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Pennon Group Plc operates and invests in the areas of water and sewerage services and waste management. It has assets of £2.6 billion and employs around 2,300 people.

There are two main subsidiaries – South West Water Limited and Viridor Waste Limited.

South West Water Limited holds the water and sewerage appointments for Devon, Cornwall and parts of Dorset and Somerset.

Viridor Waste Limited is one of the leading waste treatment and disposal businesses in the United Kingdom.



Highlights of the year

A year of excellent progress

Turnover up 13% to £471.3 million

Operating profit up 7.3% to £136.3 million*

Profit before tax up 6.2% to £78.8 million*

Earnings per share up 4.9% to 57.7p**

Dividend per share up 4.9% to 41.0p†

* Before exceptional item relating to abortive acquisition costs of £6.5 million

** Before deferred tax and exceptional item. Basic earnings per share are 49.8p

† Excluding the special interim dividend in 2002/03

Contents

Chairman's statement	2
Business review	4
Financial review	12
Board of Directors	16
Directors' remuneration report	18
Corporate governance and internal control	25
Report of the Directors	28
Independent auditors' report	30
Financial statements	31
Five year financial summary	66
Shareholder information	67

We have made excellent progress this year. Our strong results demonstrate further profitable growth in South West Water Limited and Viridor Waste Limited, affirming our strategy once again of focusing on these two key businesses.

South West Water continued to perform well and drinking water quality and bathing water compliance levels in the region are at an all time high.

Viridor Waste has traded strongly, building on the growth achieved during the past decade.

Financial overview

Group turnover rose by 13.0% to £471.3 million, due mainly to the increased revenue arising from the Ofwat approved tariff increases in South West Water and from continued strong trading by Viridor Waste.

Before an exceptional item, operating profit increased by 7.3% to £136.3 million, profit before tax increased by 6.2% to £78.8 million and earnings per share (before deferred tax) rose by 4.9% to 57.7p.

In line with the Board's previously stated progressive dividend policy, a final dividend of 27.8p per share is recommended, which, with the interim dividend of 13.2p, will result in a full year dividend of 41.0p – an increase of 4.9% on the previous year.

Following its successful reintroduction last year, the Board once again intends to offer shareholders a scrip dividend alternative.

South West Water Limited

South West Water's key objectives include providing exemplary levels of product and customer service. Independent market research carried out amongst the company's customers continues to confirm high levels of satisfaction with the overall service provided by the company. The company is also continuing its good performance against Ofwat's prescribed customer 'Levels of Service Indicators' targets and is one of the industry leaders in managing water leakage and security of supply.

A milestone was achieved during the year with the completion of the original 'Clean Sweep' coastal bathing water treatment programme. The successful delivery of this initiative is great testament to the endeavours of South West Water employees, contractors and key regional stakeholders, including customers, who have all contributed to the completion of the biggest environmental improvement programme of its kind in Europe. Other initiatives taken by South West Water have made a significant contribution to the region now having the highest percentage length of high quality rivers in England.

In April 2004, South West Water submitted its Final Business Plan to Ofwat detailing its proposed strategy, estimate of expenditure needs and effect on average bills for the period 2005-2010. The Director General of Water Services will publish his Draft Determination on price limits for the water industry in August this year and then his Final Determination in December of the prices effective from 1 April 2005.

Viridor Waste Limited

Viridor Waste again performed strongly with operating profit contributions from landfill and power generation increasing by 23.2% and 46.1% respectively.

One acquisition was made during the year and one just after the year end. These reinforced the company's stated strategy of capitalising on its strong position in landfill disposal, exploiting opportunities in renewable energy and pursuing profitable opportunities in line with the Government's developing waste management strategy.

During the year, the acquisition of the UK landfill and landfill gas business of Shanks Group Plc was pursued. It was not successful due to a substantially higher bid being made. Whilst the business would have tied-in well with Viridor's strategy, as stated on a number of occasions, any acquisition we make has to satisfy the Group's criteria for investment in the waste sector, as well as reinforcing Pennon's progressive dividend policy. We were therefore not prepared to increase our price for these assets to a point where our investment criteria would not have been satisfied.

Approach received by the Board

Earlier this summer, following media speculation, the Board confirmed that it had received a preliminary and conditional approach for the entire issued share capital of the Company from a consortium of financial investors.

The Board unanimously decided that the approach failed to recognise the strategic value of Pennon, its track record and the future prospects of its two core businesses. South West Water has consistently outperformed its regulatory contract, while Viridor Waste continues to offer significant opportunities for earnings growth. The Board rejected the approach and this was confirmed after consultation with some of the Group's largest shareholders.

Pensions

The Group pension schemes showed an indicative net deficit at 31 March 2004 of £54.0 million, a level similar to that reported at the same time last year. A recovery in investment values has been offset by an increase in liabilities and higher expectations for future inflation. In line with recommendations from the scheme actuary, the Group resumed paying employer contributions in 2002/03 and increased these to 11.5% of pensionable pay in 2003/04.

Strategy and prospects

The Board's priority continues to be the creation of shareholder value through its strategic focus on water, sewerage and waste management. This will be achieved by South West Water continuing to outperform the current regulatory contract and growing its regulatory asset value (ahead of net debt) up to 2005 and Viridor Waste capitalising on the opportunities arising from its successful focused strategy.

Board matters

I was pleased to welcome Mr Gerard Connell as a Non-executive Director to the Board on 1 October 2003. Mr Connell has extensive financial and business experience and is currently Group Finance Director of Wincanton Plc. He has been appointed as Chairman of the Board's Audit Committee.

Employees

In the seven years it has been my privilege to be Chairman of the Group, many structural and organisational changes have taken place as the Group seeks to become more efficient and profitable. Throughout the many changes, our employees have continued to demonstrate a high level of loyalty, commitment and professionalism and I thank them and my fellow Directors most sincerely for their individual and collective efforts.



KG HARVEY, Chairman, Pennon Group Plc
24 June 2004

South West Water continued to deliver sound financial performance, to outperform the regulatory contract and to maintain improvements in services to customers.

South West Water Limited

The company's turnover increased by 8% from £270.2 million to £291.8 million primarily reflecting the impact of the tariff increases approved by the Director General of Water Services together with 6,900 new customer connections.

Operating costs increased by £14.2 million to £172.9 million including £8.6 million for the operation of new capital schemes, inflation of £3.4 million and £6.3 million of other cost increases, mainly pensions, direct cost of sales and bad debts. These costs were offset by efficiency savings of £4.1 million achieved during the year.

Operating profit increased by £7.4 million to £118.9 million. During the year a further 31,000 customers switched to a measured charging basis compared to 22,000 the previous year.

Some five years ago a restructuring and continuous improvement programme specifically designed to reduce significantly overhead and operating costs was introduced. Its successful delivery is ensuring South West Water continues to outperform the demanding operational and capital efficiency targets imposed by Ofwat and is on track to continue to do so for the remainder of the current regulatory period (K3, 2000 – 2005).

Since 1995, cost reductions totalling £46.0 million have been achieved by South West Water demonstrating its excellent track record in the area of efficiency saving.

In the constant drive to achieve further efficiencies, the company has also successfully launched new major management information systems in the areas of asset management, human resources and customer service management and is currently reviewing its organisational structure to ensure that improved levels of efficiency continue to be delivered in the future.

Exemplary levels of product and customer service remain one of the company's key objectives. Market research carried out amongst South West Water's customers continues to confirm high levels of satisfaction with the overall service provided by the company which is also continuing its generally good performance against Ofwat's prescribed 'Levels of Service Indicators' targets.

The region's water storage, treatment and distribution infrastructure has been progressively and significantly enhanced over the years and, as a direct result of careful planning and focused capital expenditure, the company has been able to fulfil the expectations of its customers for adequate supplies of high quality drinking water. The company's innovative and industry-leading leakage detection and control programme continues to deliver results in line with Ofwat's mandatory leakage targets and there have been no water restrictions since 1996.

During the K3 period, planned expenditure on water mains renovation will be in the order of £135.0 million with the length of mains scheduled for improvement more than double that achieved in the K2 period (1995 – 2000). Over 400 kilometres of water mains were laid, replaced or refurbished during the year. Improvements in water supply have been matched with improvements to water quality and during the year the company maintained its *highest ever drinking water compliance* level of 99.92% with the quality standards set by the Drinking Water Inspectorate.

