for 'Blue Flag' status.

**Customer service**

In accordance with our continuous improvement plan, we have made further advancement during 2009-2010 and are currently on schedule to achieve our target of maximum Customer Service Overall Performance Assessment (OPA) points.

Of the six elements making up this score, company targets for all but one have been met or exceeded as set out in Section A. The only exception is the customer satisfaction score which at 4.43 (out of 5) was just below the target level of 4.45.

As described above, the OPA will be replaced by a new incentive mechanism (SIM) from 1 April 2010. Performance against this new measure will be a critical success factor for our Customer Services team from 2010-11. However, we will continue to monitor our performance against the current indicators and seek to continue to improve our performance against these metrics.

**OPERATING AND FINANCIAL REVIEW (continued)****D. OPERATIONAL PERFORMANCE (continued)****Customer service (continued)**

We have continued to improve and enhance our processes and procedures, redesigned and improved our web site, and enhanced our recruitment process. We have also undertaken comprehensive training and development of new and existing staff, including the development of a course entitled the "Customer Services School of Excellence" which we are running in conjunction with the Institute of Leadership and Management. This will enhance customer service through better-enabled staff dealing with enquiries and will also benefit our staff by providing a portable skill, in some cases leading to a formal qualification. We now have 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.

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 2009-10, resulting in a reduction in the level of repeat contacts and complaints. During 2008-09, we reduced written complaints by 48% compared to the previous year, the greatest improvement within the industry. This year we are continuing the momentum, currently running at around 39% further reduction.

Moving forward into 2010-11, we plan to further enhance our customer experience with more improvements to our staff training programmes 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 and Carbon Management**

The increasing importance of Energy and Carbon Management is recognised and a new Carbon Reduction Management team has been formed. The team has achieved an early success with the recent award of the Carbon Trust Standard a national standard recognising companies that have taken steps to measure and manage their carbon emissions over a three year period. Southern Water's 'green' achievement is a combination of the Company increasing the amount of renewable energy it produces, increasing the efficiency of its operations and treatment works and improving the way emissions are measured and reported.

**Generation**

Southern Water continued to generate renewable energy from their eleven Combined Heat & Power (CHP) plants. Further CHP opportunities were identified in our PR09 Business Plan to Ofwat for delivery in AMP5 and schemes at Aylesford, Ham Hill and Ashford have since been brought forward on a deferred payment basis and construction is well underway. The remaining scheme at Brighton & Hove will be delivered as part of the main contract. Southern Water has also continued to maximise 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 up. Proposals to generate power from Hydro recovery turbines installed in our outfall pipes was identified in our Business Plan and a detailed technical and economic review is underway to provide accurate information to go out to the market for competitive quotes to install turbines at up to 5 sites.

**Energy Usage**

Southern Water has continued to optimise its energy consumption and mitigate the effect of peak winter tariffs by optimising site load profiles to consume less electricity during these peak periods. Data on energy consumption is now being reported to the business monthly and proposals to provide enhanced power consumption monitoring at our top 20 power consuming sites has been progressed along with our proposals to roll out Automatic Meter Reading (AMR) devices at 2,000 sites to provide accurate consumption data which will eliminate estimated billing and help identify opportunities for further optimisation.

**Carbon footprint**

Southern Water has continued to measure and report its Carbon footprint each quarter in readiness for the introduction of CRC in April 2010 when we will have to purchase carbon vouchers in proportion to our emissions. The recent accreditation to the Carbon Trust is recognised by the CRC scheme as companies taking 'Early Action' to manage and reduce their emissions and this will be reflected in the scoring and league table positions for years 1, 2 and 3 of the scheme. As part of our PR09 business plan submission to Ofwat we carried out a detailed assessment of the anticipated emissions to construct and operate all the schemes put forward and we are now looking to build on this by developing a 'Carbon' standard to provide guidance to our designers and contractors to ensure that the carbon impact of schemes is fully understood and consistently assessed at all stages.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE (continued)**

**Cleaner Seas for Sussex**

Southern Water has started work on a £200 million scheme to bring significant environmental improvements to the East Sussex coastline. The Company is building a wastewater treatment works and sludge recycling centre on land at Lower Hoddern Farm in Peacehaven. Once complete 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.

Southern Water awarded a contract to 4-Delivery in June 2009 to commence the building works to deliver this vitally important scheme by the spring of 2013. Works have now commenced at multiple sites along the coast in addition to the Lower Hoddern Farm site. Prior to the main earthworks commencing environmental teams conducted full ecological checks at each of the sites to ensure wildlife is protected. Archaeologists have also been on site to make sure any important historical material is not damaged. At Peacehaven the archaeological strip produced evidence of roundhouses, a burial and a complete late Iron Age to early Roman pot believed to date back to between 10-70 AD.

Once the earthworks and deep excavations are complete, work will commence on the main structures associated with the works. Preparation work is currently underway for the construction of the 11 kilometres new sewer being created as part of the scheme and tunnelling activity is due to start in spring 2010.

Through a dedicated communications team, extensive community and stakeholder engagement is being conducted around the scheme including newsletters, micro-site, community liaison group meetings, one-to-one meetings, letters and updates.

**OPERATING AND FINANCIAL REVIEW (continued)**

**E. LOOKING AHEAD**

**The 2009 Periodic Review**

This has been a key year in the regulatory world, with the setting of new price limits. The 2009 Periodic Review (PR09), which concluded with the announcement of final determinations in November 2009, set price limits for the period from 2010-11 to 2014-15.

This is the culmination of a process that began in October 2007 with the publication of our Strategic Direction Statement. This document set out our 25-year vision, reflecting customers' views on the standards they expect from Southern Water and the Company's delivery plans. We set out our key objectives as

- The provision of resilient services to customers in a changing environment
- The facilitation of sustainable growth
- Recognition of our services as providing 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 7 April 2009. This plan sets out in detail our investment proposals to maintain and enhance services to customers.

Key aspects of our five-year plan included

- the completion of a new £200m wastewater treatment works for Brighton & Hove
- a universal metering programme to install meters for all customers by 2015, giving them greater control over their water bills
- reducing our carbon emissions significantly
- reducing the number of properties at risk of internal flooding
- completing the National Environment Programme of investment and investigations

Ofwat's determination made some tough assumptions on forecast revenues which impact working capital, the costs of delivering the investment programme, and on the level of operating costs including funding for the pension deficit, however we are committed to deliver our obligations over the next five years. The determination also took less account of some of the longer-term issues facing the industry such as the need for higher levels of asset replacement. Ofwat began the process by asking us to set out our 25-year strategy however, the assumptions in the price limits set take less account of the long term sustainable level of asset replacement and focus on keeping prices as low as possible over the next five years.

**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, an independent non-executive Chairman and six non-executive directors of whom four were independent. We are required by our regulatory licence to have at least three independent non-executive directors.

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 Company Secretary and the directors of each department – Finance, Operations, Capital Delivery, Assets and Data, Regulation and Competition, Customer Services and Revenue, Universal Metering Programme, Commercial and IT, Human Resources and Communications.

**People**

At the year end, Southern Water employed 1,476 full time equivalent staff across the region. This number has decreased by 67 from last year. This reflects a normal level of attrition together with the outsourcing of a number of staff as part of the establishment of the Multi Service Framework (described further below).

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 'Discovery' – a series of structured modules designed to improve management and leadership, and 'Dynamo' – a training programme designed to increase the skill base of operational staff. During the year 290 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 an increased intake of apprentices and graduates to the business. In addition we continued the sponsorship of an innovative engineering Masters degree in conjunction with the University of Brighton.

