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SOUTHERN WATER SERVICES LIMITED

OPERATING AND FINANCIAL REVIEW,

ANNUAL REPORT

AND

FINANCIAL STATEMENTS

FOR THE YEAR ENDED

31 MARCH 2011

OPERATING AND FINANCIAL REVIEW, ANNUAL REPORT AND FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011

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OPERATING AND FINANCIAL REVIEW

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

A. OUR BUSINESS

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

Water services
Southern Water supplies high quality drinking water to more than one million properties across the region, through a network of more than 13,500 kilometres of mains, 94 water treatment works and numerous pumping stations and service reservoirs

The average daily volume supplied in 2010-11 was 576 million litres a day Of the domestic properties served, 41% have a meter and pay by reference to the amount of water supplied 88% of business customers are metered

Wastewater services
Every day we treat 800 million litres of wastewater from 1 8 million domestic and business properties Wastewater is transported through a network of 21,779 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 by-products from these processes are used to produce agricultural fertilisers / soil conditioners and to generate renewable electricity using anaerobic digestion and combined heat and power 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 58,000 (2009-10 102,000) residential searches were sold The large fall is due to the removal of the requirement for Home Information Packs (HIPs) during the year, and the general property market conditions

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

Price limits were last set in 2009 for the period 2010-11 to 2014-15 The allowed increases are shown in Figure 1 below Associated with these price limits are 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 the Retail Prices Index (RPI) plus the 'K' factor

In addition to the K factor, Ofwat has modified Southern Water's licence to allow it to increase charges by an additional 1 4% in 2011-12 This additional adjustment relates to the provision of transitional tariffs to help customers moving to a water meter under the company's Universal Metering Programme, which is described in further detail in section E

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 By July 2010 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 31 inset appointments, 20 of which have been made since 2007 Of these, 18 have been granted to new entrants to the industry During the year, one inset appointment in Southern Water's area took effect, with SSE Water providing sewerage services to a new development at Graylingwell Park in Chichester, West Sussex

A review of competition in the water industry was 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 introduced 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 previous 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 Ofwat has also published a number of discussion papers on the framework for introducing more market forces to the sector The Government is expected to publish a Water White Paper in December 2011

Ofwat introduced new requirements last year 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

2010-11 marked the first year of the new regulatory period, following the price review in 2009 During this period we are committed to improving our key processes to deliver better services for customers, protecting the environment and providing safe and reliable services in the most efficient way In particular we are focused on transforming our asset management capabilities Our goal is to be recognised as the leading water company by 2015

Everything we do will contribute to one or more of the following goals

- Working for our customers and using their insight to develop and deliver excellent services
- Protecting the environment and striving to mitigate our impact on it
- Safer and more efficient, through a continued focus on our operating model, processes and ways of working
- Creating an exciting, healthy and rewarding place to work, which attracts and retains great people who are passionate and empowered to deliver their best
- Understanding and investing in our assets to ensure excellent services and serviceability
- Enhancing our capabilities by working with the very best service providers
- Delivering sustainable regulatory performance with good returns for our shareholders
- Being an integral, active and valued partner in the communities that we serve
- Positively shaping the industry agenda and actively engaging with key stakeholders and regulators

During the year we have begun that journey Particular highlights during this first year are

- Achievement of further improvements in customer services leading to a 19% reduction in complaints and a 12% reduction in billing contacts
- Early start made on the sewer flooding programme, with 13 properties removed from the register in the year (of the 41 properties funded in the final determination)
- Award of our third "President's Award" by RoSPA (Royal Society for the Prevention of Accidents) to mark twelve years of 'Gold' level performance and a 33% reduction in RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations) accidents involving our employees
- Progress made on re-building our capability to manage asset management internally, by bringing significant activities back in-house from external contractors
- The start of our Universal Metering Programme, following extensive engagement with customers in order to ensure that the transition is as smooth as possible for customers

There remain a number of key challenges for this period

OPERATING AND FINANCIAL REVIEW (continued)

A. OUR BUSINESS (continued)

Strategic goals (continued)
We recognise that there is more to do in reshaping some of our key processes to drive out operating efficiencies, following a large increase in operating expenditure this year Similarly, delivering the capital programme in the face of significant capital price deflation of 9% since the price review (as measured by the Construction Outputs Price Index (COPI)), represents a major challenge This is because, under Ofwat's methodology, the fall in COPI effectively reduces the value of the final determination capital allowance However, the reduction in the index is not necessarily matched by a reduction in the real costs that we face in procuring our capital programme

There are also significant challenges for us in managing our networks Following three harsh winters, the resilience of our water infrastructure network has reduced and as a result we have been unable to achieve the challenging leakage targets that we set for ourselves, though we continue to have the lowest leakage levels of any of the ten water and sewerage companies in England and Wales Customers expect us to manage our resources effectively, and we remain committed to leading the industry on leakage However, a re-profiling of our targets for this period, to reflect the impact of the unpredicted harsh winters is required

On the sewer network, we believe serviceability, Ofwat's measure of the effectiveness of our maintenance activity in delivering services to customers, has this year fallen to 'Marginal' status This follows increases in both pollution incidents and flooding and blockages We have put in place an action plan to address these failures

Serviceability across the other three sectors (Wastewater non-infrastructure, Water infrastructure and Water non-infrastructure) has been assessed by us as 'Stable' This follows significant investment, above the levels reflected in price limits, in restoring the serviceability of our water and, in the last period, sewerage above-ground water assets (principally treatment works) Despite the trend in some of the key indicators on the water infrastructure network, we believe these are related to our increased leakage activity (which increases the reported mains burst indicator) and some exceptional weather events, leading to prolonged interruptions

Finally, there is an urgent need to address the shortfall in our revenue base compared with the assumptions included in Ofwat's price limits The ongoing element of this shortfall amounts to £24 5m in the report year and we believe it will remain at or above this level for the whole of the five-year period While this shortfall can be recovered under the Revenue Correction Mechanism introduced at the last price review, this is likely to result in a significant bill spike in 2015-16 We believe it is prudent to take action to avoid this now and we have made some proposals to Ofwat to smooth these increases, by recovering part of the revenues in the current period and part in the next five-year period We will continue to discuss the issue with Ofwat as well as consulting with customers on their preference between small steady bill increments immediately, or a much larger increase at some point in the future

OPERATING AND FINANCIAL REVIEW (continued)

B. FINANCIAL PERFORMANCE

Accountıng policıes
The accountıng polıcıes of the Company, whıch are consıstent wıth the prıor year, are set out on pages 27-30

Profit and loss account
The profıt and loss account of Southern Water Servıces Ltd ıs summarısed ın Table 1

Table 1	Years ended 31 March 2011 £m	2010 £m	*Change* %
Turnover	647 1	679 1	*(4 7)*
Cost of sales and admın expenses	(417 1)	(375 4)	*(11 1)*
Exceptıonal bad debt charge	(38 6)	-	
Other ıncome	0 1	0 2	*(50 0)*
Operatıng profıt	191 5	303 9	*(37 0)*
Profıt on dısposal of fixed assets	0 8	1 4	*(42 9)*
Net ınterest	(180 2)	(115 2)	*(56 4)*
Profit before tax	12 1	190 1	*(93 6)*
Tax	19 9	(60 8)	*132 7*
Profıt after tax	32 0	129 3	*(75 3)*
Dıvıdends	(77 1)	(40 9)	*(88 5)*
Retaıned (loss)/profit	(45 1)	88 4	*(151 0)*

Turnover decreased by 4 7% to £647 1m (2009-10 £679 1m) compared wıth an average tarıff decrease on measured and unmeasured ıncome of -1 9%, derıved from RPI at 0 3% at November 2009 adapted by K of -0 7% The sıgnıficant reductıon over and above the tarıff reductıon reflects the outcome of a revıew of the method for estımatıng the amount of measured water and wastewater charges unbılled at the year-end Thıs revıew hıghlıghted that an element of the prevıous year's estımated unbılled charges were not subsequently beıng bılled and an adjustment to turnover has therefore been made to reflect the prevıously overestımated accrual The revıew has also led to modıficatıons to the method for estımatıng the level of unbılled charges for the current year whıch affects the comparıson wıth 2009-10 The reductıon also reflects the revenue shortfall whıch was referenced ın the Strategıc goals sectıon above

Costs ıncreased by 11 1% to £417 1m (2009-10 £375 4m) Thıs ıncrease resulted maınly from the ımpact of hıgher deprecıatıon charges, an ıncrease ın the ordınary bad debt charge, ınflatıon, and an ıncrease ın power and maıntenance costs

The exceptıonal ıtem of £38 6m relates to a one-off revısıon to the level of bad debt provısıon carrıed agaınst outstandıng receıvables

Operatıng profit for 2010-11 decreased from £303 9m ın the prevıous year to £191 5m, a 37 0% fall Thıs substantıal decrease was due to the exceptıonal ıtem relatıng to bad debt provısıonıng of £38 6m, a fall ın turnover of 4 7% amountıng to £32 0m whıch was sıgnıficantly affected by changes ın the estımates of unbılled ıtems ın prevıous years and by a revenue shortfall whıch wıll persıst throughout AMP5 unless ıt can be dealt wıth earlıer, and an 11 1% ıncrease ın cost of sales and admınıstratıve expenses amountıng to £41 7m