In November 2003, the Department for Environment, Food and Rural Affairs (DEFRA) and the Environment Agency (EA) announced the best ever bathing water quality results for beaches and bathing waters along the West Country coastline. Only one of the 141 designated bathing waters in the region regularly monitored by the EA failed to comply with the European Union (EU) mandatory standards, with Devon achieving 100% compliance for the first time ever. The results also confirmed that 115 bathing waters met the more stringent EU guideline standards, one of the best performances of any region in the UK.

South West Water's original £1 billion 'Clean Sweep' bathing water improvement programme has been pivotal in achieving these record levels of compliance and the associated financial and environmental benefits for the region. Its successful delivery is great testament to the endeavours of South West Water employees, its contractors and regional key stakeholders including customers who have all contributed to the completion of the biggest environmental improvement programme of its kind in Europe.

A rolling programme of updating and modernising inland waste water treatment works to ensure compliance with environmental standards continued throughout the year and played a major role in helping the region achieve the highest percentage length of high quality rivers in England.

In line with regulatory requirements, capital expenditure for the year reduced by £42.2 million to £139.3 million with £67.0 million invested in water supply improvements including water mains renovation, water treatment works enhancement and leakage control. Waste water services investment expenditure was £72.3 million, of which £30.8 million was invested in the company's 'Clean Sweep' bathing water improvement programme.

South West Water's Periodic Review submission for the K4 period (2005 – 2010) has been made in accordance with Ofwat's required timescale. The Draft Determination on price limits is due to be published in August this year followed by the Final Determination in December 2004 of the prices effective from 1st April 2005.

Whilst acknowledging that further price increases will be inevitable, South West Water is endeavouring to strike a realistic balance between value for money investment, financeability and customer affordability.

Viridor Waste delivered further growth both organically and by acquisition.

Viridor Waste Limited

Viridor Waste made continued excellent progress with its focused strategy of:

- capitalising on its strong position in landfill waste disposal;
- exploiting opportunities in landfill gas power generation in line with the Government's target of increasing the proportion of electricity generated from renewable sources; and
- pursuing profitable opportunities arising from the Government's developing waste management strategy.

Turnover at £183.1 million was 20.2% up on the previous year. Operating profit before goodwill amortisation at £22.7 million was 18.8% up. Since 2001, operating profit before goodwill has grown at a compound annual rate of 20%, half of which is due to organic growth of the existing business and half to acquisitions. Profit before tax, after taking account of goodwill amortisation and interest costs associated with recent acquisitions, was up 3.5% in the year to £14.7 million. This financial performance reflects the success of Viridor Waste's focused strategy.

The previous year's acquisitions, Richardson Limited, Roseland Plant Co. Limited and Parkwood Holdings Limited are now fully integrated and performing in line with expectations. They were, in total, earnings enhancing before goodwill amortisation as forecast at the time of acquisition.

In June 2003, Viridor Waste acquired Churngold Holdings Limited for £19.8 million. This was in line with its strategy of pursuing profitable opportunities arising from the Government's developing waste management strategy, particularly in the areas of transfer stations and recycling. The acquisition brought Viridor Waste additional transfer station and recycling operations in the *West Country and Scotland with excellent synergies* with Viridor's existing operations in those areas. The acquisition is now largely integrated and was earnings enhancing before goodwill amortisation, a year ahead of forecast.

In April 2004 Viridor Waste acquired Thames Waste Management Limited for £30.5 million. Thames Waste Management comprises one operational landfill site of *four million cubic metres capacity strategically located* within the M25 motorway near Sutton, Surrey, 5 megawatts (MW) of landfill gas power generation capacity, four liquid waste treatment facilities together with an associated tanker fleet. The acquisition also includes a contract to handle the disposal of Thames Water's sewage sludge analogous to its existing contract with South West Water.

During the year, Viridor Waste gained planning approval for a further 3.1 million cubic metres of landfill capacity. After taking account of usage during the year of 4.3 million cubic metres and the acquisition of Thames Waste Management, Viridor Waste's total consented landfill capacity at the end of the year was 83 million cubic metres.

Total landfill disposal volumes for the year, excluding cover, increased by 6.3% to 3.7 million tonnes, largely reflecting the full year effect of the Parkwood Holdings acquisition. Viridor Waste remains confident that landfill will be the key final waste disposal route for the UK for the medium term. The series of measures taken by the Government over the past five years to encourage recycling and minimise the amount of waste going to final disposal can be expected to slow the growth in total volumes going to landfill. However, with a waste industry average of only around six years' remaining landfill life in the UK (according to the Environment Agency's estimates) and new planning permissions being increasingly difficult to achieve, Viridor Waste's 83 million cubic metres of consented void space is expected to become an increasingly valuable resource.

During the year, Viridor Waste increased its power generation capacity by a further 4MW (after last year's 9MW increase) in line with its policy of exploiting its landfill gas for generation of electricity and benefiting from premium prices under the Government's system of renewable obligation certificates (ROCs). Once again, Viridor Waste is exploiting the scarcity value of its asset base. With a Government target of 15% of electricity to be generated from renewable sources by 2015 compared with under 4% currently, Viridor Waste expects this element of its business to continue to increase. With the Thames Waste acquisition, Viridor Waste now has a total of 45MW of renewable energy capacity of which just over half benefits from ROCs.

During the year, Viridor Waste won a 25 year PFI contract with West Sussex County Council to provide waste management and recycling services. This contract commenced operation in April 2004.

Total recycling volumes increased from 183,000 tonnes to 331,000 tonnes as the company continues to seek profitable opportunities arising from the Government's developing waste management strategy. Composting volumes of green waste in the year increased to 42,000 tonnes from 35,000 tonnes in 2002/03.

Viridor Waste sees sustainability as key to its overall business and sets great store by its environmental and social policies. These will be covered more fully in Pennon's annual Environmental and Social Report. Viridor Waste is pleased to report that ISO 14001 accreditation was gained at four more of its sites, at Lean Quarry, Cornwall, Weston-super-Mare, Somerset and its Parkwood and Salmon Pastures facilities in Sheffield, Yorkshire.

Adding value for employees

The Pennon Group is committed to a culture of continuous improvement through investment in people at all levels within the Group.

Effective and proven employee communication practices are extensively applied throughout the Group which include in-house newspapers '*Flagstaff*' and '*Viridor Voice*' and a team briefing system, '*News and Views*'. The wide use of e-communication enables the Group to communicate quickly and effectively with all employees on all important issues affecting employees and the business including Group financial performance.

Viridor Waste has seen a number of waste management companies becoming part of the organisation via acquisition. Each company brings its own unique set of employees together with its own cultures, work ethics and contractual obligations. Viridor Waste works hard to ensure that as far as possible these cultures are absorbed within the Group and it is proud of its track record in this area. With acquisitions as geographically diverse as the South East, Scotland and the South West, the new Group employees are given the support and assistance they need to become part of the team. Feedback from employees is good and there have been no industrial relations issues as a consequence of an acquisition.

A new human resources management system has been introduced for Pennon and South West Water employees which, as well as improving payroll and personnel data management, will enable staff to view their personal data and instigate certain prescribed activities through a 'self service' system.

Both South West Water and Viridor Waste have staff associations. South West Water recognises three trade unions (GMB, AMICUS and TGWU) to represent the interests of their craft and industrial employees. In addition, staff employees elect representatives to the South West Water Staff Council which deals with areas of interest to all staff employees, both trade union and non-trade union alike. The trade union UNISON participates in the Staff Council, working on a partnership basis with the company. The Viridor Waste Management Staff Association, aligned with AMICUS, the second largest trade union in the UK and with strong links with the TGWU, GMB and UNISON, is also involved in a wide variety of staff issues, including looking at a number of communications initiatives.

The Group continues to offer a wide variety of training and development programmes to its employees in accordance with the principle that training shall be based around business objectives. Training and development of staff is regularly reviewed in the light of the needs of the individual and the company and is designed to achieve quality and excellence in performance. Last year South West Water successfully achieved reaccreditation as an 'Investor in People'.

The Pennon Group recognises that a commitment to health and safety contributes to business performance by reducing injuries and ill health. The understanding of mental health issues for example has been focused upon and 90 managers and team leaders have attended stress in the workplace awareness sessions. Additionally, in order to help meet South West Water's 'Clear Water 2010' objective to reduce the length of absences, it is introducing supportive 'return to work' interviews for employees. For those who have experienced long-term sickness absence, there are individually tailored schedules for their productive return to the workplace.