Southern Water continues to support and encourage staff to fully participate in the organisation. This increases motivation, enthusiasm and performance.

**Key Partners**

During this period Southern Water has focused on ensuring the effective conclusion of five year capital investment programme ahead of targets with an emphasis on ensuring continuity of service leading into the AMP5 period.

In order to ensure continuity of performance and service from AMP4 to AMP5, Southern Water has been 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, covering water distribution, sewerage networks and mechanical and electrical maintenance.

Technical support for the AMP5 programme will be provided through the seven new Engineering Framework Agreements and we are preparing a Sourcing Process to create Construction Framework agreements. This process supports the delivery of the program and ensures optimum Commercial Solutions.

In addition Commercial arrangements have been extended with 4 Delivery to secure the delivery of the Brighton and Hove Scheme and a number of "early start" schemes in AMP 5 programme.

The Master Framework Agreements which Southern Water established to deliver a variety of 'back office' services including correspondence handling, IT Infrastructure management, Finance and Accounting and Engineering Solution and Design. These have continued to show impressive improvements in both quality of service and value for money. Based on this performance Commercial arrangements are being finalised to extend current agreements through to 31 March 2015.

**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 are:

**The risk of Ofwat's PR09 determination proving too tight**

Whilst the Board believes it can fulfil and finance its obligations over the next price limit period, it is clear that Ofwat's PR09 price settlement presents a very tough challenge for the Company. In particular, Ofwat's revenue forecasts are significantly higher than those of the Company, and as a result the Company will need to manage a tight liquidity position throughout the current regulatory period. Whilst any revenue shortfall will be corrected at the next price review, through Ofwat's new Revenue Correction Mechanism, this is an untested process, and the correction will be spread over the period from 2015 to 2020.

In addition, there are a number of operating cost pressures that Ofwat have not allowed for in full in its price determination, including the costs of funding pension deficits, energy costs and the rising cost of bad debts as a result of the economic downturn. The challenge of maintaining the serviceability of our assets in the light of the reduced level of funding allowed for in price limits also represents a key risk.

**The risk of the competition framework for water developing in a way that unfairly disadvantages incumbent companies**

Ofwat has made clear its determination to introduce greater competition in the water industry over the next five years. Whilst Southern Water welcomes competition where it is in the interests of customers, there is a risk that in its attempts to encourage customer switching, the framework established by Ofwat will unfairly disadvantage incumbent water companies.

In addition, if the recommendations of the Cave Review with respect to retail separation are pursued and potentially are extended to other parts of the value chain, key decisions on the allocation of the Regulatory Capital Value between business units will need to be taken. These decisions will have a significant effect on the financial position of the individual business units.

**OPERATING AND FINANCIAL REVIEW (continued)****G. RISK MANAGEMENT (continued)****KEY RISKS (continued)****Operational Risk**

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

The key risks in this area are currently 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 almost £1bn on asset maintenance over AMP5. It also has a pollution incident response team on standby to ensure that where incidents do occur, their impact on the environment is minimised.

**The risk of not containing microbiological failures and water supply works compliance targets not being met**

Southern Water operates 95 water supply works across the region. It is essential for the Company to minimise any breach of regulations affecting water quality in order to reduce any public health risks, the safeguarding of public health is paramount and we have in place control procedures to ensure this. Any regulation breach is thoroughly investigated and action is taken to correct.

Such incidents can lead to enforcement by the Drinking Water Inspectorate and affect our serviceability rating given by OFWAT both of which can damage the reputation of Southern Water. To minimise the risk of such incidents and failures Southern Water have put in place a Water Compliance Project which will identify and deliver improvements to all operational Water Supply Works over the early part of AMP5.

**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, result in 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 sufficient cash reserves and liquidity facilities are maintained to finance business operations for at least 12 months, the aggregate nominal value of debt maturities does not exceed 40% of RCV in any single regulatory period (and 20% of RCV in any 24 month period). Exposure to interest rate rises on current borrowings is also hedged by a subsidiary company, Southern Water Services (Finance) Limited, and accordingly current borrowings are at either fixed rates or index-linked.

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**

Both revenues and capital values are linked to RPI, and deflation during 2009 has raised the risk of a sustained period of negative inflation shrinking inflation linked cash flows and reducing the Regulatory Capital Value. This would result in a strain on the debt/RCV ratio included in our debt covenants.

This risk is managed by the inclusion of index-linked debt and derivatives within the borrowing portfolio of Southern Water, which has the result of moving the value on index-linked debt and derivatives in line with movements in inflation, albeit with a time lag.

**Capital Investment Risk**

Over the next regulatory period, AMP5, a capital investment programme of £1.7bn has been allowed for in price limits by Ofwat. 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.

The largest single element of the capital programme is the provision of a new wastewater treatment works to serve Brighton & Hove, which represents more than 10% of the value of the programme. Good progress has been made with the scheme which began at the end of AMP4 after the resolution of significant planning delays.

We continue to closely monitor progress against the allowed investment programme to ensure that any risks or programme slippage are pro-actively managed with our regulators.

## **OPERATING AND FINANCIAL REVIEW (continued)**

### **H. CORPORATE RESPONSIBILITY**

#### **Environmental Governance**

In 2008 Southern Water was registered to ISO14001, the international standard for environmental management, across an operational scope. Southern Water's management is committed to the development and execution of its environmental management system requirements.

The aims of Southern Water's Environmental Management System (EMS) are

- To identify, manage and mitigate our impacts on the environment to ensure that present and future environmental effects are controlled and that the Company's environmental performance continually improves, and
- To ensure compliance with environmental legislation, to identify and minimise environmental risk and to maximise efficiency savings

The scope of Southern Water's ISO14001 certification covers "the supply of water and treatment of wastewater, including management of capital projects by project teams and supply chain arrangements, control of operational and maintenance activities on our assets, control of waste and its transfer on specific sites, landfill facilities"

Southern Water's full commitment to the environment is presented within the Environment Policy, signed by the Chief Executive Officer. This is communicated to all employees and relevant contractors.

We have examined the Company's operational activities to determine the significance each has as a potential impact on the environment and combined this with environmental legislation and regulations that apply. Relative significance of the various aspects and compliance requirements both influence environmental improvement and action plans through development of objectives and targets reviewed on a regular basis. This effectively maintains the performance commitments in our Environment Policy, supported through a programme of training, checking, audit and management review.

#### **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 2009-2010, a range of Health and Safety initiatives have been run by the Company and many of our main contractors under the award winning corporate 'Aim for Zero Injuries' brand.

We were awarded the Royal Society for the Prevention of Accidents (RoSPA) President's Award for the second year running 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. As we are working increasingly closely, this year our key contractors took an enhanced role in the organisation and presentation of the conferences.

We also actively supported campaigns held by the UK Health and Safety Executive (HSE) and the European Agency for Safety and Health at work, and are members of the HSE's stakeholder group developing new ways of working as part of their national safety strategy.

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

**OPERATING AND FINANCIAL REVIEW (continued)**

**H. CORPORATE RESPONSIBILITY (continued)**

**Community Programme**

Our commitment to support the communities we serve, protect the environment and raise awareness of the importance of drinking water and using it wisely was demonstrated through a series of programmes, sponsorships and donations across our region

Our long-standing Learn to swim scheme for children aged four to 12 expanded to include new pools and clubs, bringing the total number taking part to 77. They include a new 50 metre pool in Portsmouth which, in addition to teaching about 1,000 children a year, will also be used as a training pool for 2012 Olympic hopefuls. As well as giving thousands of children the opportunity to learn to swim every year, the scheme continued to provide training aids, an instructors' seminar and recognise the achievements of exceptional youngsters at two awards ceremonies.