The profıt on dısposals of £0 8m (2009-10 £1 4m) relates maınly to the sale of land and buıldıngs

Net ınterest payable of £180 2m ıncreased by 56 4% (2009-10 £115 2m) Of thıs ıncrease £70 3m related to non-cash ınterest assocıated wıth ınflatıon on ındex-lınked bonds, and £7 8m to an ıncrease ın A2 preference dıvıdends for out-performance These ıncreases were partıally offset by a reductıon ın the level of ınterest payable on bonds followıng swaps taken out thıs year, swaps renegotıated and a reductıon ın the non-cash financıng charge on the pensıon defıcıt

The profıt after taxatıon for the year amounted to £32 0m (2009-10 £129 3m)

The dırectors have not declared a fınal dıvıdend for 2010-11 (2009-10 £35 0m) A final dıvıdend was paıd on 24 May 2010 ın relatıon to 2009-10 of £625 per ordınary share amountıng to £35 0m The dıvıdends charged to the profit and loss account ın the year totallıng £77 1m also ıncluded ınterım dıvıdends of £42 1m, beıng £751 43 per ordınary share (2009-10 £731 13)

OPERATING AND FINANCIAL REVIEW (continued)

B. FINANCIAL PERFORMANCE (continued)

Cash flow statement
Net cash inflow from operating activities increased to £472 5m for 2010-11 from £389 4m in 2009-10 This increase mainly reflects lower pension contributions and a reduction in working capital offset by reduced operating profits as explained in the previous section relating to the profit and loss account The decrease in pension contributions compared to the prior year of £68 8m mainly results from an exceptional one off lump sum payment of £56 1m made in 2009-10 by the company into the Southern Water Pension Scheme which covered future contributions for four years

The net cash outflow from returns on investment and servicing of finance increased to £99 1m for 2010-11 from £96 6m in 2009-10, due to an increase in the preference share dividend paid of £7 8m to the A2 shareholders This overspend has been offset by reduced interest paid due to new swaps taken out during the year and a renegotiation of the A10 swap rate

The outflow of cash relating to the purchase of tangible fixed assets was £385 4m (2009-10 £226 7m) and the net cash outflow before financing in 2010-11 was £103 0m (2009-10 £12 8m inflow)

During the year net cash outflow from financing was £13 7m as a result of repayment of indexation on the A7 swap

Balance sheet
At the end of the year to 31 March 2011, Southern Water had fixed assets of £3,912 3m (2009-10 £3,695 8m) an increase of £216 5m from March 2010 This increase largely results from capital investment of £408 5m offset by depreciation of £185 8m

Debtors falling due within one year decreased to £148 1m at 31 March 2011, from £234 5m The reduction of £86 4m is mainly as a result of having a lower net debt due from trade debtors due to an increase in the bad debt provision following an exceptional charge of £38 6m explained in note 4a of the accounts, and a lower accrual for measured income which also reduced the trade debtor balance

As at 31 March 2011 Creditors falling due within one year totalled £228 6m The increase from £194 4m at 31 March 2010 results from an increase in capital creditors due to an increase in the capital programme Creditors falling due after one year increased by £68 6m to £3,528 6m as at 31 March 2011 This increase principally resulted from inflation on index-linked bonds of £84 0m less the repayment of indexation on the A7 loan of £13 7m

The net pension deficit decreased in value to £36 8m following the latest actuarial valuation, as described in note 22

Overall net assets decreased from £810 3m to £799 4m

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

Current cost profit and loss account (appointed business)
Loss before tax was £38 7m (2009-10 profit £162 1m) 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 £90 4m (2009-10 £77 9m)
Working capital adjustment – a charge of £3 9m (2009-10 charge of £2 8m)
Financing adjustment – a credit of £50 2m (2009-10 credit of £60 9m)
Non-appointed profit before tax extracted of £3 7m (2009-10 £4 8m)
Disposal of fixed assets – a charge of £3 1m (2009-10 £3 4m)

The Infrastructure Renewals Charge (IRC) has been further increased by £7 6m to £56 4m this year, reflecting higher levels of infrastructure renewals activity required in AMP5 and the need to maintain a long-term balance between the IRC and Infrastructure Renewals Expenditure (IRE)

The current cost depreciation (CCD) charge has increased from £206 0m in 2009-10 to £219 8m in 2010-11 This is a result of an increase in the asset base and revaluation of existing assets to align with RPI increase in the year

OPERATING AND FINANCIAL REVIEW (contınued)

B. FINANCIAL PERFORMANCE (contınued)

Current cost cashflow (appointed business)
Net cash flow from operatıng actıvıtıes ıncreased to £468 8m for 2010-11 from £384 4m ın 2009-10 prıncıpally as a result of a decrease ın pensıon contrıbutıons compared to the prıor year of £68 8m, beıng an exceptıonal contrıbutıon to the pensıon deficıt of £56 1m made ın March 2010 whıch covered future contrıbutıons for four years

Net cash outflow from ınvestıng actıvıtıes ıncreased to £375 9m from £213 4m, reflectıng the fırst year of the new regulatory programme, and largely relates to ıncreased expendıture on the new Brıghton and Hove wastewater scheme Equıty dıvıdends paıd also ıncreased compared to the prevıous year by £36 9m

As a result there was a net cash outflow before fınancıng of £103 0m ın 2010-11 compared to an ınflow of £12 8m ın 2009-10

Current cost balance sheet (appointed busıness)
At the end of the perıod to 31 March 2011, Southern Water had current cost fıxed assets of £24,455 3m (2009-10 £23,100 8m) an ıncrease of £1,354 5m from 31 March 2010 The ımpact of the RPI adjustment of £1,247 7m accounted for the majorıty of the movement ın the year Overall net assets ıncreased from £20,325 5m to £21,456 9m

Net debt at the year end, as per the regulatory accounts and ıncludıng preference shares and Mezzanıne debt, was £3,373 2m (2009-10 £3,188 8m) The net debt to Regulatory Capıtal Value (RCV) ratıo, a key performance ındıcator for the Company and Ofwat on the above basıs, ıncreased from 89 4% to 89 8% (The defınıtıon of net debt for the purposes of fınancıal covenants does not ınclude preference shares and junıor debt such as the Mezzanıne debt)

The Regulatory Capıtal Value, the capıtal value used by Ofwat for prıce settıng purposes, was £3,756 5m at 31 March 2011

Dividend policy
Dıstrıbutıons may comprıse normal dıvıdends, specıal dıvıdends and shareholder loan payments Board decısıons ın respect of annual dıstrıbutıons wıll reflect consıderatıon relevant to dırectors' dutıes at law and under the Ofwat admınıstered regulatory arrangements

Dıstrıbutıon proposals submıtted to the board wıll ınclude an assessment of the proposed dıstrıbutıon on the Company's credıt ratıng, headroom under debt covenants, potentıal ımpact on the financıal flexıbılıty and the abılıty of the Company to delıver ıts capıtal programme

Dıstrıbutıon proposals submıtted to the board wıll also ınclude an assessment of the Company's performance agaınst the busıness plan ıncludıng expected performance over the balance of the regulatory perıod

Fınancıal KPIs
Under our fınancıal debt structure, there are a comprehensıve set of covenanted fınancıal ratıos Of these, there are two key ratıos, namely the ratıo of net debt to RCV and the ratıo of adjusted cash ıncome to net ınterest cost

The net debt used ın the net debt RCV ratıo ıs calculated from Southern Water's Regulatory Accounts as short and long-term senıor borrowıngs, less cash and short-term deposıts The RCV ıs set by Ofwat for fıve year perıods at perıodıc revıews and reflects forecast growth ın the asset base It ıs adjusted at each perıodıc revıew for any out-performance, shortfalls ın outputs or permıtted addıtıonal ınvestment and for certaın asset dısposals The ratıo of senıor debt to RCV ıs targeted to be maıntaıned at below 85%, ın lıne wıth our debt covenants

Senıor adjusted cash ınterest cover (measured as net cash flow less Current Cost Deprecıatıon and the Infrastructure Renewals Charge, to senıor debt ınterest) ıs targeted to be maıntaıned above 1 1 tımes, to meet covenanted levels

Net debt: RCV	
2008-09 performance	81%
2009-10 performance	80%
2010-11 performance	81%
Covenanted lock-up level	<85%
Senior cash interest cover	
2008-09 performance	1 7 tımes
2009-10 performance	1 5 tımes
2010-11 performance	1 4 tımes
Mınımum target trıgger level	1 1 tımes

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(b) 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 As stated in the section on the Profit and Loss Account, there is an exceptional item of £38 6m relating to a one-off revision to the level of bad debt provision carried against outstanding receivables

Holding company

The ultimate holding company of Southern Water is Greensands Holdings Limited (Greensands) In April 2011, the principal borrowings of Greensands were refinanced A long term financing structure has been put in place, including a £1 0bn Euro Medium-Term Note programme, out of which a £250 0m listed bond has been issued by Southern Water (Greensands) Financing Plc Along with a new £225 0m bank facility, this has been used to refinance the £441 2m of existing Greensands holding company debt and to provide a liquidity facility at the holding company £47 8m of accrued inflation on index-linked swaps to 31 March 2011 was paid out of existing cash balances at Greensands