The Group continues to operate a non-discriminatory employment policy and, in addition to its 'Whistleblowing' and family-friendly policies, is constantly updating its employment policies to ensure full compliance with, and indeed exceedance of, the requirements of new 'Flexible Working' legislation. In addition, the Group is committed to pursuing equality and diversity in all its employment activities, including ensuring there is no bias and discrimination in the treatment of people. South West Water and Viridor Waste Equal Opportunities Policies set out standards and expectations of behaviour of all employees which are applied throughout the Group.

The Group encourages share ownership by operating an Inland Revenue approved sharesave scheme open to all eligible employees. Nearly 50% of eligible employees are currently saving in one or more of the Company's sharesave contracts.

Caring for the environment

The Group plays a major role in enhancing and maintaining the quality of the environment.

An environmental policy has been in place since the early days of the Group's life. It is reviewed annually by the Environment Committee of the Board and is set out in Pennon's annual Environmental and Social Report. The policy aims to achieve continuous improvement in environmental performance. This was reflected in a further improvement in the Group's ranking in the *Business in the Environment* 2003 survey, with the Group's overall ranking rising to 40th out of 176 (mainly FTSE 350) companies, compared to 55th out of 207 companies in the 2002 survey. Its overall score improved to 92.43% from 88.11%.

The Group has been listed in the *Dow Jones World* and the *Dow Jones STOXX Sustainability Indices* following their 2003 review reports. The Group scored 66% against an industry group average of 53% and this reflects the Group's excellent performance across economic, environmental and social criteria.

The Group has also been listed as a constituent member of the *FTSE4Good Index* recognising that it meets stated corporate responsibility criteria. In particular, the listing

acknowledges that the Group has policies and management systems in place to address social, environmental and ethical risks.

South West Water has been recognised by The Green Organisation by receiving two Gold Awards in the organisation's prestigious *Green Apple Awards*. The Gold awards were received for the 'De Lank Trunk Main Rehabilitation' project in Cornwall, which was undertaken in a very environmentally sensitive location, and for the company's 'Going for Green Energy Strategy', developed to reduce the company's environmental impact and create energy cost savings.

The important task of treating and disposing of society's waste in a sustainable and highly engineered manner is undertaken by the two principal operating companies within the Group, South West Water and Viridor Waste. Both companies acknowledge the importance of environmental sustainability and are committed to ensuring that their operations are undertaken in a manner which has regard to their environmental impact.

Viridor Waste has already achieved ISO 14001, the international environmental management standard, at most of its key sites and has a policy of gaining accreditation by its acquired companies. Recently, accreditation was gained at four more of its sites, at Lean Quarry in Cornwall, Weston-super-Mare, Somerset and at the Parkwood and Salmon Pastures facilities in Sheffield, Yorkshire. Key functions within South West Water have ISO 9001 accreditation, the international quality management standard, and the company is currently developing its strategy for the introduction of ISO 14001 across its business.

During the year, South West Water maintained its highest ever performance in drinking water compliance of 99.92% with the quality standards set by the Drinking Water Inspectorate.

South West Water's waste water compliance was the best ever achieved with 98.70% of the equivalent population served by waste water treatment works, compliant with sanitary parameters. In addition, the coastal waste water treatment improvement programme, 'Clean Sweep', continues to be a key contributor to the region having some of the finest bathing waters and beaches in Europe.

The region achieved over 99% compliance with European Union (EU) mandatory standards and 115 bathing waters met the more stringent EU guideline standards, the best performance of any region in the UK. The Environment Agency has also stated that the region features a higher percentage length of high quality rivers than any other region in England.

The Group is a major producer of renewable energy. Viridor Waste has substantially increased its landfill gas generation capacity thereby helping to achieve the Government's target of 15% of electricity generated from renewable energy by 2015. Following the April 2004 acquisition of Thames Waste Management Limited, Viridor Waste's capacity for power generation from landfill gas is now 45MW and the company generated 272 gigawatt hours (GWh) of energy during the year. South West Water for its part generates over 12GWh from hydro-electric and combined heat and power plants. In total, the Group generates the equivalent of 127% of its own electricity from renewable resources.

Construction activity associated with the Group's water, sewerage and waste management activities can have a significant impact on the local neighbourhood as well as on the natural habitat. The Group is committed to working closely with planners and interested parties to minimise such impacts and to ensure that the sites blend in with the natural environment. At most landfill sites and on many of the Group's construction projects, close contact continues to be maintained with the local community through formal liaison groups to discuss and, whenever possible, mitigate potential problems. This underlines the approach of the Group in its determination to be a good neighbour.

Involvement with the community

As a major Company within the region, Pennon Group feels it is of vital importance to invest in and help promote regional activities and assist in the overall enhancement and development of the region.

A substantial programme of community-based initiatives has been delivered over the past 14 years which has seen many individuals and organisations both large and small benefit from financial and practical support. These include the Eden Project, the National Maritime Museum, the National Marine Aquarium and many hundreds of smaller local initiatives.

South West Water fully recognises the role its customers play in assisting it to provide levels of product and services in line with customers' expectations. To encourage customer feedback, the company carries out consultation exercises to ensure it understands their views.

Viridor Waste continues to be heavily involved in the local community in areas where it operates and in the wider social arena. Viridor Waste has active liaison groups at over 90% of its major operational sites which provide an open channel of communication between the company, local residents and other parties with an interest or role in the operation of the site. The company continues to sponsor local charitable work and has also contributed to National Campaigns, e.g. Jeans for Genes Day and Breast Cancer Awareness Day. The company also supports local schools and has provided financial assistance to three secondary schools located near landfill facilities. This support is in line with the partnership approach adopted with schools in all of the operational areas.

The Group's financial involvement in the community is channelled through a number of initiatives:

■ *Charitable Donations* – Charitable donations by Pennon Group amounting to £50,000 were made during the year. These donations were primarily to charities operating in Devon and Cornwall, where the average size of donation of around £500 can make a significant impact on the services provided by these organisations.

■ *South West Water Community Sponsorship Programme* – Funds amounting to £62,000 were awarded during the year across a wide range of activities.

■ *Landfill Tax Credit Scheme (LTCS)* – This scheme enables Viridor Waste to deliver lasting environmental and social benefits for communities in the vicinity of its landfill operations. The Government made changes to the scheme at the beginning of the year, re-allocating funding previously available for sustainable waste management research and development to a public spending programme. This resulted in a reduction in the amount available for distribution by Viridor Waste. At the same time a new biodiversity category was created and made eligible for funding through the reduced scheme. Projects are now being funded under this category that will enrich local biodiversity and provide lasting quality wildlife habitats.

Over £40 million has now been distributed to Environmental Bodies via the Scheme, providing funding for over 1,000 projects since it began in 1996. Funds of £4.6 million were awarded in the year to a diverse range of projects which enabled development of village and community halls, play areas, museums and other local amenity facilities, together with lakelands, wetlands, woodlands and other conservation initiatives. Most of the funding is distributed through local steering groups and decisions are taken using the three primary criteria of sustainability, value for money and proven local need. The continued success of the LTCS helps secure additional matched-funding for projects and strengthens local partnerships between Viridor Waste and the communities in which it operates.

■ *Pennon Environmental Fund Committee* – The Committee was formed with the specific aim of bringing environmental and social benefits to the communities within South West Water's operating area by utilising some of Viridor Waste's landfill tax credits. Following the changes to the landfill tax credit regulations, the amount

it had available to distribute was considerably less than in previous years. During the year it distributed £100,000 to support a diverse range of projects across the region.

■ *South West Water Special Assistance Fund* – The Fund was established to provide help to customers trying to pay their water and sewerage bills but who, for reasons of severe financial or personal difficulties, were having problems paying the full amount. Although South West Water provides administrative support to the Fund, the decisions on applications for help are made by a panel drawn from the South West Water Customer Consultative Group.

Social and Ethical Policy

The Pennon Group aims to establish and preserve a reputation for integrity and fair dealing. It believes that such a reputation is essential to the long term well-being of the Group itself, its shareholders, employees, customers, suppliers and the community in which it operates. To facilitate these ethical business practices, the Group has adopted a Social and Ethical Policy which is applied Group-wide. The six key areas are finance, employees, customers and suppliers, community, management responsibility and communications. More comprehensive details of the Social and Ethical Policy may be found in the Environmental and Social Report.

The Group operates a non-discriminatory employment policy and every reasonable effort is made to ensure that no current or future employee is disadvantaged because of age, gender, religion, colour, ethnic origin, marital status, sexual orientation, or disability.