We continued our sponsorship of the South and South East in Bloom competition, which attracted 207 entries, including 77 in the schools section. The winners were presented with trophies by BBC Blue Peter gardener Chris Collins at an awards ceremony attended by more than 400 guests. We also developed our Blooming Schools programme, which has now seen more than 47,000 children create 316 gardens in their schools.

Now in its 11<sup>th</sup> year, our popular water efficiency play featuring a family called the Drips was seen by more than 4,000 children aged five to 11 across our region. Facepack Theatre visited 22 schools and gave 26 performances of the new-look show, which incorporated our water efficiency and water for health characters Mr Save-It and Mr Drink-It.

Mr Save-It and Mr Drink-It made other visits to schools and we continued our partnership with Worthing Thunder basketball team at 32 schools across Sussex to promote healthy lifestyle choices and the importance of water for health.

For a third year, we sponsored the Brighton Festival Children's Parade, which was led by members of our staff. More than 4,000 children from 70 local schools took part and each received a water bottle which could be refilled at our water station at the end of the parade. Alongside the festival, we again supported the Festival Fringe by sponsoring Fringe City, a free outdoor event for the community over four weekends in May.

We supported the Brighton Theatre Royal's Christmas creative education programme and 90 children attended workshops based around health and vitality. The workshops used the adventure theme of the theatre's Christmas show, Peter Pan, to encourage the children to be active and to look after themselves. The youngsters were then invited to a matinee performance of the show.

More than £300,000 was raised through charity events during the year. These included our annual ball, which raised £72,000 for the National Society for the Prevention of Cruelty to Children, the Royal National Lifeboat Institution and WaterAid. The same three charities also benefited from £70,000 raised at our annual race day, along with Cancer Research UK, AAIR (Asthma, Allergy and Inflammation Research), Chestnut Tree House Children's Hospice and the Sussex Community Foundation.

Our 10<sup>th</sup> anniversary WaterAid golf day raised a record £11,000 for the charity, which provides water, sanitation and hygiene education to some of the world's poorest people, while our Health and Safety Charity Challenge, in which we make a donation for each hazard or near miss reported in the workplace, raised £12,000 for regional Air Ambulance trusts.

In addition, monthly Dress Down Days at our main offices raised £9,365 for 39 charities and our Community Chest forum made 112 donations, totalling £14,825, to schools or community groups.

Our Community Volunteering Programme gives staffs the opportunity to spend two days a year helping a charity or community project and 170 days were taken during the year – a 300 per cent increase on the previous year.

**OPERATING AND FINANCIAL REVIEW (continued)**

**H. CORPORATE RESPONSIBILITY (continued)**

**Community Programme (continued)**

**Awards and Achievements**

Our work was recognised with a number of awards during 2009-10

- 1 We won three accolades at the Water Industry Achievement Awards, including a special award sponsored by industry regulator Ofwat. The awards were People Initiative of the Year for our apprenticeship scheme, designed to increase staff recruitment and retention, Health and Safety Initiative of the Year for reducing the number of accidents in the workplace through our Aim for Zero Injuries campaign and Outstanding Innovation 2009 (sponsored by Ofwat), further recognising our apprenticeship scheme.
- 2 Our health and safety performance was recognised with a Royal Society for the Prevention of Accidents (RoSPA) President's Award, presented to companies demonstrating outstanding performance in health and safety at work by receiving 10 consecutive RoSPA Gold Awards
- 3 We won a Chartered Institute of Public Relations (CIPR) President's Grand Prix for Outstanding Internal Communications for our campaign to introduce staff to a new computer system. The campaign was also successful in the CIPR PRide Awards for the Home Counties South region, in which our Communications department was named Outstanding In-House Public Relations Team for the third year running. We also won a silver award in the Best Event category for our Learn to Swim Achiever Awards
- 4 We received the Training Award in the Sussex Business Awards for the breadth and depth of our staff training and development schemes
- 5 A £12.3 million upgrade at our Fullerton Wastewater Treatment Works in Hampshire was recognised as best Major Project in the Institution of Civil Engineers South Branch Construction Awards
- 6 We won a silver award in the Kent and Medway Highway Authorities and Utilities Committee Considerate Contractor Scheme
- 7 Our Blooming Schools initiative, which encourages children to improve their school environment as part of our sponsorship of the South and South East in Bloom competition, was named Best Low Budget Sponsorship (under £50,000) in the UK in the Hollis Sponsorship Awards
- 8 We received the internationally-recognised ISO 9001 accreditation for meeting tough targets for our customer service
- 9 The way in which we have improved our business processes to make life easier for our customers was recognised with a UK ARIS Business Process Excellence Award
- 10 Our Aim for Zero Injuries campaign was highly commended in the internal communications category of the Fresh PR Awards. Our Learn to Swim scheme was also highly commended for community relations

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2010**

The directors of Southern Water Services Limited (Registered no 02366670) present their report and the audited financial statements for the year ended 31 March 2010

**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 20, which are incorporated in this report by reference.

**RESULTS AND DIVIDENDS**

The profit and loss account on page 25 shows the Company's results, dividends and profit for the year. Further details are also available in the OFR on pages 6 to 7.

In the prior year a final dividend of £378.57 per ordinary share (£21.2m in total) relating to the year ended 31 March 2008 was paid. No final dividend for 31 March 2009 was declared.

Interim dividends of £731.13 per ordinary share (2008-09 £1,766.18 per share), totalling £40.9m (2008-09 £98.9m) were also paid during the year, resulting in total dividends paid and charged in the current financial year of £40.9m (2008-09 £120.1m). The final dividend for the year ended 31 March 2010 of £625.00 per ordinary share (£35.0m in total) was declared on 28 April 2010.

**DIRECTORS AND THEIR INTERESTS**

The directors who held office during the year ended 31 March 2010 and up to the date of signing the financial statements were as follows:

Michael Welton	(Chairman)
Leslie Dawson	(Executive Director) ( <i>Resigned 25 May 2010</i> )
Howard Goodbourn	(Executive Director)
Robert Armstrong	(Independent Non-Executive Director)
Cheryl Black	(Independent Non-Executive Director)
David Golden	(Independent Non-Executive Director)
Steven Marshall	(Independent Non-Executive Director) ( <i>Resigned 31 January 2010</i> )
Paul Moy	(Non-Executive Director) ( <i>Appointed 22 February 2010</i> )
Phillip Peters	(Non-Executive Director) ( <i>Resigned 12 January 2010</i> )
Surinder Toor	(Alternate Non-Executive Director) ( <i>Resigned 13 January 2010</i> )
Surinder Toor	(Non-Executive Director) ( <i>Appointed 13 January 2010</i> )
Mark Walters	(Alternate Non-Executive Director) ( <i>Appointed 13 January 2010</i> )
Jaron Yuen	(Non-Executive Director) ( <i>Appointed 22 February 2010</i> )
Jason Zibarras	(Non-Executive Director) ( <i>Resigned 31 January 2010</i> )

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

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

**RESEARCH AND DEVELOPMENT**

The improvement of existing services and processes, together with the identification and development of new technology and solutions, are important aspects of the Company's strategy to enhance the quality of service to customers and improve methods of working. Research and development expenditure for the year amounted to £2.5m including £2.0m on fixed assets (2009 £1.1m, £nil on fixed assets).