No change has been made to the Southern Water securitisation covenants

Also in April 2011 Southern Water further strengthened its inflation hedging by taking on £441 2m of long dated inflation linked swaps at their market value, in return for the cancellation of an equivalent value £124 0m of cumulative redeemable preference shares

OPERATING AND FINANCIAL REVIEW (continued)

D. OPERATIONAL PERFORMANCE

Customer services
Ofwat now measures company performance using the Service Incentive Mechanism (SIM), which focuses on six quantitative measures and one qualitative measure This is a change from the previous Overall Performance Assessment (OPA) with the fundamental differences being the inclusion of the concept of wanted/unwanted contact and the removal of some of the OPA measures Price limits can be adjusted for comparatively good or poor performance from the SIM index at price reviews

A range of customer service indicators which make up the SIM score have been specified by Ofwat The quantitative measures include data from telephone handling and written complaints The values are adjusted according to the number of properties served, enabling comparison between other companies

Ofwat have engaged a market research company to conduct customer satisfaction surveys in respect of all 21 water and water & sewerage companies Four surveys are conducted each year from which the qualitative score is derived

The scores are not used from performance in year 1 of the AMP but will be for the remaining four years We pay particular attention to these indicators and Southern Water's comparative performance and aim to achieve an incremental improvement in both the score and relative positioning of the Company each year For example, through better processes we have managed a reduction in the level of repeat contacts and complaints for the fourth consecutive year The outturn for the year has shown a reduction of 19%, or almost 3,000 fewer complaints compared with the previous year

Water services
Our Water Resources Management Plan was approved by Defra and was published in October 2009 The Water Resources Management Plan sets 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, for the current AMP, this will be achieved through universal metering, developing new resources and leakage reductions

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 a percentage of 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

Drinking water compliance (based on calendar years)	
2005 performance	99 96%
2006 performance	99 95%
2007 performance	99 95%
2008 performance	99 97%
2009 performance	99 98%
2010 performance	99 90%
2011 *target*	99 99%
Leakage (based on financial years)	
2005-06 performance	93 Ml/d
2006-07 performance	82 Ml/d
2007-08 performance	83 Ml/d
2008-09 performance	87 Ml/d
2009-10 performance	95 Ml/d
2010-11 performance	92 Ml/d

OPERATING AND FINANCIAL REVIEW (continued)

D OPERATIONAL PERFORMANCE (continued)

Water Services (continued)
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 90% for the 2010 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

Minimising leakage, together with metering, is a key component of the strategy to ensure adequacy of water resources Southern Water's aim is to beat annual leakage targets agreed with Ofwat The target was 83 Ml/d for 2010-11 We are very disappointed to report that, despite finding and repairing a record 22,000 leaks during the year, we have not met this target, with levels for the year being at 92 Ml/d This reflects both the starting point for the year which, following the harsh winter in 2009-10, was unusually high and was then followed by another harsh winter in 2010-11

However, even at the reported level, our leakage levels remain the lowest of the ten water and sewerage companies in England & Wales Given the early delivery of our River Arun scheme, which means that the security of supply index is at 100%, the leakage level will have no impact on water availability for customers

Customers expect us to manage our resources effectively, and we remain committed to leading the industry on leakage However, having experienced three consecutive harsh winters, which are particularly unusual in the South, we believe that the profile of leakage levels set out in our business plan is no longer realistic We are discussing these issues with Ofwat and hope to agree a revised target profile

Wastewater services and the environment
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 to date

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 performance	7 Category 1&2 pollution incidents
2011 *target*	6 Category 1&2 pollution incidents

Wastewater treatment works compliance (failures of numeric consents – based on calendar years)

2005 performance	14
2006 performance	15
2007 performance	3
2008 performance	3
2009 performance	4
2010 performance	4
2011 *target*	6

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

OPERATING AND FINANCIAL REVIEW (continued)

D. OPERATIONAL PERFORMANCE (continued)

Wastewater services and the environment (continued)
During the 2010 calendar year the vast majority of our 371 Wastewater Treatment Works met their consent conditions but, unfortunately, 4 failed This performance, however, was further demonstration of the dramatic performance improvement achieved since 2006 when there were 15 failures

Pollution incidents occur mainly as a result of issues 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 While 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 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 continued to be part of the Company's targets

Bathing water quality
During the 2010 bathing water season (1 May to 30 September) the Environment Agency tested 82 beaches in the region for compliance with the EU Bathing Water Directive standards All 82 beaches met the mandatory or 'good' EU standard while 68% also met the much stricter (20 times tighter) guideline or 'excellent' standard

Energy use
Southern Water is implementing a range of initiatives during AMP5 to reduce energy consumption and CO_2 emissions to mitigate climate change

We have made significant investment in biogas fuelled CHP (Combined Heat and Power) and now have 13 operational units with the capacity to generate over 10% of our power demand Opportunities for wind and solar energy are also being explored

We are also making significant investment in improving management information on energy consumption We are currently installing 2,000 smart meters at our smaller sites to provide accurate and timely consumption data Another initiative is to install enhanced consumption monitoring at our top 20 power consuming sites to provide greater granularity on the process and individual asset consumption and we are currently trialling a range of solutions prior to implementation

Energy efficiency
Improved energy efficiency is also a key focus for AMP5 and we have a range of initiatives including improved pump and blower efficiency monitoring, advanced aeration control and energy recovery through the installation of hydro turbines in outfall pipes Detailed feasibility work on the hydro turbines has been completed and work is due to commence shortly on the development of our pump and blower efficiency monitoring strategy

Cleaner Seas for Sussex
Southern Water started construction work on its £300m scheme to bring significant environmental improvements to the East Sussex coastline around Brighton during the summer of 2009 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 we meet the requirements of the EU Urban Wastewater Directive

Southern Water awarded a contract to 4Delivery in June 2009 to commence the building works to deliver this vitally important scheme by the spring of 2013 Work is now underway on ten sites located between Brighton Marina and Friars Bay, Peacehaven, constructing the new wastewater treatment works, 11 kilometres of new sewer tunnel, three pumping stations, and access points to allow us to connect the new system to the existing sewer network

The main concrete structures on the treatment site are starting to take shape as well as the shafts along the route, allowing mechanical and electrical fitting to begin We have positioned a long sea outfall in the sea bed off Friars Bay ready to be connected to the tunnel once this is complete

The new sewer tunnel is progressing well and the sections between the new Marine Drive Pumping Station and Ovingdean, and Portobello and Peacehaven are now complete, with the remainder of the tunnels due for completion by the end of 2011

Through a dedicated communications team, extensive community and stakeholder engagement is being conducted This is backed by a comprehensive programme to support the local community through sponsorship and other initiatives, including newsletters, a dedicated website, community liaison group meetings, one-to-one meetings, letters and updates

OPERATING AND FINANCIAL REVIEW (continued)

E. LOOKING AHEAD

AMP5

2010-11 was the first year of the current five year regulatory period, AMP5

Over this period Southern Water expects to deliver capital investment of about £1 7bn This expenditure will allow us to maintain our asset base in a way that continues to deliver stable service to customers, as well as secure adequate resources to meet growth and deliver environmental improvements and improved levels of service

The largest single project in the programme is the completion of the new wastewater treatment works to serve the residents of Peacehaven, Telscombe Cliffs, Saltdean, Rottingdean, Ovingdean and Brighton and Hove under our Cleaner Seas for Sussex project This project commenced in AMP4 and is expected to be complete by March 2013

Our Universal Metering Programme will increase the proportion of customers who pay according to measured volumes to 92% We believe water metering is the fairest way to charge for water and the overwhelming majority of our customers agree Since 1990 all new homes have been fitted with a water meter and 41% of our customers are already metered The programme will entail the installation of around 486,000 meters Metering leads on average to consumption reductions of about 10% Our programme will, therefore, help ensure that we can meet the demand of all of our current and future customers as well as benefit the environment

Delivering stable 'serviceability' across all of our assets is a key target for AMP5 Currently Ofwat assesses our water non-infrastructure assets as not stable following concerns about the level of compliance failures Performance has significantly improved over the last year and is now at a level consistent with stable asset performance An exception in 2010-11 is for Sewage Infrastructure which is assessed as 'marginal' This follows increases in both pollution incidents and flooding and blockages We have put in place an action plan to address these failures and aim to return to 'stable' in 2011-12

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 five non-executive directors, of whom three are independent We are required by our regulatory licence to have at least three independent non-executive directors

Details of the Board are given on page 19 of the accounts and published on our website

The day-to-day operations of the business are overseen by the Executive Management Team This group, led by a new Chief Executive Officer (who joined in February 2011), consists of the directors of each department Finance & Regulation, Operations, Capital Delivery & Commercial, Asset Management, Customer Services & Revenue, Universal Metering Programme, IT and Estates, Human Resources, Communications and the Company Secretary

People
At the year end, Southern Water had 1,562 full time equivalent staff across the region This number has decreased by 36 from last year

The Company is committed to improving employees' skills through continued learning, and our investment in staff development continued through the year A number of development programmes were completed including 'Discovery' – a series of structured modules to improve management and leadership, and 'Dynamo' – a training programme to increase the skill base of operational staff During the year, 290 employees attended Leadership Conferences 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
We have established a new Multi Service Framework agreement for all core Utility Services in AMP5, which includes the following