The Group's previously mentioned 'Whistleblowing' policy supports its approach to ethics in business by encouraging employees to raise, in accordance with a formalised procedure, concerns which relate to potential unlawful conduct, financial malpractice, dangers to the public or damage to the environment. This policy also protects employees who raise such concerns from victimisation or harassment.

The Group's financial results showed growth in turnover, operating profit* and profit before tax*.

Operating profit

Turnover rose by 13.0% to £471.3 million. South West Water Limited turnover was £291.8 million, up 8.0% on 2002/03, principally resulting from the additional increase in tariffs approved by the regulator. Turnover for Viridor Waste Limited at £183.1 million was 20.2% up on 2002/03. The acquisition of Churngold Holdings Limited accounted for £16.2 million, increased existing business £8.8 million and increased landfill tax £5.8 million.

Group operating profit before the exceptional item (relating to abortive acquisition costs of £6.5 million) increased by £9.3 million to £136.3 million. South West Water achieved a £118.9 million operating profit, up £7.4 million on 2002/03. Viridor Waste contributed £20.2 million (after goodwill amortisation of £2.5 million) up £2.6 million on 2002/03 and representing 15.6% of the operating profit of the Group in 2003/04 (2002/03 – 13.9%).

Group earnings before interest, taxation, depreciation and goodwill amortisation (EBITDA) amounted to £222.0 million before the exceptional item (2002/03 £206.3 million) including South West Water £181.7 million (2002/03 £170.7 million) and Viridor Waste £43.2 million (2002/03 £38.2 million).

Total Group operating costs were £335.0 million excluding the exceptional item, (2002/03 £290.2 million) and included the following major categories of expenditure:

	£ million
Depreciation and goodwill amortisation	88.6
Manpower	57.9
Landfill tax	48.5
Raw materials and consumables	23.4
Property costs	14.5
Transport	13.8
Power	10.6
Abstraction and discharge consent costs	7.3
Statutory operating licences and royalties	5.5
Lease rentals – plant and machinery	3.5
Offsetting the above power costs was revenue from power generation of £13.7 million.	

*before exceptional item

Finance costs

Net interest payable was £57.2 million (2002/03 £52.1 million), which was 2.4 times covered by Group operating profits in both years.

Gross interest payable was £66.6 million. Gross interest receivable of £9.4 million was derived from the investment of temporarily surplus funds.

Net interest payable represents an average rate of 5.5% when measured against average net debt (2002/03 6.0%).

Profit before tax

Profit before tax was £78.8 million before the exceptional item, £4.6 million up on 2002/03, an increase of 6.2%.

Vinidor Waste achieved a pre-tax return on investment in 2003/04 of 7.5% (2002/03 7.4%).

Taxation

The corporation taxation charge for the year was £7.5 million (2002/03 £3.4 million). The deferred tax charge for the year was £3.3 million (2002/03 £13.7 million).

Earnings per share

Earnings per share before deferred tax and the exceptional item increased by 4.9% to 57.7p. Basic earnings per share increased 12.4% to 49.8p.

Dividends and retained earnings

The Directors recommend the payment of a final dividend of 27.8p per share for the year ended 31 March 2004. Together with the interim dividend of 13.2p per share paid on 6 April 2004 this makes a total dividend for the year of 41.0p per share, an increase of 4.9% on the dividend for 2002/03 after excluding the special interim dividend of 70.0p per share in 2002/03.

The dividend of 41.0p is paid out of adjusted earnings per share of 52.4p before deferred tax, giving a cash dividend cover of 1.3 times.

The total cost of the interim and recommended final dividend of the Company is £51.1 million. The retained surplus of £10.4 million has been transferred to reserves.

International Financial Reporting Standards

The Group will be required to adopt International Financial Reporting Standards (IFRS) for its 2005/06 financial year. In preparation for this, existing international standards are being reviewed, although determining the full effect of adopting these standards depends upon the completion of the standard-setting process by the International Accounting Standards Board and the endorsement of standards by the European Union.

The principal differences between current UK and international accounting standards likely to impact on the Group are expected to be in relation to deferred tax, goodwill, fixed asset accounting and pensions.

Investment

Capital expenditure by the Group on tangible fixed assets was £170.0 million (2002/03 £204.6 million). The major categories of expenditure comprised:

	£ million
South West Water	
Water mains renovation	29.0
Water supply leakage control	8.4
Water treatment works	4.2
Sewage treatment works	30.3
Sewerage	30.7
Sewage sludge treatment	4.7

	£ million
Viridor Waste	
Landfill	17.5
Power generation	2.1
Collection	5.3

Other expenditure included investment in information systems, metering and transport.

In the opinion of the Directors the current market value of land and buildings is not significantly different from the holding cost shown in the financial statements.

Financing

The net cash inflow from operating activities was £215.1 million (2002/03 £198.9 million). Capital expenditure cash outflow in 2003/04 was £181.9 million, a reduction from £201.7 million in 2002/03. The cash outflow for acquisitions was £20.0 million (2002/03 net outflow of £37.2 million). Equity dividends paid and servicing of net debt involved a cash outflow of £88.3 million (2002/03 £190.2 million, including the payment of the special dividend of £95.9 million).

Overall, the net cash outflow of the Group, before the use of liquid resources and financing, was £72.5 million (2002/03 £226.7 million outflow).

Financing during the year included £36.4 million drawdown of finance lease facilities (2002/03 £62.6 million).

At 31 March 2004 loans and finance lease obligations were £1,341.8 million and the Group held current asset investments and cash of £267.7 million. Net borrowings increased by £85.5 million during the year from £988.6 million to £1,074.1 million, principally as a result of the payment of dividends, the cost of acquisitions of £20.0 million and capital expenditure of £181.9 million.

Net borrowings represent 119% of shareholders' funds compared with 111% in 2002/03.

The Group uses financial derivatives, usually interest rate swaps, to manage the mix of fixed and floating rate debt, to ensure that at least 50% of net debt is at fixed rate. To take advantage of current historically low interest rates and reduce the risk of adverse movements over the next

few years, South West Water has entered into swap arrangements to fix the interest rate on the majority of its debt for the period up to the next Periodic Review.

The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and *are not, therefore, an exposure for the Group*. These instruments are analysed in more detail in note 27 to the financial statements.

The borrowing powers of the Directors are limited to two and a half times capital and reserves, as defined in the Company's Articles of Association. At 31 March 2004 the limit was £2.3 billion. The Directors confirm that the Group can meet its short-term requirements from the existing borrowing facilities without breaching covenants or other borrowing restrictions.

Pensions

The Company operates a defined benefit pension scheme for existing staff of, and new entrants to, Pennon and South West Water and for certain employees of Viridor Waste. Having reviewed practices in the waste industry, Pennon set up a defined contribution scheme in July 2003 for other Viridor Waste employees and employees from certain acquired waste companies.

The last actuarial valuation of the Pennon defined benefit scheme in April 2001 indicated a scheme surplus, enabling continuation of the employer contribution holiday in 2001/02. In response to deteriorating stock market conditions, the Group resumed employer cash contributions of 4.8% and 11.5% of pensionable pay in 2002/03 and 2003/04 respectively, in line with recommendations from the scheme actuary.

The next triennial actuarial review is currently underway and is expected to result in additional costs of up to £6 million in 2004/05.

Under Financial Reporting Standard 17 'Retirement Benefits', the Group pension schemes had net liabilities at 31 March 2004 of £54.0 million. This represents circa 6% of total market capitalisation.

Payments to suppliers

It is the Company's payment policy for the year ending 31 March 2005 to follow the Code of The Better Payment Practice Group on supplier payments. Information about the Code can be obtained from www.payontime.co.uk. The Company will agree payment terms with individual suppliers in advance and abide by such terms. The ratio, expressed in days, between the amount invoiced to the Company by its suppliers during 2003/04 and the amount owed to its trade creditors at 31 March 2004 was 49 days.

Share capital

During the year the Company's issued ordinary share capital increased from £137.2 million to £137.9 million. The weighted average number of shares in issue during the year was 123.5 million (2002/03 128.8 million). The reduction results from the share capital consolidation undertaken in September 2002.

The value of net assets per share at book value at 31 March 2004 was 725p.

Permission was obtained from shareholders at the annual general meeting in July 2003 to purchase up to 10% of the Company's ordinary share capital. Renewal of the authority will be sought at the July 2004 annual general meeting.