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2010 (continued)**

**FINANCIAL RISK MANAGEMENT**

The Financial Risk Management policy is included in the OFR on pages 1 to 20

**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. The information in these publications and briefings covers a wide range of subjects that affect the business including, progress on business and capital projects, the impact of regulatory issues, including the recent Ofwat price determination and wider financial and economic issues that may affect the Company.

***Equal opportunity***

The Company's policy is to promote equality of opportunity in recruitment, employment continuity, training and career development. The Company takes full account of the needs of people with disabilities and follows set policies and procedures to support reasonable adjustments in the workplace.

***Health and safety***

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

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

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

**CREDITOR PAYMENT POLICY AND PRACTICE**

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

The Company's policy and practice is to agree terms of payment when agreeing the terms of the transaction, to include the terms in contracts and to pay in accordance with its contractual and legal obligations. The Company's trade creditor days at 31 March 2010 were 45 days (2009: 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 2010 (continued)**

**CHARITABLE DONATIONS**

The Company made donations of £1,016,775 (2009 £1,028,599) to a variety of charities over the year. Donations in the year comprised £1,000,000 (2009 £1,000,000) 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 £16,775 (2009 £28,599) 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**

The final dividend for the year ended 31 March 2010 of £625.00 per ordinary share (£35.0m in total) was declared on 28 April 2010 (2009 £nil) and paid on 24 May 2010.

**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 2010. Further information is set out in note 1 'Basis of accounting' on page 29.

**QUALIFYING THIRD PARTY INDEMNITY**

Following shareholder approval the company has also provided an indemnity for its directors and the secretary, which is a qualifying third party indemnity provision for the purposes of the Companies Act 2006.

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2010 (continued)**

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

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

Company law requires the directors to prepare financial statements for each financial year. Under that law 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). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the 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.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and 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 2006. 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.

**STATEMENT OF DISCLOSURE 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) he/she 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 Section 418 of the Companies Act 2006.

**INDEPENDENT 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  
Company Secretary  
10 June 2010

## SOUTHERN WATER SERVICES LIMITED

**PROFIT AND LOSS ACCOUNT**

For the year ended 31 March 2010

	Notes	2010 £m	2009 £m
<b>Turnover</b>	1,2,3	<b>679.1</b>	677.8
Cost of sales	3	(348.1)	(337.1)
Gross profit		<u>331.0</u>	<u>340.7</u>
Administrative expenses	3	(27.3)	(26.8)
Other operating income	3	<u>0.2</u>	<u>0.3</u>
<b>Operating profit</b>		<b>303.9</b>	314.2
Profit on disposal of fixed assets		1.4	7.6
<b>Profit on ordinary activities before interest and taxation</b>		<b>305.3</b>	321.8
Interest payable and similar charges	7	(177.0)	(240.1)
Interest receivable and similar income	7	61.8	67.7
<b>Profit on ordinary activities before taxation</b>	4	<u>190.1</u>	<u>149.4</u>
Tax on profit on ordinary activities	8	(60.8)	(52.0)
<b>Profit on ordinary activities after taxation</b>	20	<u>129.3</u>	<u>97.4</u>
Dividends	9,20	(40.9)	(120.1)
<b>Profit/(loss) for the financial year</b>		<u><b>88.4</b></u>	<u>(22.7)</u>

The above results relate to continuing operations

The Notes on pages 29 to 51 form part of these financial statements

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

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**

For the year ended 31 March 2010

	Notes	2010 £m	2009 £m
<b>Profit on ordinary activities after taxation</b>		<b>129.3</b>	97.4
Actuarial loss recognised in the pension scheme	20,22	(54.3)	(38.5)
Movement on deferred tax relating to pension deficit	17	10.5	10.8
Movement on current tax relating to pension deficit	17	4.7	-
<b>Total recognised gains for the year</b>		<b>90.2</b>	<b>69.7</b>

SOUTHERN WATER SERVICES LIMITED

**BALANCE SHEET**

As at 31 March 2010

	Notes	2010 £m	2009 £m
<b>Fixed assets</b>			
Tangible assets	10	3,666.6	3,616.6
Investments	11	<u>29.2</u>	<u>29.2</u>
		<b>3,695.8</b>	<b>3,645.8</b>
<b>Current assets</b>			
Stocks	12	1.2	1.6
Debtors amounts falling due within one year	13	234.5	212.6
Debtors amounts falling due after one year	14	812.3	820.3
Cash at bank and in hand		<u>288.7</u>	<u>360.4</u>
		<b>1,336.7</b>	<b>1,394.9</b>
<b>Creditors: amounts falling due within one year</b>	15	<u>(194.4)</u>	<u>(311.2)</u>
<b>Net current assets</b>		<b>1,142.3</b>	<b>1,083.7</b>
<b>Total assets less current liabilities</b>		<u><b>4,838.1</b></u>	<u><b>4,729.5</b></u>
<b>Creditors amounts falling due after more than one year</b>	16	<b>(3,460.0)</b>	<b>(3,393.2)</b>
<b>Provision for liabilities and charges</b>			
Environmental obligations	17	(0.3)	(0.4)
Deferred taxation	17	(451.5)	(440.1)
<b>Grants and contributions</b>	18	<b>(50.1)</b>	<b>(51.5)</b>
<b>Net assets excluding pension deficit</b>		<u><b>876.2</b></u>	<u><b>844.3</b></u>
<b>Pension deficit</b>	22	<b>(65.9)</b>	<b>(83.3)</b>
<b>Net assets including pension deficit</b>		<u><b>810.3</b></u>	<u><b>761.0</b></u>
<b>Capital and reserves</b>			
Called up share capital	19	0.1	0.1
Share premium	20	46.3	46.3
Profit and loss account	20	763.9	714.6
<b>Total shareholders' funds</b>		<u><b>810.3</b></u>	<u><b>761.0</b></u>

The financial statements on pages 25 to 51 were approved by the Board and authorised for issue on 10 June 2010 and signed on its behalf by



Howard Goodbourn  
Finance Director

SOUTHERN WATER SERVICES LIMITED

**CASH FLOW STATEMENT**  
for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
<b>Net cash inflow from operating activities</b>	21	389.4	443.3
<b>Returns on investments and servicing of finance</b>			
Interest received		62.7	70.7
Interest paid		(144.8)	(163.8)
Preference share dividends		(14.5)	(13.7)
<b>Net cash outflow from returns on investments and servicing of finance</b>		<u>(96.6)</u>	<u>(106.8)</u>
<b>Taxation</b>		(25.5)	(21.0)
<b>Capital expenditure and financial investment</b>			
Purchase of tangible fixed assets		(226.7)	(330.6)
Receipt of grants and contributions		10.7	9.6
Sale of tangible assets		2.4	8.5
<b>Net cash outflow for capital expenditure and financial investment</b>		<u>(213.6)</u>	<u>(312.5)</u>
<b>Equity dividends paid</b>		(40.9)	(120.1)
<b>Net cash inflow/(outflow) before financing</b>		<u>12.8</u>	<u>(117.1)</u>
<b>Financing</b>			
Increase in borrowings		50.0	298.3
Repayment of loans		(183.3)	(20.0)
Issue costs of new loans		-	(2.1)
Deferred swap receipts		48.8	-
<b>Net cash (outflow)/inflow from financing</b>		<u>(84.5)</u>	<u>276.2</u>
<b>(Decrease)/increase in net cash</b>		<u>(71.7)</u>	<u>159.1</u>
<b>Reconciliation to net debt</b>			
Net debt at beginning of year		(3,189.8)	(3,014.0)
(Decrease)/increase in net cash		(71.7)	159.1
Movements in borrowings		133.3	(278.3)
Debt issue costs		-	2.1
Deferred swap receipts (see note 16)		(48.8)	-
Other non cash changes		(11.8)	(58.7)
<b>Net debt at end of year</b>		<u>(3,188.8)</u>	<u>(3,189.8)</u>

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010**

**1 Accounting policies**

**Basis of accounting**

The financial statements 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 2006

**Basis of preparation**

The financial statements 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 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it and its subsidiary undertaking are included by full consolidation in the consolidated financial statements 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

**Accrued income**

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. Expenditure on fixed assets relating to development projects is written off over the expected useful life of those assets

**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 FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)****1 Accounting policies (continued)****Tangible fixed assets**

Tangible fixed assets are stated at historic purchase cost less accumulated depreciation. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use.