- Clancy Docwra Limited - for Water Distribution, Sewerage Networks and Mechanical & Electrical (M&E) (Isle of Wight)
- Morrison Utility Services Limited - for M&E (Eastern region)
- Barhale Trant Utilities Limited - for M&E (Western region)

Technical support for the AMP5 programme will be provided through seven Engineering Framework Agreements, developing this framework into a Centre of Excellence to deliver enhanced customer and stakeholder benefits

In addition, commercial arrangements continued with 4Delivery to deliver the £300m Cleaner Seas for Sussex wastewater treatment scheme

OPERATING AND FINANCIAL REVIEW (continued)

G. RISK MANAGEMENT

A central database of key risks is maintained and all managers have access to and the ability to raise risks on the database Risks are assessed in terms of impact in the following areas

- Financial
- Reputation
- Health and safety
- Security of supply
- Regulatory, environmental and legal

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

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

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

KEY RISKS

Regulatory risk

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

Following the completion of the 2009 price review, Ofwat launched a number of projects to review whether the regulatory regime remained fit to face the challenges of the future It is also looking at greater use of market mechanisms in order to drive innovation and efficiencies At the same time, DEFRA asked David Gray to review Ofwat and whether any changes needed to be made to the regulator and its statutory duties in order to meet these future challenges

This raises the risk that any significant changes to the regulatory regime will disadvantage water companies in general or Southern Water specifically We are engaging with Ofwat on their programme of reform and have made a submission to the Gray Review of Ofwat We are also working with Water UK to ensure that any changes resulting from these reviews deliver better more effective regulation in the interests of all stakeholders

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 While 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 Significant focus continues in the area of pollution reduction through a dedicated task force leading planned programmes of sewer maintenance and rehabilitation, rising main replacement and extensive jetting, including pumping station refurbishment, wet well cleaning and condition based monitoring

OPERATING AND FINANCIAL REVIEW (continued)

G RISK MANAGEMENT (continued)

KEY RISKS (continued)

Operational risk (continued)

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 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 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 is carrying out a Water Compliance Project which has and will continue to 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 will do 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, and 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 to manage this accordingly

The risks associated with COPI and the Universal Metering Programme are reported in the section on Strategic Goals on page 2

The risk of a sustained period of negative inflation
Although inflation is currently above target, both revenues and capital values are linked to RPI, and a sustained period of negative inflation causing a reduction in cash inflow from revenue linked to inflation, along with a reduction in the Regulatory Capital Value 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

Ratings
An investment grade credit rating is required to be maintained to ensure continued access to the capital markets, in order to efficiently finance the capital investment programme, and to refinance existing debt maturities when they fall due This requirement is a condition of the regulatory licence (and also a primary duty of Ofwat when setting prices to ensure companies can finance their functions), and a condition of borrowing covenants where a failure to maintain certain prescribed credit ratings could lead to a restriction on dividend payments

OPERATING AND FINANCIAL REVIEW (continued)

G. RISK MANAGEMENT (continued)

KEY RISKS (continued)

Capital investment risk

The 2010-11 accounts mark the completion of the first year of the current five year regulatory review period For this period, a capital investment programme of £1 7bn has been allowed for in price limits by Ofwat The company is on target to deliver the programme Failure to deliver significant elements of the capital programme risks adjustments to the Regulatory Capital Value at the next review, enforcement action by the Environment Agency, DWI or Ofwat and threatens the integrity of services

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

Private Sewers

The government has announced that privately owned sewers and lateral drains will be transferred to water and wastewater companies The legislation to facilitate the transfer is currently passing through Parliament and we expect the transfer to take effect from 1 October 2011 The total length of transferred sewers is unknown, but we estimate that it may be as much as the current length of public sewer, some 20,000 km The costs associated with maintaining these newly adopted assets were not allowed for when Ofwat set price limits in 2009 However, as the costs result from a change in legislation, they qualify as a 'relevant change of circumstance' under the conditions of our licence, which means that we can apply to Ofwat for an interim determination of our K factor to recover the costs incurred

OPERATING AND FINANCIAL REVIEW (continued)

H. CORPORATE RESPONSIBILITY

Environmental Governance
In 2008 Southern Water was registered to ISO14001, the international standard for environmental management 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
- To ensure compliance with environmental legislation, to identify and minimise environmental risk, to prevent pollution 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 and 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 their potential impact on the environment and combined this with environmental legislation and regulations that apply This influences environmental improvement and action plans through development of objective 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 and Safety
The health and safety of all employees, customers and contractors is 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 2010-11, a range of Health and Safety initiatives have been run by the Company and many of our main contractors under our award winning 'Aim for Zero Injuries' brand

We were awarded the Royal Society for the Prevention of Accidents (RoSPA) President's Award for the third year running in its International Occupational Health and Safety Awards, presented to companies which have achieved excellent Health and Safety performance over a number of years We also achieved a 33% reduction in RIDDOR accidents involving our employees compared to the previous year and a 44% reduction in the number of injuries resulting in lost time

Several of our key contractors were also recognised by RoSPA with a range of awards during the year

As part of a wide range of activities to support the European Week of Safety and Health, we ran a large regional Health and Safety Conference for more than 250 operational staff and key contractors Because 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 In particular, we are members of the HSE's stakeholder group and have taken an active part as a partner in developing the new "Estates Excellence" model for improving health and safety in the UK

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

We remain committed to supporting the communities we serve and continued with a series of programmes, sponsorships and donations across our region

More than 80 pools and clubs now take part in our Learn to Swim scheme for children aged four to 12 Paralympic gold medallist Sascha Kindred helped promote the scheme in which more than 500,000 children have been taught to swim Olympian Duncan Goodhew also continues to act as a figurehead for this award-winning programme

We continued our sponsorship of the South and South East in Bloom competition, which attracted a record 260 entries, including 93 in the schools' section and also continued our award-winning Blooming Schools programme in which more than 61,000 children have created 409 gardens in their schools

Now in its twelfth year, our popular water efficiency play was seen by more than 4,000 children aged five to 11 Facepack Theatre visited 25 schools and gave performances of the show, which incorporates our water efficiency and water for health characters Mr Save-It and Mr Drink-It

In conjunction with the Design Council, we launched the Water Design Challenge, an innovative education programme for secondary school pupils that tasks them to come up with ways to save water. The challenge was successfully piloted in five schools and the winner, The World's Smallest Water Museum – designed by students at Sholing Technology College in Southampton – was built and is being showcased at a number of events The programme will be rolled out to more schools in 2011

We worked in partnership with the Smallpeice Trust to deliver STEM Days in ten secondary schools About 500 students took part in a water-themed practical challenge, using skills associated with science, technology, engineering and maths

We launched a programme with Gillingham Football Club in Kent to help 150 disadvantaged children in Medway We also formed a partnership with Sussex County Cricket Club in which more than 500 schoolchildren took part in the Southern Water Ashes Competition, with 20 winning a place at the finals held at the County Ground in Hove The programme highlighted the importance of drinking water for health

We sponsored the Brighton Dome Family Theatre Programme, which was launched with a puppetry workshop at a local primary school We supported the Brighton Theatre Royal's creative educational programme and 220 children attended workshops which promote health and vitality and encourage children to look after themselves In addition, we again supported the Brighton Festival Fringe by sponsoring Fringe City and more than 1,400 people visited Brighton sewers on our organised tours during the summer

More than £350,000 was raised through charity events These included our annual ball, which raised £75,000 for the National Society for the Prevention of Cruelty to Children, the Royal National Lifeboat Institution and Cancer Research UK The same charities benefited from £80,000 raised at our annual race day, along with WaterAid, AAIR (Asthma, Allergy and Inflammation Research), Chestnut Tree House Children's Hospice and the Sussex Community Foundation

Our eleventh WaterAid golf day raised £10,000 for the charity, which provides water, sanitation and hygiene education to some of the world's poorest people Our Health and Safety Charity Challenge, in which we make a donation for each hazard or near miss reported in the workplace, raised £14,000 for regional Air Ambulance trusts More than £80,000 was raised during the year by including lottery leaflets for three of the region's children's hospices – Demelza House, Chestnut Tree House and Naomi House – when we sent bills to our customers

In addition, monthly Dress Down Days at our main offices raised over £11,000 for 31 charities and our Community Chest forum made 91 donations totalling over £8,000

Our Community Volunteering Programme gives staff the opportunity to spend two days a year helping a charity or community project, and 202 days were taken during the year – an 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

1 For the fourth year running, we were recognised at the Water Industry Achievement Awards, winning two awards The awards were for Community Campaign of the Year for the work we do to support local communities and charities and Customer Satisfaction Initiative of the Year for our Help Us Get Better Tours, where customers who have made complaints are invited to visit the company

2 The communications team was voted Outstanding In-House PR Team for the fourth consecutive year at the regional Chartered Institute of Public Relations (CIPR) Awards We also won awards for the Best Use of Photography and Design for the Water Design Challenge, Best Campaign (under £10,000) for our Fight the Fat campaign, which highlights the hazards of pouring cooking fat down the sink, and Best Community Relations Programme for Blooming Schools

3 For the second time, we received the Grand Prix at the annual CorpComms Awards We also won Best Communications by a Private Sector Company for the Water Design Challenge and Best CSR Strategy for Blooming Schools Our FOG campaign was highly commended