■ **Kenneth George Harvey** *BSc, CEng, FIEE (63)*

Non-executive Chairman

Was appointed on 1 March 1997. He was formerly chairman and chief executive of Norweb Plc. He was chairman of National Grid Holdings in 1995 and was previously deputy chairman of London Electricity and earlier its engineering director. He is also a non-executive chairman of Beaufort International Plc and a non-executive director of National Grid Transco Plc.

■ **Robert John Baty** *OBE, FREng, CEng, FICE, FCIWEM, CCMI, ACI Arb (60)*

Chief Executive, South West Water Limited

Was appointed on 1 March 1996. He was formerly engineering and scientific director of South West Water Services Limited having joined South West Water Authority in 1988. Previously he held engineering and operational appointments with North West Water Authority.

■ **Colin Irwin John Hamilton Drummond** *MA, MBA, LTCL, CCMI (53)*

Chief Executive, Viridor Waste Limited

Was appointed on 1 April 1992. Prior to joining the Company he was a divisional chief executive of Coats Viyella, having previously been corporate development director of Renold plc, a strategy consultant with the Boston Consulting Group and an official of the Bank of England. He was a member of the Government's Advisory Committee for Business in the Environment between 2001 and 2003.

■ **David Jeremy Dupont** *MA, MBA (50)*

Group Director of Finance

Was appointed on 2 March 2002. He was formerly regulatory and finance director of South West Water Limited, having joined Pennon Group Plc (then South West Water Plc) in 1992 as strategic planning manager. Previously he held business planning and development roles with Gateway Corporation.

■ **Gerard Dominic Connell** *MA, FCA (46)*

Senior independent Non-executive Director

Was appointed on 1 October 2003. He is currently Group Finance Director of Wincanton Plc. Previously he was a director of Hill Samuel and a managing director of Bankers Trust and has held other corporate finance and business development positions in the City and in industry.

■ **Katharine Mary Hope Mortimer** *MA, BPhil (58)*

Non-executive Director

Was appointed on 1 May 2000. She is currently a freelance financial consultant, a member of the Crown Agents Foundation Council and a director of Crown Agents Asset Management Limited and Crown Agents Financial Securities Limited. She was formerly a director of N M Rothschild & Sons Limited, Director of Policy at the Securities and Investments Board, Chief Executive of Walker Books and was a member of the Competition Commission between 1995 and 2001.

■ **Dinah Alison Nichols** *CB, BA Hons (60)*

Non-executive Director

Was appointed on 12 June 2003. She was formerly Director General (Environment) at the Department for Environment, Food and Rural Affairs and previously held various senior appointments within Government departments including being Head of the Water Directorate during the period of water privatisation. She is also a Crown Estate Commissioner, a non-executive director of Shires Smaller Companies Plc, a board member of Toynbee Housing Association and the chairman of Toynbee Partnership Housing Association.

Committees of the Board

■ **Audit**

G D Connell (Chairman)
Ms K M H Mortimer
Ms D A Nichols

■ **Environment**

B A O Hewett (Chairman) (co-opted member)
R J Baty
C I J H Drummond

■ **Nomination**

K G Harvey (Chairman)
G D Connell
Ms K M H Mortimer
Ms D A Nichols

■ **Remuneration**

Ms K M H Mortimer (Chairman)
G D Connell
Ms D A Nichols

■ **Company secretary and registered office**

K D Woodier
Peninsula House, Rydon Lane, Exeter EX2 7HR
Registered in England No 2366640

■ **Auditors**

PricewaterhouseCoopers LLP
Chartered Accountants
31 Great George Street, Bristol BS1 5QD

■ **Registrars**

Lloyds TSB Registrars
The Causeway, Worthing, West Sussex BN99 6DA

Directors' remuneration report

The Remuneration Committee

The Remuneration Committee's terms of reference include advising the Board on the framework of executive remuneration for the Group and responsibility for determining the remuneration and terms of employment of the Executive Directors and senior management of the Group. The Committee comprises three Non-executive Directors, being Ms K M H Mortimer, who chairs the Committee, Mr G D Connell (appointed to the Committee on 1 October 2003) and Ms D A Nichols (appointed to the Committee on 12 June 2003). Sir Geoffrey Chipperfield and Mr A T Fletcher were members of the Committee until their retirement from the Board as Non-executive Directors on 31 July 2003. During the year the Committee met on eight occasions and received advice, or services, that materially assisted the Committee in their consideration of remuneration matters from Mr K G Harvey (Chairman of the Company), Mr K D Woodier (Group General Counsel & Company Secretary), the Monks Partnership – remuneration consultants, (not appointed by the Committee) and Hewitt Bacon & Woodrow – pensions and remuneration consultants (appointed by the Committee).

Market data from the Monks Partnership and from Independent Remuneration Solutions on Non-executive Directors' fees have been considered by the Executive Directors in determining the fees of the Non-executive Directors (please refer to page 21).

The Monks Partnership is a trading part of PricewaterhouseCoopers LLP who provided audit and non-audit services to the Group and Hewitt Bacon & Woodrow provided actuarial and investment pensions advice to the Group during the year.

Remuneration policy

The policy of the Group, which will be applied in 2004/05 and is also currently intended to be applied in each subsequent year, continues to be to provide for Executive Directors a remuneration package which is adequate to attract, retain and motivate good quality executives and which is commensurate with the remuneration packages provided by companies of similar size and complexity.

Executive Directors

The remuneration package of the Executive Directors is summarised below. It comprises salary, annual bonus, long term incentives, pensions, car benefit and health cover. The total package is regularly reviewed by the Committee to ensure that it is consistent with overall policy. In 2004/05 (subject to fluctuations in the Company's share price and not taking account

of the proposal to operate in 2004/05 the Company's Restricted Share Plan at a level up to 150% of basic salary for the reason stated in section (iii) on the opposite page) it is expected that just over 60% of Directors' potential direct remuneration (i.e. excluding pensions, car benefit and health cover) will again be performance related. It is intended that this balance between performance related and that which is not related to performance will continue.

(i) *Basic salary and benefits* – These are set out on page 22 for each Executive Director and are not related to performance. However, the Committee determines revised salaries, usually on an annual basis, for Executive Directors based upon surveys conducted by external consultants (being the Monks Partnership during 2003/04) and the performance of the individual Executive Directors which they assess with the advice of Mr K G Harvey, Chairman. Other benefits, not mentioned below, include contributory pension provision, a fully expensed car and health cover.

(ii) *Performance related bonus* – Annual performance related bonuses are awarded in accordance with an Incentive Bonus Plan for Executive Directors and based on the achievement of overall corporate and individual objectives established by the Committee. The maximum cash bonus achievable under the Plan for Executive Directors is 40% of basic salary which can be matched by a conditional award of shares in the Company of an equivalent value as a long term incentive. Any shares awarded usually have to be held for a period of three years and are conditional upon continuous service with the Company. During this period the Directors, in respect of these shares, are entitled to receive any dividends declared by the Company. No additional performance conditions applicable to the release of these shares are considered appropriate by the Committee in view of the performance conditions applicable to the initial award of the shares.

The following corporate and individual objectives of the Executive Directors applicable to the cash bonus and to the matched deferred share award for 2004/05 were determined by the Committee as appropriate having regard to the activities of the Group that each individual Director could most influence and also to the overall performance of the Group, all of which seek to align the interests of the Directors with those of shareholders:

R J Baty

– A bonus of up to a maximum of 10% for outperformance of Group earnings per share against budget and up to 30% bonus calculated by reference to the average bonus earned by the Directors of South West Water (which relate to outperformance against the operating costs and the profit before tax budgets of

the company; the position the company achieves in the overall performance assessment of water and sewerage companies established by the Director General of Water Services; and the achievement of a range of service standards set by the Director General of Water Services for the company).

C I J H Drummond

– A bonus of up to a maximum of 10% for outperformance of Group earnings per share against budget and up to 30% bonus calculated by reference to outperformance of profit before tax of Viridor Waste against budget; and for personal objectives relating to key business targets of Viridor Waste.

D J Dupont

– A bonus of up to a maximum of 10% for outperformance of Group earnings per share against budget and up to 30% bonus for outperformance against budget relating to net debt and net interest of the Group, profit before tax of South West Water and Viridor Waste; and for personal objectives relating to Group financing.

(The previous references to a percentage bonus relate to a percentage of the annual basic salary of each Executive Director in 2004/05). The achievements of the Executive Directors against their individual performance objectives are assessed by the Committee following the financial year end when the audited results of the Company and performance against parameters set are known. This enables the Committee to apply largely objective criteria in determining the level of bonus (if any) that should be awarded, with the advice of Mr K G Harvey, Chairman.