- 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 relate 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 work 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 1 of the Companies Act 2006 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 financial statements 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 FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (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**

Stock is held for use in the production of water supply and treatment of wastewater. Stock is held at replacement cost.

**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.

**Deferred revenue**

Deferred revenue includes monies received from customers where the related turnover has not yet been recognised. Amounts are deferred to the balance sheet and released to the profit and loss account in line with the period of the service provided.

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (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 United Kingdom.

**3 Classification of turnover and revenue costs**

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

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

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 4 Profit on ordinary activities before taxation

Profit on ordinary activities before taxation is stated after charging/(crediting)	2010 £m	2009 £m
Employee costs (note 5a)	36.5	43.9
Depreciation on		
- owned assets	176.5	165.4
- assets held under finance leases	0.4	0.4
	<u>176.9</u>	<u>165.8</u>
Rentals under operating leases		
Other	3.5	3.6
Research and development expenditure	0.5	1.1
Release of grants and contributions (note 18)	(2.6)	(2.6)
Fees receivable by the Company's auditors in respect of		
- Statutory audit of the Company's financial statements	0.1	0.3
- Other services pursuant to legislation	0.1	0.1
- All other services	0.5	0.5

## 5 Employee information

	2010 £m	2009 £m
<b>(a) Employee costs (including directors' emoluments):</b>		
Wages and salaries	46.6	50.6
Social security costs	3.9	4.0
Pension costs	4.7	5.1
Total employee costs	<u>55.2</u>	<u>59.7</u>
Less charged as capital expenditure	<u>(18.7)</u>	<u>(15.8)</u>
Charged to the profit and loss account	<u>36.5</u>	<u>43.9</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

	2010 Number	2009 Number
Operations	945	997
Customer Services	295	254
Corporate Centre	268	267
	<u>1,508</u>	<u>1,518</u>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

**6 Directors' emoluments**

	2010 £000	2009 £000
Aggregate emoluments (including benefits in kind)	1,376	1,410
Aggregate emoluments under the Long Term Incentive Plan	<u>173</u>	<u>285</u>

No retirement benefits accrued to directors (2009 none) under a Southern Water defined benefit scheme  
Retirement benefits accrued to two directors (2009 two) under a Southern Water defined contribution scheme

Details of emoluments and benefits for the highest paid director

	2010 £000	2009 £000
Aggregate highest paid director's emoluments and benefits	731	748
Aggregate highest paid director's emoluments under the Long Term Incentive Plan	<u>144</u>	<u>210</u>

During the year the Company made contributions of £80,000 (2009 £80,000) 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 partial award was made payable to each participant in 2010, and a further award is potentially payable in 2011. The awards are calculated 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 2010 is the final year of the Long Term Incentive Scheme and the amounts disclosed above are the awards attributed to the financial year.

**7 Interest**

	2010 £m	2009 £m
<b>Interest payable and similar charges</b>		
Interest payable on other loans	3.6	0.1
Interest paid to group companies	140.3	164.2
Indexation	13.7	56.5
Amortisation of issue costs	2.7	2.5
Amortisation of gilt lock proceeds	(0.1)	(0.1)
Amortisation of deferred credits	(4.2)	-
Amortisation of bond premium	(0.6)	(0.6)
Amortisation of discount	0.3	0.4
Other finance expense (note 22)	6.8	3.4
Dividends on preference shares- see note below	14.5	13.7
<b>Total interest payable and similar charges</b>	<u>177.0</u>	<u>240.1</u>
<b>Interest receivable</b>		
Interest receivable from Southern Water Services Group Limited	56.9	56.9
Other interest receivable	4.9	10.8
<b>Total interest receivable</b>	<u>61.8</u>	<u>67.7</u>

The preference share dividends were paid on 7 October 09 and 31 March 10 and Class A1 amounted to £40 per share and Class B £70 per share (totalling £13.7m (2009 £13.7m)). A dividend of £0.8m (2009 £nil) was declared and paid to the Class A2 preference shareholders in September 2009 for outperformance in the year ending 31 March 2009.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 8 Tax on profit on ordinary activities

	2010 £m	2009 £m
<b>Current tax:</b>		
UK corporation tax on profits for the year	49.4	17.2
Adjustment in respect of prior years	-	(1.3)
	<u>49.4</u>	<u>15.9</u>
<b>Deferred tax:</b>		
Origination and reversal of timing differences	12.0	29.7
Adjustment in respect of prior years	(0.6)	5.3
Pension cost relief in excess of pension cost charge	-	1.1
Total deferred tax	<u>11.4</u>	<u>36.1</u>
Total tax on profit on ordinary activities	<u><u>60.8</u></u>	<u><u>52.0</u></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

	2010 £m	2009 £m
<b>Profit on ordinary activities before tax</b>	<u>190.1</u>	<u>149.4</u>
<b>Current tax:</b>		
UK corporation tax on profits for the year at 28% (2009 28%)	53.2	41.8
Adjustments in respect of prior years	-	(1.3)
Permanent differences	8.2	6.2
<b>Tax charge on ordinary activities</b>	<u>61.4</u>	<u>46.7</u>
Timing differences	(12.0)	(30.8)
<b>Current tax charge for year</b>	<u><u>49.4</u></u>	<u><u>15.9</u></u>

## 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

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 9 Dividends per share

	2010 £ per ordinary share	2009 £ per ordinary share	2010 £m	2009 £m
<b>Ordinary shares</b>				
Interim dividend – 30 Sept	365.57	355.40	20.5	19.8
Interim dividend – 28 Nov	-	1,055.36	-	59.1
Interim dividend – 31 Dec	182.78	177.71	10.2	10.0
Interim dividend – 31 Mar	182.78	177.71	10.2	10.0
Total interim dividend	<u>731.13</u>	<u>1,766.18</u>	<u>40.9</u>	<u>98.9</u>
Final dividend – prior year	-	378.57	-	21.2
<b>Total ordinary dividend</b>	<u><b>731.13</b></u>	<u><b>2,144.75</b></u>	<u><b>40.9</b></u>	<u><b>120.1</b></u>

The final dividend paid in 2009 related to the year ended 31 March 2008

A final dividend for the year ended 31 March 2010 of £625.00 per ordinary share (£35.0m in total) was declared on 28 April 2010 (2009: £nil) and paid on 24 May 2010

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 10 Tangible fixed assets and capital commitments