4 The FOG campaign was a finalist in the annual Utility Industry Achievement Awards, along with our charity work and the Water Design Challenge

5 Our internal communications campaign to inform staff about the introduction of a new business critical system won a CIPR Excellence Award

6 Our film A Pleasant and Water Efficient Day, featuring a nine-year-old 'water stewardess' giving water saving tips in the style of an airline safety presentation, won the Public Relations category of the International Visual Communications Awards (IVCA)

7 Our health and safety performance was recognised with a further Royal Society for the Prevention of Accidents (RoSPA) President's Award, presented to companies demonstrating outstanding performance in health and safety

8 We were awarded Investors in People accreditation for the second time

9 A scheme to enhance Eastney Pumping Station in Portsmouth and provide nine million litres of additional storage to help prevent flooding won bronze in the Considerate Constructors National Site Awards 2010 The scheme was also highly commended in the Major Projects Category of the South Branch of the Institute of Civil Engineers Annual Awards

10 We retained ISO 9001 2008 accreditation for our Non-Financial Regulatory Reporting and Quality Management System

11 Our Testwood Lakes site in Totton, Hampshire, won two awards in the British Ornithological Society's Business Bird Challenge 2010

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2011

The directors of Southern Water Services Limited (Registered no 02366670) present their report and the audited financial statements for the year ended 31 March 2011

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 4 million people and provides wastewater services to 4 3 million people

BUSINESS REVIEW

The information that fulfils the requirement of the business review can be found in the Operating and Financial Review (OFR) on pages 1 to 18, which are incorporated in this report by reference

FUTURE DEVELOPMENTS

The information regarding future developments of the Company can be found in the Operating and Financial Review (OFR) on pages 1 to 18

RESULTS AND DIVIDENDS

The profit and loss account on page 23 shows the Company's results, dividends and profit for the year Further details are also available in the OFR on pages 4 to 5

The exceptional item in the year ended 31 March 2011 of £38 6m relates to a revision of the level of bad debt provision required

In the prior year the directors recommended a final dividend of £625 00 per ordinary share (£35 0m in total) which was paid in the current financial year

Interim dividends of £751 43 per ordinary share (2009-10 £731 13 per share), totalling £42 1m (2009-10 £40 9m) were also paid during the year, resulting in total dividends paid and charged in the current financial year of £77 1m (2009-10 £40 9m) The directors do not recommend payment of a final dividend for 2011 (2010 £35 0m)

DIRECTORS AND THEIR INTERESTS

The directors who held office during the year ended 31 March 2011 and up to the date of signing the financial statements were as follows

Michael Welton	(Chairman)
Matthew Wright	(Executive Director) *(Appointed 28 February 2011)*
Leslie Dawson	(Executive Director) *(Resigned 25 May 2010)*
Howard Goodbourn	(Executive Director) *(Resigned 7 March 2011)*
Robert Armstrong	(Independent Non-Executive Director)
Cheryl Black	(Independent Non-Executive Director)
David Golden	(Independent Non-Executive Director)
Colin Hood	(Non-Executive Director *(Appointed 23 February 2011)*
Paul Moy	(Non- Executive Director)
Surinder Toor	(Non-Executive Director) *(Resigned 23 February 2011)*
Surinder Toor	(Alternate Non-Executive Director) *(Appointed 23 February 2011)*
Mark Walters	(Alternate Non-Executive Director) *(Resigned 23 February 2011)*
Jaron Yuen	(Alternate Non-Executive Director)

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

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 £0 9m including £0 4m on fixed assets (2009-10 £2 5m, £2 0m on fixed assets)

REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

FINANCIAL RISK MANAGEMENT

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

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

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 2011 were 42 days (2010 45 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 2011 (continued)

CHARITABLE DONATIONS

The Company made donations of £286,403 (2010 £1, 016,775) to a variety of charities over the year Donations in the year comprised £220,000 (2010 £1,000,000) to the Southern Water Charitable 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 £66,403 (2010 £16,775) 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

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 2011 Further information is set out in note 1 'Basis of accounting' on page 27

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 2011 (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 prepared 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 these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting 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, and
- 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 by order of the Board

Kevin Hall
Company Secretary
10 June 2011

PROFIT AND LOSS ACCOUNT
For the year ended 31 March 2011

	Note	2011 £m	2011 £m	2010 £m	2010 £m
Turnover	1,2,3		**647.1**		679 1
Cost of sales	3				
- before exceptional item		**(382.6)**		(348 1)	
- exceptional item	4	**(38 6)**		-	
Cost of sales including exceptional item			**(421.2)**		(348 1)
Gross profit			**225.9**		331 0
Administrative expenses	3		**(34.5)**		(27 3)
Other operating income	3		**0.1**		0 2
Operating profit before exceptional item			**230.1**		303 9
Exceptional item			**(38 6)**		
Operating profit			**191 5**		303 9
Profit on disposal of fixed assets			**0.8**		1 4
Profit on ordinary activities before interest and taxation			**192.3**		305 3
Interest payable and similar charges	7		**(240 5)**		(177 0)
Interest receivable and similar income	7		**60 3**		61 8
Profit on ordinary activities before taxation	4		**12.1**		190 1
Tax on profit on ordinary activities	8		**19.9**		(60 8)
Profit on ordinary activities after taxation	20		**32 0**		129 3
Dividends	9,20		**(77.1)**		(40 9)
(Loss)/profit for the financial year			**(45 1)**		88 4

The above results relate to continuing operations

The Notes on pages 27 to 48 form part of these financial statements

There is no difference between the (loss)/profit on ordinary activities before taxation and the retained (loss)/profit for the years stated above and their historical cost equivalents

STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES
For the year ended 31 March 2011

	Note	2011 £m	2010 £m
Profit on ordinary activities after taxation		**32.0**	129 3
Actuarial gain/(loss) recognised in the pension scheme	20,22	**48 6**	(54 3)
Movement on deferred tax relating to pension deficit	17	**(18 5)**	10 5
Movement on current tax relating to pension deficit		**4.1**	4 7
Total recognised gains for the year		**66.2**	90 2

BALANCE SHEET
As at 31 March 2011

	Note	2011 £m	2010 £m
Fixed assets			
Tangible assets	10	**3,883.1**	3,666 6
Investments	11	**29 2**	29 2
		3,912.3	3,695 8
Current assets			
Stocks	12	**1.6**	1 2
Debtors amounts falling due within one year	13	**148.1**	234 5
Debtors amounts falling due after more than one year	14	**812.3**	812 3
Cash at bank and in hand		**172.0**	288 7
		1,134.0	1,336 7
Creditors: amounts falling due within one year	15	**(228.6)**	(194 4)
Net current assets		**905.4**	1,142 3
Total assets less current liabilities		**4,817.7**	4,838 1
Creditors amounts falling due after more than one year	16	**(3,528 6)**	(3,460 0)
Provision for liabilities			
Environmental obligations	17	**(0.9)**	(0 3)
Deferred taxation	17	**(402.9)**	(451 5)
Grants and contributions	18	**(49.1)**	(50 1)
Net assets excluding pension deficit		**836.2**	876 2
Pension deficit	22	**(36.8)**	(65 9)
Net assets		**799.4**	810 3
Capital and reserves			
Called up share capital	19	**0.1**	0 1
Share premium	20	**46.3**	46 3
Profit and loss account	20	**753.0**	763 9
Total shareholders' funds		**799.4**	810 3

The financial statements on pages 23 to 48 were approved by the Board and authorised for issue on 10 June 2011 and signed on its behalf by

M. R. Wright

Matthew Wright
Chief Executive Officer

CASH FLOW STATEMENT
for the year ended 31 March 2011

	Notes	2011 £m	2010 £m
Net cash inflow from operating activities	21	**472 5**	389 4
Returns on investments and servicing of finance			
Interest received		**60 3**	62 7
Interest paid		**(137.1)**	(144 8)
Preference share dividends		**(22.3)**	(14 5)
Net cash outflow from returns on investments and servicing of finance		**(99.1)**	(96 6)
Taxation		**(23.4)**	(25 5)
Capital expenditure and financial investment			
Purchase of tangible fixed assets		**(385.4)**	(226 7)
Receipt of grants and contributions		**9.3**	10 7
Sale of tangible assets		**0.2**	2 4
Net cash outflow for capital expenditure and financial investment		**(375.9)**	(213 6)
Equity dividends paid		**(77 1)**	(40 9)
Net cash (outflow)/inflow before financing		**(103 0)**	12 8
Financing			
Increase in borrowings		**-**	50 0
Repayment of loans		**(13.7)**	(183 3)
Deferred swap receipts		**-**	48 8
Net cash outflow from financing		**(13.7)**	(84 5)
Decrease in net cash		**(116.7)**	(71 7)
Reconciliation to net debt			
Net debt at beginning of year		**(3,188.8)**	(3,189 8)
Decrease in net cash		**(116.7)**	(71 7)
Movements in borrowings		**13.7**	133 3
Deferred swap receipts (see note 21(b))		**-**	(48 8)
Other non cash changes		**(81 4)**	(11 8)
Net debt at end of year		**(3,373.2)**	(3,188 8)

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011

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 The principal accounting policies, which have been applied consistently, are set out below