(iii) Long Term Incentive Plan – A Restricted Share Plan for Executive Directors and senior management, as approved by shareholders at the annual general meeting on 29 July 1997, was operated by the Company during the year. However, in respect of the Executive Directors and certain senior management, no award was made during the year because of the existence of unpublished price sensitive information relating to the Company. Subject to shareholder approval of a change to the rules of the Restricted Share Plan at the annual general meeting on 29 July 2004, it is the Company's intention to make in 2004 the usual annual awards and, in addition, for the Executive Directors and senior management who did not receive the awards in 2003, a further award of up to 75% of their basic salary (being an equivalent percentage to that which they did not receive in 2003). The Plan currently provides for Executive Directors to receive a conditional award of shares in the Company up to a value of 75% of their basic salary provided they make a matching investment in shares of the Company (by way of shares they

already hold or which they purchase) in the ratio of one investment share for every four shares awarded. The eventual number of shares, if any, which the Directors may receive is dependent upon the achievement of the performance condition of the Plan over the restricted period, being not less than three years. During the restricted period the Directors are entitled to receive, in respect of the awarded share, any dividends declared by the Company. In respect of the awards made to the Directors for the years 1997, 1998 and 1999, no shares vested at the end of each successive three year restricted period because the performance criteria had not been met on each occasion. With regard to the year 2000 award, all of the shares awarded to Directors were due to vest at the end of the three year restricted period in September 2003 because the performance condition had been met in full. However, because of the existence of unpublished price sensitive information relating to the Company at this time these shares did not vest until 27 May 2004. It is also expected that all of the shares awarded in 2001 to Directors will vest at the end of the three year restricted period in September 2004 because the performance condition has been met in full. For each of the years 2000, 2001 and 2002 the performance condition was:

The total shareholder return (TSR) achieved by the Company in the performance period must be greater than that of the Company at or nearest to (but not above) the 50th percentile position of the comparator group.

The comparator group applicable in 2003/04 was as follows, with the comparator group applicable to other award years being similar in content and size:

awg Plc
Bristol Water Group Plc
British Energy Plc
Centrica Plc
Dee Valley Group Plc
East Surrey Holdings Plc
International Power Group Plc
Kelda Plc
National Grid Transco Plc
Pennon Group Plc
Scottish & Southern Energy Plc
Scottish Power Plc
Severn Trent Plc
South Staffordshire Group Plc
United Utilities Plc
Viridian Plc

Directors' remuneration report

The TSR performance condition was applied by the Committee because, based upon advice received previously from Meis – remuneration consultants, it believes that this is an appropriate measure to align the interests of the Executive Directors with those of shareholders. In addition, the Committee believes that comparing the TSR of the Company to the other companies in the comparator group is appropriate because the other companies operate in a sector similar to that of the Company and therefore it is possible to demonstrate superior performance by the Company if its TSR is at least higher than half of the other companies in the comparator group.

If the performance condition is met then 50% of an award for the year in question will vest with 100% of an award vesting if the Company achieves a position at least equal or closest to but not above the 75th percentile position of the comparator group. The achievement of a position between the 50th percentile position and the 75th percentile position will result in vesting in steps reflecting the number of companies within that third quartile of the comparator group.

The TSR of each company in the comparator group is measured by Hewitt Bacon & Woodrow and is calculated by taking the average market value of each company's shares for the whole of March before the beginning of the three year performance period and comparing this to the average market value of the same shares for the whole of March at the end of the three year period. The share price is averaged for the whole of the month of March to avoid any distortion of the TSR values from any significant daily share price movements during the month.

(iv) Sharesave Scheme – Executive Directors are entitled to participate in this Scheme. It is an all-employee plan to which performance conditions do not apply.

(v) Service Agreements – In accordance with Company policy, all Executive Directors have service agreements which are subject to one year's notice and which expire when Directors reach their normal retirement age. No provision is made for termination payments under the service agreements. In the event of termination by the Company of any Executive Director's service agreement, the Board would determine what payments, if any, should be made to the Director depending on the circumstances of the termination. The dates of the agreements are:

Mr R J Baty	26 February 1996
Mr C I J H Drummond	5 March 1992
Mr D J Dupont	2 January 2003

(vi) Provision for Pension – Executive Directors participate in the Pennon Group Pension Scheme and the Pennon Group Executive Pension Scheme. These are funded defined benefit schemes. Through membership of these schemes, Executive Directors will be provided with a pension which, dependent on length of service at normal retirement date (age 60 or 62), will normally amount to two thirds of final pensionable pay (subject to any restriction in respect of the Earnings Cap).

Mr C I J H Drummond and Mr D J Dupont are subject to the Earnings Cap and both were provided with additional pension benefits under the unapproved funded Supplementary Scheme in order to bring their pension benefits up to a level which would have been provided under the other schemes if the Earnings Cap had not applied. Executive Directors included in the unapproved pension arrangements received payments equivalent to the tax liability which arises in respect of Company contributions to the Supplementary Pension Scheme.

The pensionable pay for Executive Directors consists of the highest basic salary in any consecutive twelve month period of service within five years of retirement. Bonuses are not included in pensionable pay.

In determining remuneration arrangements for Executive Directors, full consideration is given to their impact on the pension funds and costs of providing individual pension arrangements.

Total shareholder return graph

The graph shows the value, over the five year period ending in March 2004, of £100 invested in Pennon Group on 31 March 1999 compared with the value of £100 invested in the FTSE All-Share Utilities – Other Index. This Index is considered appropriate as it is a broad equity market index of which the Company is a constituent.

This performance graph has been produced in accordance with Schedule 7A of the Companies Act 1985 as introduced by the Directors' Remuneration Report Regulations 2002.

GRAPH

Non-executive Directors

Non-executive Directors' remuneration (excluding the Chairman, Mr K G Harvey) consisting of fees only as set out on page 22, is determined by the Board of Directors (in the absence of the Non-executive Directors and the Chairman) and is usually reviewed biennially, although in 2003/04 they were reviewed after one year to take account of any market changes in Non-executive Directors' fees arising from the impact of the Higgs Review on Non-executive Directors. The intention is to review fees again at the end of 2004/05 because it is believed that the impact of the Higgs Review on Non-executive Directors increased duties and obligations has not yet been fully reflected in fee levels. In

reviewing the fees, the Executive Directors take account of market information on Non-executive Directors' fees, most recently from the Monks Partnership and Independent Remuneration Solutions, as presented to them by the Group General Counsel & Company Secretary. The policy is to set fees around the median level compared to the market, which the Executive Directors believe is appropriate to attract and retain suitably experienced Non-executive Directors on the Board. The Chairman's remuneration is set by the Executive Directors in the same manner having regard to the same considerations but in addition, the Chairman receives car benefit and health cover. No other benefits or remuneration are received by the Chairman.

The fees of the Non-executive Directors (excluding the Chairman) that would have been payable for the full year were made up as follows:

	Basic fee £000	Audit/Remuneration Committee membership fee (£2,500 per Committee) £000	Deputy Chairmanship fee £000	Chairman of Committee fee £000	Second Board fee £000	Total £000
<i>Non-executive Directors</i>						
Sir Geoffrey H Chipperfield*	25	5	5	2	–	37
A T Fletcher*	25	5	–	2	12 [†]	44
G D Connell	25	5	–	2	–	32
Ms K M H Mortimer	25	5	–	2	–	32
Ms D A Nichols	25	5	–	–	–	30

*Retired from the Board on 31 July 2003

[†]Mr A T Fletcher remains a Non-executive Director of the Viridor Waste Limited Board

The Non-executive Directors (excluding the Chairman) have contracts for services which are subject to the Articles of Association of the Company and which may be extended by agreement between the Company and the Non-executive Directors. No provision is made for any termination payment under these contracts.

The dates of their contracts are:

	Date of contract	Expiry of contract
Sir Geoffrey H Chipperfield	14 July 1993	31 July 2003
A T Fletcher	14 May 1993	31 July 2003
G D Connell	30 September 2003	30 September 2006
Ms K M H Mortimer	1 May 2000	30 April 2006
Ms D A Nichols	10 June 2003	11 June 2006

The Chairman, Mr K G Harvey, has a contract for services dated 30 September 1998 which is subject to 12 months' notice. No provision is made for any termination payments under this contract.