## (a) Tangible assets

	Freehold land & buildings £m	Plant & Machinery £m	Infra- structure assets £m	Assets in the course of construction £m	Other £m	Total £m
<b>Cost:</b>						
At 1 April 2009	1,324.6	1,583.5	1,703.1	142.1	430.7	5,184.0
Transfer to						
Grants/Contributions LTC*	1.9	1.8	-	-	0.3	4.0
Additions	(7.4)	18.9	37.5	173.1	12.0	234.1
Transfers	3.1	4.8	1.8	(31.2)	21.5	-
Grants & contributions	-	-	(8.1)	-	-	(8.1)
Disposals	0.1	(0.6)	(3.5)	-	0.4	(3.6)
<b>At 31 March 2010</b>	<b>1,322.3</b>	<b>1,608.4</b>	<b>1,730.8</b>	<b>284.0</b>	<b>464.9</b>	<b>5,410.4</b>
<b>Accumulated depreciation:</b>						
At 1 April 2009	340.7	484.4	471.3	-	271.0	1,567.4
Transfer to						
Grants/Contributions LTC*	1.1	1.8	-	-	-	2.9
Charge for the year	39.7	56.7	49.7	-	30.8	176.9
Disposals	0.1	(0.4)	(3.5)	-	0.4	(3.4)
<b>At 31 March 2010</b>	<b>381.6</b>	<b>542.5</b>	<b>517.5</b>	<b>-</b>	<b>302.2</b>	<b>1,743.8</b>
<b>Net book amount:</b>						
<b>At 31 March 2010</b>	<b>940.7</b>	<b>1,065.9</b>	<b>1,213.3</b>	<b>284.0</b>	<b>162.7</b>	<b>3,666.6</b>
At 31 March 2009	983.9	1,099.1	1,231.8	142.1	159.7	3,616.6

\* LTC = Long term creditor

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals during the years ended 31 March 2010 and 31 March 2009 was £35.4m and £46.0m, respectively. Of the grants and contributions set against infrastructure assets during the years ended 31 March 2010 and 31 March 2009, £2.8m and £2.8m respectively relates to infrastructure renewals.

For the years ended 31 March 2010 and 31 March 2009, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £176.8m and £168.7m, respectively.

Freehold land is stated at a cost of £46.5m and £47.7m at 31 March 2010 and 31 March 2009, 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.

	2010 £m	2009 £m
Cost	11.7	11.7
Aggregate depreciation	(9.8)	(9.4)
Net book amount	<u>1.9</u>	<u>2.3</u>

Outstanding payments and interest associated with this lease are negligible.

	2010 £m	2009 £m
(b) Capital commitments		
In respect of contracts placed	<u>600.1</u>	<u>402.0</u>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

**11 Fixed asset investments**

	2010 £m	2009 £m
<b>Shares in group undertakings</b>		
At 1 April and 31 March	<u>29.2</u>	<u>29.2</u>

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

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

**12 Stocks**

	2010 £m	2009 £m
Raw materials	0.9	1.1
Work in progress	0.3	0.5
	<u>1.2</u>	<u>1.6</u>

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

	2010 £m	2009 £m
Trade debtors	109.3	107.3
Amounts owed by group undertakings	17.4	0.6
Other debtors	7.9	8.2
Accrued income	82.1	87.4
Prepayments	17.8	9.1
	<u>234.5</u>	<u>212.6</u>

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

**14 Debtors: amounts falling due after more than one year**

	2010 £m	2009 £m
Other debtors	-	8.0
Loans owed by group undertakings	<u>812.3</u>	<u>812.3</u>
	<u>812.3</u>	<u>820.3</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 FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 15 Creditors: amounts falling due within one year

	2010 £m	2009 £m
Loans and other borrowings (see note (i) below)	-	146 0
Trade creditors	34.3	18 2
Loans from group undertakings (see note (ii) below)	30.3	30 3
Amounts owed to group undertakings	26.7	6 4
Capital creditors and capital accruals	53.4	51 4
Taxation and social security	2.0	1 3
Debt issue costs (note 16)	(2.7)	(2 7)
Accruals and deferred revenue	43.7	59 9
Bond premium deferred	0.3	0 3
Deferred gilt lock proceeds (note 16)	0.1	0 1
Deferred swap receipts (note 16)	6.3	-
	<u>194.4</u>	<u>311 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
- (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

	2010 £m	2009 £m
Loans and other borrowings		
Loan from Southern Water Services (Finance) Limited	3,130.9	3,154 5
Other borrowings	50.0	-
Class A1 Preference shares (see note (v) below)	150.0	150 0
Class B Preference shares (see note (v) below)	110.0	110 0
Debt issue costs (see note (vi) below)	(47.1)	(49 8)
Bond premium deferred	5.4	5 6
Deferred gilt lock proceeds (see note (vii) below)	5.8	5 9
Deferred swap receipts (see note (ii) below)	38.3	-
Total Loans and other borrowings	<u>3,443.3</u>	<u>3,376 2</u>
Deferred revenue (see note (viii) below)	16.7	17 0
<b>Total Creditors falling due after more than one year</b>	<u><b>3,460.0</b></u>	<u><b>3,393 2</b></u>
	2010 £m	2009 £m
<b>Repayments fall due as follows:</b>		
Between two and five years	50.0	-
After five years not by instalments	3,376.5	3,414 5
	<u><b>3,426 5</b></u>	<u><b>3,414 5</b></u>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

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

In the year to 31 March 2010, Southern Water Services (Finance) Limited ("SWSF") did not raise or advance to SWS any further additional debt (2009 £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 -

	2010	2009
	£m	£m
<b>Loans</b>		
Class A £350m 6.202% fixed rate 2029	350.0	350.0
Class A £150m 3.716% index linked 2034	179.7	182.2
Class A £35m 3.716% index linked 2034	42.5	42.5
Class A £350m 6.650% fixed rate 2026	350.0	350.0
Class A £150m 3.826% index linked 2023	179.7	182.2
Class A £350m 5.010% fixed rate 2021	350.0	350.0
Class A £150m 5.010% fixed rate 2041	150.0	150.0
Class A £200m 4.510% fixed rate 2052	200.0	200.0
Class A £300m 5.135% fixed rate 2056	300.0	300.0
Class A £300m 6.135% fixed rate 2019	300.0	300.0
Artesian £165m 4.086% index linked 2033	197.6	200.5
Artesian £156.5m 3.645% index linked 2032	182.9	185.6
	<u>2,782.4</u>	<u>2,793.0</u>
Fixed swapped to Index-linked – (note (i) below)	(877.0)	(600.0)
Index-linked swaps – (note (i) below)	945.7	644.3
Total Class A Debt	<u>2,851.1</u>	<u>2,837.3</u>
Class B £250m 7.879% fixed rate 2038 (note (iii) below)	250.0	250.0
Senior mezzanine £127.2m 11.97% fixed rate 2038 (note (iv) below)	15.4	67.2
Intercompany creditor	14.4	-
Total loans from Southern Water Services (Finance) Limited	<u>3,130.9</u>	<u>3,154.5</u>
Capex facility £50m 6m LIBOR plus 3%	50.0	-
Class A1 Preference shares (note (v) below)	150.0	150.0
Class B Preference shares (note (v) below)	110.0	110.0
Debt issue costs (note (vi) below)	(47.1)	(49.8)
Bond premium deferred	5.4	5.6
Deferred gilt lock proceeds (note (vii) below)	5.8	5.9
Deferred swap receipts (see note (ii) below)	38.3	-
	<u>3,443.3</u>	<u>3,376.2</u>

These loans (excluding the preference shares) 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.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