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 ultimate 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 estimate 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

Estimate of unbilled income

The estimate of unbilled income 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, historical billing and consumption information, and subsequent actual billings

Bad debts

The bad debt provision is calculated by applying estimated recovery rates to various categories of debt and reflecting past collections experience and expectations of future recovery of outstanding receivables at the year end

Capital instruments

The issue costs of capital instruments are 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

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

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

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

iii) Freehold land is not depreciated

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

Grants and contributions

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

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

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 2011 (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 2011 (continued)

4 Profit on ordinary activities before taxation

Profit on ordinary activities before taxation is stated after charging/(crediting)	**2011** **£m**	2010 £m
Employee costs (note 5a)	**42.3**	36 5
Depreciation on		
- owned assets	**185.4**	176 5
- assets held under finance leases	**0.4**	0 4
	185.8	176 9
Rentals under operating leases		
Other	**3.5**	3 5
Research and development expenditure	**0.5**	0 5
Release of grants and contributions (note 18)	**(2.7)**	(2 6)
Exceptional item (see note (a) below)	**38.6**	-
Fees receivable by the Company's auditors in respect of		
- Statutory audit of the Company's financial statements	**0.2**	0 1
- Other services pursuant to legislation	**0.1**	0 1
- All other services	**0.8**	0 5

(a) The exceptional item of £38 6m relates to a revision of the level of bad debt provision required for outstanding receivables

5 Employee information

	2011 **£m**	2010 £m
(a) Employee costs (including directors' emoluments).		
Wages and salaries	**48 8**	46 6
Social security costs	**4.0**	3 9
Pension costs	**8.5**	4 7
Total employee costs	**61.3**	55 2
Less charged as capital expenditure	**(19.0)**	(18 7)
Charged to the profit and loss account	**42.3**	36 5

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

	2011 **Number**	2010 Number
Operations	**886**	945
Customer Services	**325**	295
Corporate Centre	**294**	268
	1,505	1,508

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

6 Directors' emoluments

	2011 £000	2010 £000
Aggregate emoluments (including benefits in kind)	**1,090**	1,376
Compensation for loss of office	**1,730**	-
Company pension contributions to money purchase pension schemes	**147**	108
Aggregate emoluments under the Long Term Incentive Plan	**-**	173

No retirement benefits accrued to directors (2010 none) under a Southern Water defined benefit scheme Retirement benefits accrued to two directors (2010 two) under a Southern Water defined contribution scheme

Details of emoluments and benefits for the highest paid director

	2011 £000	2010 £000
Aggregate highest paid director's emoluments and benefits	**361**	731
Aggregate highest paid director's emoluments under the Long Term Incentive Plan	**-**	144

During the year the Company made contributions of £81,939 (2010 £80,000) to a money purchase pension scheme in respect of the highest paid director's qualifying services

7 Interest

	2011 £m	2010 £m
Interest payable and similar charges		
Interest payable on other loans	**6.4**	3 6
Interest paid to group companies	**131.4**	140 3
Indexation	**84.0**	13 7
Amortisation of issue costs	**2.7**	2 7
Amortisation of gilt lock proceeds	**(0.1)**	(0 1)
Amortisation of deferred credits	**(5.0)**	(4 2)
Amortisation of bond premium	**(0.6)**	(0 6)
Amortisation of discount	**0.3**	0 3
Other finance expense (note 22)	**(0.9)**	6 8
Dividends on preference shares- see note below	**22.3**	14 5
Total interest payable and similar charges	**240.5**	177 0
Interest receivable and similar income		
Interest receivable from Southern Water Services Group Limited	**56 9**	56 9
Deposit interest receivable	**3.4**	4 9
Total interest receivable	**60.3**	61 8

The preference share dividends were paid on 30 September 10 and 31 March 11 and Class A1 amounted to £40 per share and Class B £70 per share (totalling £13 7m (2010 £13 7m)) A dividend of £8 6m (2010 £0 8m) was declared and paid to the Class A2 preference shareholders in September 2010 at base value (see note 16(vi)) plus an amount for outperformance in the year ending 31 March 2010

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

8 Tax on profit on ordinary activities

	2011 £m	2010 £m
Current tax:		
UK corporation tax on profits for the year	**32.3**	49 4
Adjustment in respect of prior years	**(4.6)**	-
	27.7	49 4
Deferred tax:		
Origination and reversal of timing differences	**(16.4)**	12 0
Adjustment in respect of prior years	**(1.2)**	(0 6)
Effect of corporation tax rate charge	**(31.0)**	-
Impact of rate change on pension charge	**1.0**	-
Total deferred tax	**(47.6)**	11 4
Total tax on profit on ordinary activities	**(19.9)**	60 8

The tax assessed for the year is different to the standard rate of corporation tax in the UK (28%) due to the following factors

	2011 £m	2010 £m
Profit on ordinary activities before tax	**12.1**	190 1
Current tax:		
UK corporation tax on profits for the year at 28% (2010 28%)	**3.4**	53 2
Adjustment in respect of prior years	**(4.6)**	-
Permanent differences	**12.5**	8 2
Tax charge on ordinary activities	**11.3**	61 4
Timing differences	**16.4**	(12 0)
Current tax charge for year	**27.7**	49 4

Factors that may affect future tax charges

On 23 March 2011 the UK Government announced a reduction in the main rate of corporation tax from 28% to 26% effective from 1 April 2011. The rate change was substantively enacted by the balance sheet date, and deferred tax balances have been calculated using the new rate of 26% A £31 0m credit is recognised in the profit and loss account in the year to reflect the reduction in the deferred tax liability as a result of the rate change In addition, charges of £1 7m in the profit and loss account and £0 8m in the statement of total recognised gains and losses are recognised to reflect the reduction in the deferred tax asset relating to the pension deficit

The Government has also indicated that it intends to enact future reductions in the main tax rate of 1% each year down to 23% by 1 April 2014 The future main tax rate reductions are expected to have a similar impact on the financial statements as outlined above albeit at a rate of reduction of 1% rather than 2%, however the actual impact will be dependent on the Company's deferred tax position at that time

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 2011 (continued)

9 Dividends per share

	2011 £ per ordinary share	2010 £ per ordinary share	**2011 £m**	2010 £m
Ordinary shares				
Interim dividend – 2 Jul	**182 78**	-	**10.2**	-
Interim dividend – 30 Sep	**182 78**	365 57	**10.2**	20 5
Interim dividend – 16 Dec	**182.78**	-	**10.3**	-
Interim dividend – 31 Dec	-	182 78	-	10 2
Interim dividend – 31 Mar	**203 09**	182 78	**11.4**	10 2
Total interim dividend	**751 43**	731 13	**42 1**	40 9
Final dividend – prior year	**625 00**	-	**35 0**	-
Total ordinary dividend	**1,376.43**	731 13	**77 1**	40 9

The final dividend paid in 2011 related to the year ended 31 March 2010 (2009 £nil) and was declared on 28 April 2010 and paid on 24 May 2010

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (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
Cost:						
At 1 April 2010	1,322 3	1,608 4	1,730 8	284 0	464 9	5,410 4
Additions	(0 2)	48 4	50 8	288 6	20 9	408 5
Transfers	7 2	30 1	34 1	(98 4)	27 0	-
Grants & contributions	-	-	(10 7)	4 6	-	(6 1)
Disposals	-	0 3	(3 1)	-	0 1	(2 7)
At 31 March 2011	1,329 3	1,687 2	1,801 9	478 8	512.9	5,810 1
Accumulated depreciation:						
At 1 April 2010	381 6	542 5	517 5	-	302 2	1,743 8
Charge for the year	36 8	60 3	56.4	-	32 3	185 8
Disposals	-	0 3	(3 0)	-	0 1	(2 6)
At 31 March 2011	418 4	603 1	570.9	-	334 6	1,927 0
Net book amount:						
At 31 March 2011	**910.9**	**1,084.1**	**1,231.0**	**478.8**	**178.3**	**3,883.1**
At 31 March 2010	940 7	1,065 9	1,213 3	284 0	162 7	3,666 6

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals during the years ended 31 March 2011 and 31 March 2010 was £62 5m and £35.4m, respectively Of the grants and contributions set against infrastructure assets during the years ended 31 March 2011 and 31 March 2010, £3 6m and £2 8m respectively relates to infrastructure renewals

For the years ended 31 March 2011 and 31 March 2010, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £187.5m and £176 8m, respectively

Freehold land is stated at a cost of £46 2m and £46 5m at 31 March 2011 and 31 March 2010, 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

	2011 £m	2010 £m
Cost	11.7	11 7
Aggregate depreciation	(10.2)	(9 8)
Net book amount	1.5	1 9

Outstanding payments and interest associated with this lease are not material

(b) Capital commitments	**2011 £m**	2010 £m
In respect of contracts placed	402.3	600 1

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

11 Fixed asset ınvestments

	2011 £m	2010 £m
Shares in group undertakıngs		
At 1 Aprıl and 31 March	**29.2**	29 2

The ınvestment represents a 100% holdıng of the ıssued Ordınary shares of Southern Water Servıces (Fınance) Ltd ("SWSF"), a company ıncorporated ın the Cayman Islands The prıncıpal actıvıty of the company ıs to raıse debt finance Thıs ınvestment generated losses of £0 9m ın the year (2010 profit £0 5m) and has net lıabılıtıes of £468 2m (2010 £429 2m)