Directors' remuneration report

Emoluments of Directors

The emoluments of individual Directors are shown in the table below:

	Salary/fees £000	Performance related bonus payable [†] £000	Other emoluments £000	Payments related to supplementary pension £000	Total 2004 £000	Total 2003 Restated £000
<i>Chairman:</i>						
K G Harvey	143	–	21	–	164	151
<i>Executive Directors:</i>						
R J Baty	170	49	15	–	234	218
C I J H Drummond	170	59	20	51	300	273
D J Dupont	150	45	16	35	246	196
<i>Non-executive Directors:</i>						
Sir Geoffrey H Chipperfield*	12	–	–	–	12	34
G D Connell	16	–	–	–	16	–
A T Fletcher*	15	–	–	–	15	41
Ms K M H Mortimer	31	–	–	–	31	27
Ms D A Nichols	24	–	–	–	24	–
Total	731	153	72	86	1,042	940

*Retired from the Board on 31 July 2003 but Mr A T Fletcher remains a Non-executive Director of Viridor Waste Limited and received a fee for this directorship after 31 July 2003 of £11,000.

[†]In addition to the cash bonus, Directors receive a conditional award of shares for a matching amount as referred to in a note to (c) Annual Incentive Bonus Plan – Deferred Shares on page 24 and which is subject to a future service criterion. This is a change to the presentation previously adopted and the total for 2003 above has been restated accordingly.

Other emoluments are car benefit and health cover.

No expense allowances chargeable to tax or termination/compensation payments were made during the year.

Directors' pensions

Defined benefit pensions accrued and payable on retirement for Directors holding office during 2003/04 are shown in the table below:

	Increase in accrued pension during 2003/04 (net of inflation) £000 <i>a</i>	Increase in accrued pension during 2003/04 £000 <i>b</i>	Accrued pension at 31 March 2004 £000 <i>c</i>	Transfer value at 31 March 2004 £000 <i>d</i>	Transfer value at 31 March 2003 £000 <i>e</i>	Increase in transfer value (net of Directors' contributions) £000 <i>f</i>	Transfer value of Column <i>a</i> (net of Directors' contributions) £000 <i>g</i>
R J Baty	8	12	122	2,316	1,872	435	152
C I J H Drummond	6	7	57	768	572	187	71
D J Dupont	8	9	47	551	377	167	87

Column *a* above is the increase in accrued pension during 2003/04 (net of inflation). It recognises:

- i* the accrual rate for the additional period's service based upon the pensionable pay at the end of the period; and
- ii* the effect of pay changes in real terms (net of inflation) upon the accrued pension at the start of the year.

Column *b* is the actual increase in accrued pension during 2003/04.

Column *c* is the accrued pension at 31 March 2004 payable at normal retirement age.

Column *d* is the transfer value of the accrued pension set out in column *c* as at 31 March 2004.

Column *e* is the transfer value of the accrued pension at the end of the previous financial year on 31 March 2003.

Column *f* is the increase in the transfer value during the year (column *d* minus column *e*) after deducting Directors' contributions.

Column *g* is the transfer value of column *a*, less Directors' contributions.

Columns *d*, *e*, *f* and *g* have been calculated in accordance with Actuarial Guidance Note GN11.

Directors' pensions *continued*

The Supplementary Pension Scheme, which mainly funds pension provision above the Earnings Cap, provides benefits in tax-paid lump sum form at retirement. Appropriate figures have been included in the accrued pension totals shown on page 22.

Directors have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the table shown on page 22.

Directors' share interests

(a) Shareholdings

The number of shares of the Company in which Directors held beneficial interests at 31 March 2004 and 31 March 2003 were:

	2004	2003		2004	2003
R J Baty	28,722	26,792	K G Harvey	2,644	2,644
C I J H Drummond	14,455	12,270	Ms K M H Mortimer	256	256
D J Dupont	15,924	15,841			

Additional shares have been acquired/(sold) by the Directors since 31 March 2004 as follows:

	a	b	c
R J Baty	77	16,174	(6,632)
C I J H Drummond	49	16,174	(6,632)
D J Dupont	49	6,842	(2,806)

Column *a* shares were acquired as a result of participation in Personal Equity Plans and Individual Savings Accounts on 8 April 2004.

Column *b* shares were acquired on 27 May 2004 as a result of vesting of the 2000 award under the Restricted Share Plan.

Column *c* shares were the number of column *b* shares sold on 28 May 2004 to meet the income tax and National Insurance liabilities of the Directors in respect of their receipt of the column *b* shares.

There have been no other changes in the beneficial interests or the non-beneficial interests of the Directors in the ordinary shares of the Company between 1 April 2004 and 30 May 2004.

(b) Restricted Share Plan

In addition to the above beneficial interests, the following Directors have a contingent interest in the number of shares shown below, representing the maximum number of shares to which they would become entitled under the Group's Long Term Incentive Plan if all of the relevant criteria were met.

	Conditional awards held at 1 April 2003	Conditional awards made in year	Market price upon award in year	Vesting in year	Conditional awards held at 31 March 2004	Date of end of period for qualifying conditions to be fulfilled
<i>R J Baty</i>						
12/9/00	16,174	–	598p	–	16,174*	11/9/03
11/9/01	16,294	–	622p	–	16,294	10/9/04
16/9/02	18,514	–	638p	–	18,514	15/9/05
<i>C I J H Drummond</i>						
12/9/00	16,174	–	598p	–	16,174*	11/9/03
11/9/01	16,294	–	622p	–	16,294	10/9/04
16/9/02	18,514	–	638p	–	18,514	15/9/05
<i>D J Dupont</i>						
12/9/00	6,842	–	598p	–	6,842*	11/9/03
11/9/01	7,038	–	622p	–	7,038	10/9/04
16/9/02	14,694	–	638p	–	14,694	15/9/05

*These shares vested after the year end on 27 May 2004 at a market price of 730p per share as detailed in column *b* of the table in (a) Shareholdings, above.

Directors' remuneration report

Directors' share interests *continued*

During the year the Directors received dividends on the above shares in accordance with the conditions of the Restricted Share Plan, details of which may be found in the Directors' remuneration report on page 19.

(c) Annual Incentive Bonus Plan – Deferred Shares (long term incentive element)

Director and date of award	Conditional awards held at 1 April 2003	Conditional awards made in year	Market price upon award in year	Vesting in year	Conditional awards held at 31 March 2004	Date of end of period for qualifying conditions to be fulfilled
R J Baty						
26/7/02	7,885	–	652p	–	7,885	25/7/05
25/7/03	–	6,435	652p	–	6,435	24/7/06
C I J H Drummond						
26/7/02	5,554	–	652p	–	5,554	25/7/05
3/12/02	1,161	–	607p	–	1,161	2/12/05
25/7/03	–	7,990	652p	–	7,990	24/7/06
D J Dupont						
26/7/02	4,728	–	652p	–	4,728	25/7/05
25/7/03	–	6,146	652p	–	6,146	24/7/06

A further conditional award of shares will be made in 2004/05 to match the amount of the cash bonus shown in the Emoluments of Directors table on page 22. (Paragraph (ii) on page 18 of the Directors' remuneration report sets out the provisions relating to the conditional award of shares pursuant to the Annual Incentive Bonus Plan).

During the year, the Directors received dividends on the above shares in accordance with the conditions of the Bonus Plan, details of which may be found in the Directors' remuneration report on pages 18 and 19.

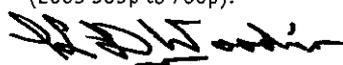
(d) Sharesave Scheme

Details of options to subscribe for shares of the Company under the all-employee Sharesave Scheme were:

Director and date of grant	Options held at 1 April 2003	Granted in year	Exercised in year	Market price on exercising	Options held at 31 March 2004	Exercise price	Exercise period/maturity date
R J Baty							
4/7/00	1,260	–	1,260	584p	–	461p	–
10/7/01	792	–	–	–	792	489p	1/9/04 – 1/3/05
8/7/03	–	1,047	–	–	1,047	530p	1/9/06 – 1/3/07
C I J H Drummond							
4/7/00	2,101	–	2,101	584p	–	461p	–
8/7/03	–	1,745	–	–	1,745	530p	1/9/06 – 1/3/07
D J Dupont							
9/7/02	2,924	–	–	–	2,924	566p	1/9/07 – 1/3/08

(e) Share price

The market price of the Company's shares at 31 March 2004 was 690.5p (2003 660p) and the range during the year was 575p to 697p (2003 585p to 760p).