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

In respect of the specific instruments above

- (i) In the year ended 31 March 2010, SWSF entered into various swap agreements converting a total of £227.0m of Class A debt from the original fixed interest rate to a real interest rate linked to RPI (Retail Price Index) plus capitalised inflation on the nominal value of the underlying Class A debt

The table below analyses the total value of swaps entered into by SWSF as at 31 March 2010

Nominal value of debt	Fixed interest rate	Index Linked interest rate	Nominal value of debt plus capitalised RPI
£50.0m	6.202%	3.200%	£51.2m
£177.0m (see note ii)	5.010%	2.161%	£185.5m
£150.0m	5.010%	1.145%	£173.0m
£200.0m	4.510%	0.570%	£225.4m
£300.0m	5.135%	1.510%	£310.6m
<u>£877.0m</u>			<u>£945.7m</u>

- (ii) The interest rates on the swaps entered into during the year were above the market rate at the time of entering into these transactions

The consideration for taking on these swaps was offset by the holders of these swaps against a similar liability with a parent company, Greensands Investments Ltd ("GSI"). The directors of GSI agreed to waive an amount equivalent to the negative value of the swaps against the Senior Mezzanine loan to SWC, who has in turn passed this waiver amount down to SWSF and SWS.

The value of the negative swaps and subsequent waiver amounts was £51.8m

In SWS, an amount of £48.8m has been capitalised on the balance sheet as a deferred swap receipt credit and is being amortised to the profit and loss account over the life of the related swap instruments. A further £3.0m was paid on behalf of SWSF by GSI as part of re-assigning the swaps and is shown as an intercompany creditor in the balance sheet of SWS.

Also during the year, one of the external swap agreements changed counterparties. As a result of this, SWSF received a payment equal to the premium on the new agreement of £11.45m and passed this cash on to SWS. This is held on the balance sheet as an intercompany creditor.

- (iii) The interest rate on the Class B £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.

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)**

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

- (v) The preference shares issued have been classified as loans in the financial statements as required by FRS 25. All shares are redeemable at the option of SWS at any time.

The Class A1 and B preference shares, which do not carry voting rights, were issued on the 23 July 2003, and are redeemable at their nominal value plus the share premium paid, on 31 March 2038 or at the Company's option anytime earlier. Class A1 and B shares were issued at £1,000 per share and the amounts received totalled £260.0m for both classes of shares. Class A2 preference shares were issued for £0.01 per share on the 7 May 2003 and the amount received totalled £1.500. Class A2 shares, 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 2010 for outperformance in the year ending March 2010.

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

- (vi) 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 2010 debt issue costs amounted to £49.8m of which £2.7m represents the short-term amount which is disclosed separately in note 15.
- (vii) 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.
- (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 FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 17 Provision for liabilities

(a) Environmental obligations	2010 £m	2009 £m
At 1 April	0.4	0.9
Utilised in year	(0.1)	(0.5)
At 31 March	<u>0.3</u>	<u>0.4</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	2010 £m	2009 £m
Accelerated capital allowances	472.1	460.7
Other timing differences	(20.7)	(20.6)
<b>Deferred taxation</b>	<u>451.4</u>	<u>440.1</u>

Movement in deferred tax provision	2010 £m	2009 £m
Deferred tax provided at 1 April	440.1	405.1
Prior year adjustment	(0.6)	5.3
Deferred tax charge in Profit and Loss Account		
- Other timing differences	12.0	29.7
<b>Deferred tax provided at 31 March</b>	<u>451.5</u>	<u>440.1</u>

Deferred tax asset relating to pension deficit	2010 £m	2009 £m
<b>At 1 April</b>	<b>32.4</b>	<b>22.7</b>
Deferred tax charge in profit and loss account	-	(1.1)
Deferred tax charged to the statement total recognised gains and losses	10.5	10.8
<b>At 31 March</b>	<u><b>42.9</b></u>	<u><b>32.4</b></u>

The deferred tax asset of £42.9m (2009 £32.4m) 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 2009	51.5
Transfer from fixed assets	1.1
Receivable in year	0.1
Released to profit and loss account	(2.6)
<b>At 31 March 2010</b>	<u><b>50.1</b></u>

These grants and contributions relate to non-infrastructure assets.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)**

**19 Called up share capital**

	2010 £m	2009 £m
<b>Equity shares</b>		
Authorised		
46,050,000 ordinary shares of £1 each	<u>46.1</u>	<u>46.1</u>
Allotted and fully paid		
56,000 ordinary shares of £1 each	<u>0.1</u>	<u>0.1</u>
Non-equity shares		
Authorised and issued		
<b>Preference shares</b>		
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 2009	0.1	46.3	714.6	761.0
Profit after tax	-	-	129.3	129.3
Dividends paid	-	-	(40.9)	(40.9)
Actuarial loss on pension scheme	-	-	(54.3)	(54.3)
Movement on deferred tax relating to pension asset	-	-	10.5	10.5
Movement on current tax relating to pension asset	-	-	4.7	4.7
<b>At 31 March 2010</b>	<u>0.1</u>	<u>46.3</u>	<u>763.9</u>	<u>810.3</u>

The profit and loss reserve includes recognised losses of £108.8m (2009: £115.7m) less deferred taxation of £42.9m (2009: £32.4m) 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 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
<b>At 31 March 2009</b>	<u>0.1</u>	<u>46.3</u>	<u>714.6</u>	<u>761.0</u>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 21 (a) Cash flow from operating activities

	2010 £m	2009 £m
<b>Continuing operations</b>		
Operating profit	303.9	314.2
Depreciation charge	176.9	165.8
Difference between pension charge and cash contributions (see note (i) below)	(68.0)	(7.2)
Amortisation of grants and contributions	(2.6)	(2.6)
Decrease in environmental provision	(0.1)	(0.5)
Increase/(decrease) in deferred revenue due after one year	0.1	(0.3)
Decrease in stocks	0.4	0.6
Increase in debtors	(24.5)	(8.6)
Increase/(decrease) in creditors	3.3	(18.1)
<b>Total net cash inflow from operating activities</b>	<b>389.4</b>	<b>443.3</b>

- (i) On 31 March 2010, the Company made an exceptional one off lump sum payment of £56.1m into the Southern Water Pension Scheme (SWPS)

## 21 (b) Analysis of net debt

	At 31 March 2009 £m	Cash Flow £m	Other non- cash changes £m	At 31 March 2010 £m
Cash deposits	360.4	(71.7)	-	288.7
Cash and cash equivalents	360.4	(71.7)	-	288.7
Debt issue costs	52.5	-	(2.7)	49.8
Gilt lock proceeds (see note 16)	(6.0)	-	0.1	(5.9)
Deferred swap receipts (see note 16)	-	(48.8)	4.2	(44.6)
Loans due within one year	(176.3)	146.0	-	(30.3)
Loans due after one year	(3,420.4)	(12.7)	(13.4)	(3,446.5)
	<b>(3,189.8)</b>	<b>12.8</b>	<b>(11.8)</b>	<b>(3,188.8)</b>

The non-cash movement of £11.8m relates to an increase in debt as a result of indexation plus the amortisation of loan issue costs, gilt lock proceeds and deferred swap credits

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

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (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 £66.0m (2009 deficit £83.3m). 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.

On 31 March 2010, the Company made an exceptional one off lump sum payment of £56.1m into the Southern Water Pension Scheme (SWPS).

**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. Legal and General and Blackrock are unit registrars for Southern Water Pension Scheme unit holdings, and appoint custodians at individual Pooled Fund level (not Client holding level).