The Dırectors are satısfied that the carryıng value of the ınvestment ıs supported by the underlyıng assets and actıvıtıes of SWSF

There are no ındırect subsıdıarıes resultıng from thıs ınvestment

12 Stocks

	2011 £m	2010 £m
Raw materıals	**1.1**	0 9
Work ın progress	**0.5**	0 3
	1.6	1 2

13 Debtors: amounts falling due within one year

	2011 £m	2010 £m
Trade debtors	**69 6**	109 3
Amounts owed by group undertakıngs	**8 0**	17 4
Other debtors	**9.4**	7 9
Accrued ıncome	**48.1**	82 1
Prepayments	**13.0**	17 8
	148.1	234 5

Amounts owed by group undertakıngs are unsecured, ınterest-free and settled regularly

14 Debtors: amounts falling due after more than one year

	2011 £m	2010 £m
Loans owed by group undertakıngs	**812.3**	812 3
	812 3	812 3

Loans owed by group undertakıngs represent a loan to Southern Water Servıces Group Lımıted whıch ıs secured on the assets held under the Southern Water Servıces Group Securıty agreement and repayable on 31 July 2052 wıth ınterest payable at 7%

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

15 Creditors· amounts falling due within one year

	2011 £m	2010 £m
Trade creditors	20.5	34 3
Loans from group undertakings (see note (i) below)	30.3	30 3
Amounts owed to group undertakings	27.9	26 7
Capital creditors and capital accruals	77.8	53 4
Taxation and social security	2.0	2 0
Debt issue costs (note 16)	(2.7)	(2 7)
Accruals and deferred revenue	67.4	43 7
Bond premium deferred	0.3	0 3
Deferred gilt lock proceeds (note 16)	0.1	0 1
Deferred swap receipts (note 16)	5.0	6 3
	228.6	194 4

Notes

(i) 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

	2011 £m	2010 £m
Loans and other borrowings		
Loan from Southern Water Services (Finance) Limited	3,201.1	3,130 9
Other borrowings	50.0	50 0
Class A1 Preference shares (see note (vi) below)	150.0	150 0
Class B Preference shares (see note (vi) below)	110.0	110 0
Debt issue costs (see note (vii) below)	(44.4)	(47 1)
Bond premium deferred	5.1	5 4
Deferred gilt lock proceeds (see note (viii) below)	5.7	5 8
Deferred swap receipts (see note (iii) below)	34.7	38 3
Total Loans and other borrowings	3,512.2	3,443 3
Deferred revenue (see note (ix) below)	16.4	16 7
Total Creditors falling due after more than one year	3,528.6	3,460 0

	2011 £m	2010 £m
Repayments fall due as follows:		
Between two and five years	50.0	50 0
After five years not by instalments	3,461.1	3,376 5
	3,511.1	3,426 5

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

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

In the year to 31 March 2011, Southern Water Services (Finance) Limited (SWSF) did not raise or advance to SWS any further additional debt (2010 £nil)

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 -

	2011	2010
Loans	**£m**	£m
Class A £350m 6 202% fixed rate 2029	**350.0**	350 0
Class A £150m 3 716% index linked 2034	**188.2**	179 7
Class A £35m 3 716% index linked 2034	**44.5**	42 5
Class A £350m 6 650% fixed rate 2026	**350.0**	350 0
Class A £150m 3 826% index linked 2023	**188.2**	179 7
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	**207 0**	197 6
Artesian £156 5m 3 645% index linked 2032	**191 6**	182 9
	2,819 5	2,782 4
Fixed swapped to Index-linked – (note (ii) below)	**(877.0)**	(877 0)
Index-linked swaps – (note (ii) below)	**978 8**	945 7
Total Class A Debt	**2,921.3**	2,851 1
Class B £250m 7 879% fixed rate 2038 (note (iv) below)	**250.0**	250 0
Senior Mezzanine £127 2m 11 97% fixed rate 2038 (note (v) below)	**15.4**	15 4
Intercompany creditor	**14.4**	14 4
Total loans from Southern Water Services (Finance) Limited	**3,201.1**	3,130 9
Capex facility £50m 6m LIBOR plus 3%	**50.0**	50 0
Class A1 Preference shares (note (vi) below)	**150 0**	150 0
Class B Preference shares (note (vi) below)	**110 0**	110 0
Debt issue costs (note (vii) below)	**(44.4)**	(47 1)
Bond premium deferred	**5 1**	5 4
Deferred gilt lock proceeds (note (viii) below)	**5 7**	5 8
Deferred swap receipts (note (iii) below)	**34.7**	38 3
	3,512.2	3,443 3

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 2011 (continued)

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

In respect of the specific instruments above

(i) SWSF has entered into swap agreements that have converted £195m of its Class A £300m from a fixed rate of 6 125% to floating rates of LIBOR plus a margin with a LIBOR cap at 5% This swapped rate has been reflected in the rate charged to SWS plus 0 01%

(ii) As at 31 March 2011, SWSF was party to various swap agreements converting a total of £877 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 2011

Nominal value of debt		Original Fixed interest rate	Swapped Index Linked interest rate	Nominal value of debt plus capitalised RPI
£50 0m		6 202%	3 200%	£53 7m
£177 0m	(see note iii)	5 010%	2 161%	£180 7m
£150 0m		5 010%	0 510%	£181 3m
£200 0m		4 510%	0 070%	£236 2m
£300 0m		5 135%	0 657%	£326 9m
£877 0m				£978 8m

(iii) The interest rates on the swaps entered into during the previous 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 was 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 previous 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

(iv) 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%

(v) The interest rate on the Senior Mezzanine loan is fixed at 11 97% until March 2022 when it reverts to LIBOR plus 6 25% with a premium of 0 01%

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

(vi) 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 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 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 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 2011 for outperformance in the year ending March 2011

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

(vii) 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 2011 debt issue costs amounted to £47 1m of which £2 7m represents the short-term amount which is disclosed separately in note 15

(viii) 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

(ix) 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

17 Provision for liabilities

(a) Environmental obligations	**2011 £m**	2010 £m
At 1 April	**0 3**	0 4
Utilised in year	-	(0 1)
Increase in year	**0.6**	-
At 31 March	**0.9**	0 3

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 value

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

17 Provision for liabilities (continued)

(b) Deferred taxation	**2011 £m**	2010 £m
Accelerated capital allowances	**426.8**	472 1
Other timing differences	**(23.9)**	(20 6)
Deferred taxation	**402 9**	451 5

Movement in deferred tax provision	**2011 £m**	2010 £m
Deferred tax provided at 1 April	**451.5**	440 1
Prior year adjustment	**(1.2)**	(0 6)
Deferred tax charge in Profit and Loss Account	**(16.4)**	12 0
Effect of corporation tax rate change	**(31.0)**	-
Deferred tax provided at 31 March	**402.9**	451 5

Deferred tax asset relating to pension deficit	**2011 £m**	2010 £m
At 1 April	**42 9**	32 4
Adjustment in respect of prior years	**(0.1)**	-
Deferred tax charge in profit and loss account	**-**	-
Deferred tax charged to the statement of total recognised gains and losses	**(17.7)**	10 5
Impact of rate change		
Charge in profit and loss account	**(1.0)**	-
Charged to the statement of total recognised gains and losses	**(0.8)**	-
At 31 March	**23.3**	42 9

The deferred tax asset of £23 3m (2010 £42 9m) 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 2010	50 1
Receivable in year	1 7
Released to profit and loss account	(2 7)
At 31 March 2011	**49.1**

These grants and contributions relate to non-infrastructure assets

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

19 Called up share capital

	2011	2010
	£m	£m
Equity shares		
Authorised		
46,050,000 ordinary shares of £1 each	**46.1**	46 1
Allotted and fully paid		
56,000 ordinary shares of £1 each	**0.1**	0 1
Non-equity shares		
Authorised and issued		
Preference shares		
150,000 Class A1 shares of £1 each	**0.2**	0 2
150,000 Class A2 shares of £0 01 each	**0.0**	0 0
110,000 Class B shares of £1 each	**0.1**	0 1

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	Share premium	Profit and loss account	Total
	£m	£m	£m	£m
At 1 April 2010	0 1	46 3	763 9	810 3
Profit after tax	-	-	32 0	32 0
Dividends paid	-	-	(77 1)	(77 1)
Actuarial gain on pension scheme	-	-	48 6	48 6
Movement on deferred tax relating to pension asset	-	-	(18 5)	(18 5)
Movement on current tax relating to pension asset	-	-	4 1	4 1
At 31 March 2011	**0 1**	**46 3**	**753.0**	**799.4**

The profit and loss reserve includes recognised losses of £60 2m (2010 £108 8m) less deferred taxation of £23 3m (2010 £42 9m) in respect of pension scheme liabilities of the group pension fund

	Called up share capital	Share premium	Profit and loss account	Total
	£m	£m	£m	£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
At 31 March 2010	**0 1**	**46 3**	**763.9**	**810.3**