- 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 2010 amounted to £0.4m (2009 £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 valuation of the combined scheme as at 31 March 2010 is currently in progress. 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 2010/11 are £7.4m and £0.3m respectively.

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

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

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 FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (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 2010 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.

	2010 % pa	2009 % pa	2008 % pa
Price inflation	3.8	3.2	3.7
Rate of increase in salaries (plus an age-related promotional scale)	4.3	4.5	5.0
Rate of increase of pensions in payment	3.8	3.2	3.7
Rate of increase for deferred pensions	3.8	3.2	3.7
Discount rate	5.7	6.9	6.6
Expected return on assets	7.2	7.2	7.1

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. In 2010, the Company has used the post-retirement mortality assumptions comprising the '92' series based medium cohort mortality tables modified for appropriate assumptions.

	2010 years	2009 years
Longevity at age 65 for current pensioners		
Male	21.7	21.6
Female	24.7	24.6
Longevity at age 65 for future pensioners		
Male	23.2	23.1
Female	26.1	26.1

The assets and liabilities in the schemes and the expected rates of return at 31 March 2010 and 31 March 2009 were:

	Rate of return 2010 %	Rate of return 2009 %	Value at 2010 £m	Value at 2009 £m
Equities	8.4%	8.4%	280.1	190.6
Government bonds	4.6%	4.2%	60.9	62.2
Non-Government bonds	5.7%	6.9%	76.5	57.6
Cash	4.7%	4.0%	62.7	8.4
Total market value of Plan assets			480.2	318.8
Total value of Plan liabilities			(589.0)	(434.5)
Accrued deficit in the Plan			(108.8)	(115.7)
Related deferred tax asset			30.5	32.4
Deferred tax on current year pension contribution			12.4	-
Net pension liability			(65.9)	(83.3)

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.

The pension deficit includes a deferred tax asset of £12.4m in relation to the increased pension contribution made by the company during the year (see note 21(a)(i)).

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 22 Pensions (continued)

## Reconciliation of the present value of the scheme liabilities

	2010 £m	2009 £m
Scheme liabilities at start of year	434.5	479.4
Current service cost	4.7	5.0
Interest cost	29.5	31.2
Member contributions	1.5	2.5
Actuarial gain on liabilities	137.9	(65.7)
Actual benefit payments	(18.0)	(17.9)
Administrative expenses paid	(0.7)	-
Curtailments	(0.4)	-
Scheme liabilities at end of year	<u>589.0</u>	<u>434.5</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%	+/- 8
Mortality	+/- 1 yr	+/- 3

\*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

	2010 £m	2009 £m
At 1 April	318.8	398.4
Expected return on assets	22.7	27.8
Gain/(loss) on assets	83.6	(104.2)
Company contributions	72.3	12.2
Member contributions	1.5	2.5
Benefit payments	(18.0)	(17.9)
Administrative expenses paid	(0.7)	-
Bid value of scheme assets at 31 March	<u>480.2</u>	<u>318.8</u>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 22 Pensions (continued)

Analysis of amounts charged to operating profit are as follows:

	2010 £m	2009 £m
Employer's current service cost	4.7	5.0
Employer's past service cost	-	-
Expected return on pension scheme assets	(22.7)	(27.8)
Interest on pension scheme liabilities	29.5	31.2
Curtailments	(0.4)	-
<b>Total P&amp;L expense before deduction for tax</b>	<b>11.1</b>	<b>8.4</b>

Analysis of the amounts recognised in STRGL:

	2010 £m	2009 £m
Actuarial return less expected return on pension scheme assets	83.6	(104.3)
Experience (loss)/gain arising on scheme liabilities	(12.9)	13.1
(Loss)/gain on change of assumptions (financial and demographic)	(125.0)	52.7
<b>Total loss recognised in STRGL before adjustment for tax</b>	<b>(54.3)</b>	<b>(38.5)</b>

The cumulative amount of actuarial losses recognised in the statement of recognised gains and losses is £140.9m (2009 £86.6m)

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

	2010 £m	2009 £m
Deficit in the scheme at 1 April	(115.7)	(81.0)
Employer's contributions	72.3	12.2
Employer's current service cost	(4.7)	(5.0)
Employer's past service cost	-	-
Cost of curtailments	0.4	-
Other finance expense	(6.8)	(3.4)
Actuarial loss	(54.3)	(38.5)
<b>Deficit in the scheme at end of year</b>	<b>(108.8)</b>	<b>(115.7)</b>
Deferred tax relating to scheme deficit	30.5	32.4
Deferred tax on current year pension contribution	12.4	-
<b>Net deficit at end of year</b>	<b>(65.9)</b>	<b>(83.3)</b>

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)

## 22 Pensions (continued)

History of gains and losses for the year to 31 March 2010 are as follows:

	2010	2009	2008	2007	2006
<b>a. Experience adjustment on planned assets</b>					
Amount (£m)	(83.6)	104.3	37.5	3.2	(39.7)
<b>b. Experience adjustment on scheme liabilities</b>					
Amount (£m)	12.9	(13.1)	7.1	(7.1)	(4.6)
<b>c. Total amount recognised in the STRGL</b>					
Fair value of assets at year end (£m)	480.2	318.8	398.4	409.9	387.5
Actuarial value of liabilities at year end (£m)	(589.0)	(434.5)	(479.4)	(513.9)	(525.5)
Deficit in scheme at year end (£m)	(108.8)	(115.7)	(81.0)	(104.0)	(138.0)

The current year and prior year have 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 years prior to 31 March 2009 at bid value.

## 23 Contingent liabilities

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.

The Company had no contingent liabilities for capital claims at the year end (2009: £nil).

## 24 Financial commitments

As at 31 March 2010, 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	
	2010 £m	2009 £m	2010 £m	2009 £m
Expiring within one year	-	-	0.2	0.3
Expiring between two and five years	-	-	0.2	0.8
Expiring after more than five years	1.3	1.3	0.1	0.1
	<u>1.3</u>	<u>1.3</u>	<u>0.5</u>	<u>1.2</u>

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

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2010 (continued)**

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

The immediate parent undertaking is SWS Holdings Limited

The 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 2010 are IIF International SW UK Investments Limited (advised by JP Morgan Investments Inc ) and The Northern Trust Company

Greensands Holdings Limited is the only group company to prepare consolidated financial statements, copies of which may be obtained from the Company Secretary of Greensands Holdings Limited at Southern House, Yeoman Road, Worthing, BN13 3NX

The Company has taken advantage of the exemption under Financial Reporting Standard 8 (revised) in not disclosing details of transactions with other companies which are 100% owned on the basis that the consolidated financial statements in which the Company is included are publicly available

**26 Post Balance Sheet Events**

A final dividend for the year ended 31 March 2010 of £625 00 per ordinary share (£35 0m in total) was declared on 28 April 2010 (2009 £nil) and paid on 24 May 2010

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

We have audited the financial statements of Southern Water Services Limited for the year ended 31 March 2010 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. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

**Respective responsibilities of directors and auditors**

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

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, 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.

**Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements.

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

**Opinion on financial statements**

In our opinion the financial statements

- give a true and fair view of the state of the company's affairs as at 31 March 2010 and of its profit and cash flows for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

**Opinion on other matter prescribed by the Companies Act 2006**

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

**Matters on which we are required to report by exception**

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

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



Graham Lambert (Senior Statutory Auditor)  
For and on behalf of PricewaterhouseCoopers LLP  
Chartered Accountants and Statutory Auditors  
Gatwick  
10 June 2010