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

21 (a) Cash flow from operating activities

	2011 £m	2010 £m
Continuing operations		
Operating profit	**191.5**	303 9
Depreciation charge	**185.8**	176 9
Difference between pension charge and cash contributions (see note (i) below)	**0.8**	(68 0)
Amortisation of grants and contributions	**(2.7)**	(2.6)
Increase/(decrease) in environmental provision	**0.6**	(0 1)
Increase in deferred revenue due after one year	**-**	0 1
(Increase)/decrease in stocks	**(0.4)**	0 4
Decrease/(increase) in debtors	**86 4**	(24 5)
Increase in creditors	**10.5**	3 3
Total net cash inflow from operating activities	**472.5**	389 4

(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 2010 £m	Cash Flow £m	Other non-cash changes £m	**At 31 March 2011 £m**
Cash deposits	288 7	(116 7)	-	**172.0**
Cash and cash equivalents	288 7	(116 7)	-	**172.0**
Debt issue costs	49 8	-	(2 7)	**47.1**
Gilt lock proceeds (see note 16)	(5 9)	-	0 1	**(5.8)**
Deferred swap receipts (see note 16)	(44 6)	-	4 9	**(39.7)**
Loans due within one year	(30 3)	-	-	**(30.3)**
Loans due after one year	(3,446 5)	13 7	(83 7)	**(3516.5)**
	(3,188 8)	(103 0)	(81 4)	**(3,373.2)**

The non-cash movement of £81 4m 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 2011 (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 £36 8m (2010 deficit £65 9m) 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, was closed to new members on 31 December 1998, re-opened in July 2003 and closed once more to new entrants on 1 April 2005 This scheme has nine trustee directors The Southern Water Services Executive Pension Scheme (SWEPS) was also closed to new entrants and merged with the SWPS, on 1 April 2005

   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 2011 amounted to £0 4m (2010 £0 4m) 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 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 2011/12 are £6 8m and £0 3m respectively

The principal assumptions in the valuation were as follows

	2007
	SWPS
	% pa
Return on investments pre-retirement	**6.6**
Return on investments post-retirement	**5 2**
Salary growth	**4.5**
Pension increases on the excess over guaranteed minimum pensions	**3.2**

The assets of the scheme had a market value of £410 6m at 31 March 2007 This was sufficient to cover 81% of the scheme's benefits

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (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 2011 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

	2011	2010	2009
	% pa	% pa	% pa
Price inflation (RPI)	**3.5**	3 8	3 2
Price inflation (CPI)	**2.6**	-	-
Rate of increase in salaries (plus an age-related promotional scale)	**3.0**	4 3	4 5
Rate of increase of pensions in payment (MIS* members only)***	**2 6**	-	-
Rate of increase of pensions in payment (Old section** members only)***	**3.5**	3 8	3 2
Rate of increase of pensions in payment (all other members)***	**3.3**	3 8	3 2
Rate of increase for deferred pensions(MIS* members only)***	**2.6**	-	-
Rate of increase for deferred pensions(all other members)***	**3.5**	3 8	3 2
Discount rate	**5.6**	5 7	6 9
Expected return on assets	**6.9**	7 2	7 2

* MIS refers to the Southern Water Mirror Image Pension Scheme Pensions in payment and deferment for this section will be indexed in line with the Consumer Price Index

** For this section the Trustee will endeavour to meet any indexation of excess pension above the 5% per annum cap on increases that apply to other sections of the Scheme

*** in excess of any Guaranteed Minimum Pension (GMP) element

Assumptions regarding future mortality experience are set based on advice, published statistics and experience In 2011, the Company has used the post-retirement mortality assumptions comprising the '92' series based medium cohort mortality tables modified for appropriate assumptions

	2011	2010
	years	years
Longevity at age 65 for current pensioners		
Male	**21 8**	21 7
Female	**24 7**	24 7
Longevity at age 65 for future pensioners		
Male	**23 2**	23 2
Female	**26.2**	26 1

The assets and liabilities in the schemes and the expected rates of return at 31 March 2011 and 31 March 2010 were

	Rate of return 2011	Rate of return 2010	**Value at 2011 £m**	Value at 2010 £m
Equities	**8.0%**	8 3%	**325.8**	280 1
Government bonds	**4.3%**	4 5%	**79.8**	60 9
Non-Government bonds	**5.6%**	5 7%	**92.0**	76 5
Cash	**3.9%**	4 6%	**3.0**	62 7
Total market value of Plan assets			**500.6**	480 2
Total value of Plan liabilities			**(560.7)**	(589 0)
Accrued deficit in the Plan			**(60.1)**	(108 8)
Related deferred tax asset			**15.6**	30 5
Deferred tax on current year pension contribution			**7.7**	12 4
Net pension liability			**(36.8)**	(65 9)

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
The pension deficit includes a deferred tax asset of £7 7m in relation to the increased pension contribution made by the Company during the year to 31 March 2010 (see note 21(a)(i))

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

22 Pensions (continued)

Reconciliation of the present value of the scheme liabilities

	2011 £m	2010 £m
At 1 April	589 0	434 5
Current service cost	8.1	4 7
Interest cost	33.3	29 5
Member contributions	0.3	1 5
Actuarial (gain)/loss on liabilities	(47.5)	137 9
Benefits paid	(21.3)	(18 0)
Administrative expenses paid	(1.2)	(0 7)
Curtailments	-	(0 4)
Scheme liabilities at 31 March	560.7	589 0

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

	2011 £m	2010 £m
At 1 April	480.2	318 8
Expected return on assets	34.2	22 7
Gain on assets	1.1	83 6
Employer contributions	7.3	72 3
Member contributions	0.3	1 5
Benefits paid	(21.3)	(18 0)
Administrative expenses paid	(1.2)	(0 7)
Bid value of scheme assets at 31 March	500.6	480 2

Analysis of amounts charged to operating profit are as follows:

	2011 £m	2010 £m
Employer's current service cost	8.1	4 7
Expected return on pension scheme assets	(34.2)	(22 7)
Interest on pension scheme liabilities	33.3	29 5
Curtailments	-	(0 4)
Total P&L expense before deduction for tax	7.2	11 1

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (contınued)

22 Pensions (continued)

Analysis of the amounts recognised in STRGL:

	2011 £m	2010 £m
Actuarıal return less expected return on pensıon scheme assets	1.1	83 6
Experıence gaın/(loss) arısıng on scheme lıabılıtıes	6.0	(12 9)
Gaın/(loss) on change of assumptıons (fınancıal and demographıc)	41.5	(125 0)
Total gain/(loss) recognised in STRGL before adjustment for tax	48.6	(54 3)

The cumulatıve amount of actuarıal losses recognısed ın the statement of recognısed gaıns and losses ıs £92 3m (2010 £140 9m)

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

	2011 £m	2010 £m
Deficıt ın the scheme at 1 Aprıl	(108.8)	(115 7)
Employer's contrıbutıons	7.3	72 3
Employer's current servıce cost	(8.1)	(4 7)
Cost of curtaılments	-	0 4
Other fınance expense	0.9	(6 8)
Actuarıal loss	48.6	(54 3)
Deficıt ın the scheme at end of year	(60.1)	(108 8)
Deferred tax relatıng to scheme deficıt	15.6	30 5
Deferred tax on current year pensıon contrıbutıon	7.7	12 4
Net deficit at end of year	(36.8)	(65 9)

History of gains and losses for the year to 31 March 2011 are as follows:

	2011	2010	2009	2008	2007
a. Experience adjustment on planned assets					
Amount (£m)	(1 1)	(83 6)	104 3	37 5	3 2
b. Experience adjustment on scheme liabilities					
Amount (£m)	(6.0)	12 9	(13 1)	7 1	(7 1)
c. Total amount recognised in the STRGL					
Faır value of assets at year end (£m)	500.6	480 2	318 8	398 4	409 9
Actuarıal value of lıabılıtıes at year end (£m)	(560 7)	(589 0)	(434 5)	(479 4)	(513 9)
Deficıt ın scheme at year end (£m)	(60.1)	(108 8)	(115 7)	(81 0)	(104 0)

The assets ın the current year and the years ended 31 March 2010 and 2009 have been valued at bıd value as per FRS 17 amendment Southern Water has taken advantage of an exemptıon ın FRS 17 amendment, not to restate the years prıor to 31 March 2009 at bıd value

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2011 (continued)

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 (2010 £nil)

24 Financial commitments

As at 31 March 2011, 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**	
	2011	2010	**2011**	2010
	£m	£m	**£m**	£m
Expiring within one year	-	-	**0.1**	0 2
Expiring between two and five years	-	-	**0.1**	0 2
Expiring after more than five years	**1 3**	1 3	**0 1**	0 1
	1 3	1 3	**0.3**	0 5

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

25 Related party transactions and ultimate holding party

The immediate parent undertaking is SWS Holdings Limited

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 2011 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

In April 2011, the principle borrowings of Greensands Holdings Limited were refinanced As part of this refinancing Southern Water entered into £441 0m of long dated inflation linked swaps at their market value of £124 0m, in return for the cancellation of an equivalent value of cumulative redeemable preference shares

No change has been made to the Southern Water securitisation covenants

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 2011 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 statement of directors' responsibilities 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 and express an opinion on 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 read all the financial and non-financial information in the Operating and Financial Review and annual report of the directors to identify material inconsistencies with the audited financial statements If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report

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 2011 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.

Graham Lambert (Senior Statutory Auditor)
For and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Gatwick
10 June 2011