By Order of the Board

K D WOODIER, Group General Counsel & Company Secretary

24 June 2004

Compliance

The Board is committed to the highest standards of corporate governance with the aim of continuing to enhance its effectiveness. The Annual Report is the principal means of reporting to shareholders on the Board's governance policies. This section sets out how the principles of good corporate governance contained in Section 1 of the Combined Code issued in June 1998 and annexed to the UK Listing Authority Rules have been applied by the Company in practice. A number of the enhanced corporate governance practices adopted by the Board during the year arise from the new Code on Corporate Governance derived from a review of the role and effectiveness of Non-executive Directors by Derek Higgs and a review of audit committees by a group led by Sir Robert Smith, which is applicable to companies reporting years beginning on or after 1 November 2003. Reporting against this new Code will commence in the Company's 2005 Annual Report. Throughout the year, the Company has complied with the provisions of the 1998 Combined Code except in respect of the appointment of a Senior independent Non-executive Director for part of the year as set out below.

The Board

The Board of Directors at the end of the year comprised the Chairman, three Executive Directors and four Non-executive Directors. Ms D A Nichols and Mr G D Connell were appointed Non-executive Directors on 12 June and 1 October 2003 respectively. Sir Geoffrey Chipperfield and Mr A T Fletcher were also Non-executive Directors on the Board until their retirement on 31 July 2003. All of the Non-executive Directors are considered to be independent and Sir Geoffrey Chipperfield was the Senior independent Non-executive Director until his retirement on 31 July 2003, with Mr G D Connell being subsequently appointed to the position on 7 June 2004. The biographies on page 17 demonstrate a broad range of business and financial experience and there is a clear separation in the roles of Chairman and the Chief Executives of South West Water Limited and Viridor Waste Limited. All Directors are subject to re-election at least every three years.

During the year the Board met on twelve occasions and at each meeting all Directors were present with the exception of Ms Nichols and Mr Baty each on one occasion. The Board has adopted a Group Policy which includes a schedule of matters reserved for its decision. The Board has delegated more detailed consideration of certain matters to Board Committees, to the subsidiary boards of South West Water Limited and Viridor Waste Limited and to the Executive Directors and Group General Counsel & Company Secretary as appropriate. Recognising this policy, the matters reserved to the Board include the approval of financial statements, acquisitions and disposals, major items of capital

expenditure, authority levels for other expenditure, risk management and approval of the Strategic Plan and annual operating budgets. The Board operates by receiving written reports circulated in advance from the Executive Directors and the Group General Counsel & Company Secretary on matters within their respective business areas within the Group. Under the guidance of the Chairman, all matters before the Board are discussed openly and, if necessary, presentations and advice are received on occasions from other senior executives within the Group or external advisers.

Directors have access to the advice and services of the Group General Counsel & Company Secretary and the Board has established a procedure whereby Directors, in order to fulfil their duties, may seek independent professional advice at the Company's expense. The training needs of Directors are reviewed on a regular basis.

The Board has adopted an internal procedure to evaluate the performance of the whole Board, each Committee, the Chairman, each individual Director and the Group General Counsel & Company Secretary. This evaluation procedure is being carried out for the year by the Group General Counsel & Company Secretary, seeking all participants' views on a range of prescribed questions designed to ensure objective evaluation of performance. The participants' responses are then to be summarised by the Group General Counsel & Company Secretary for the Board to consider and determine whether any changes are necessary for the Board to be more effective.

All Directors are equally accountable for the proper stewardship of the Group's affairs with the Non-executive Directors having a particular responsibility for ensuring strategies proposed for the development of the business are critically reviewed. The Non-executive Directors also critically examine the operational and financial performance of the Group and fulfil a key role in corporate accountability through their membership of various Committees of the Board. Group Policy allocates the tasks of giving detailed consideration to specified matters, to monitoring executive actions and to assessing reward to the Board Committees as follows:-

Audit Committee

The Audit Committee was chaired by Sir Geoffrey Chipperfield until his retirement on 31 July 2003 and then came under the Chairmanship of Mr G D Connell from his appointment on 1 October 2003. The other members of the Committee during the year were Mr A T Fletcher (until his retirement on 31 July 2003), Ms K M H Mortimer and Ms D A Nichols (from her appointment on 12 June 2003). During the year, the Committee met on four

Corporate governance and internal control

Audit Committee *continued*

occasions and all members were present. Its Terms of Reference includes reviewing the adequacy and effectiveness of the financial and operating controls and reporting systems of the Group (through the work undertaken by the external auditors and internal audit section of the Company); considering overall budgetary controls and executive delegations; considering the annual review undertaken by the Group of the effectiveness of the system of internal control to ensure compliance by the Group with the Group Risk Management Policy and internal controls; approving annually an audit plan for the Group; considering and recommending to the Board the appointment of external auditors of the Company and its subsidiaries and approving their remuneration; discussing with the external auditors the scope of their audit and considering the reports of the external auditors; and considering matters, including those relating to any unethical or fiduciary activities, which Directors may wish to raise with the Chairman of the Committee. The Committee pays particular attention to the independence and objectivity of the auditors and has established a policy for the engagement of the auditors for non-audit work by the Group. In addition, the Company's current auditors ensure that the senior partner responsible for the external audit of the Group remains responsible for such audit for no more than five years and that there is an independent concurring review partner of the auditors who is involved in planning and in the reviewing of the final accounts of the Company and also any critical matters that may be identified in the audit. Details of audit and non-audit fees are contained in note 3 to the Financial Statements on page 39. The Group Director of Finance attends by invitation and the Company's auditors have the right of direct access to the Committee without the presence of any Executive Director.

Remuneration Committee

The Remuneration Committee was chaired by Ms K M H Mortimer from 1 August 2003 and Mr G D Connell (from his appointment on 1 October 2003) and Ms D A Nichols (from her appointment on 12 June 2003) were members of the Committee. Sir Geoffrey Chipperfield chaired the Committee until his retirement on 31 July 2003 and Mr A T Fletcher was also a member of the Committee until his retirement on 31 July 2003. The Committee met on eight occasions during the year and all members were present. The Committee is responsible for determining the remuneration and terms of employment of the Executive Directors and senior management of the Group. Members of the Remuneration Committee do not participate in decisions concerning their own remuneration. The Directors' report on remuneration, which also provides more information on the activities of the Remuneration Committee, appears on pages 18 to 24.

Nomination Committee

The Nomination Committee was chaired by Mr K G Harvey and also comprised Ms K M H Mortimer and both Sir Geoffrey Chipperfield and Mr A T Fletcher until their retirement on 31 July 2003. Ms D A Nichols was appointed a member of the Committee on 12 June 2003 and Mr G D Connell on 1 October 2003. It meets as and when required to select and recommend to the Board suitable candidates for appointment as Executive and Non-executive Directors. During the year, it met with all members present on two occasions to consider the appointment of Non-executive Directors. In order to assist in the determination of the suitability of the persons recommended for appointment, each Non-executive Director and the Executive Directors met the candidates independently.

Environment Committee

The Environment Committee was chaired by Mr B A O Hewett (a co-opted member and former Non-executive Director of the Company) and also comprised the Chief Executives of South West Water Limited and Viridor Waste Limited. The Committee met four times during the year with all members present except Mr Drummond on one occasion. It is responsible for reviewing and monitoring the environmental policies of Group companies and their achievement of environmental objectives and targets and considering the Group's annual Environmental and Social Report.

Internal control

■ Wider aspects of internal control

The Board confirms that it continues to apply procedures in accordance with the guidance *'Internal Control: Guidance for Directors on the Combined Code'*. As part of these procedures the Board has a formalised risk management policy which provides for the identification of key risks in relation to the achievement of the business objectives of the Group. This policy is applied by all business units within the Group in accordance with an annual timetable.

A full risk and control assessment is undertaken annually by the management of each business to identify financial and non-financial risks. Each business unit management committee then receives as part of its regular management reports an enhanced and focused assessment of key risks against corporate objectives. The Board at each meeting receives from Executive Directors details of any new high level risks identified and how they are to be managed, together with details of any changes to existing risks and their management. The Boards of South West Water Limited and Viridor Waste Limited also receive at each meeting similar reports in respect of their own areas of responsibility. All senior managers are required to certify on an annual basis that they have established effective controls to manage risks and to

Internal control *continued*

operate in compliance with legislation and Group procedures. All of these processes serve to ensure that a culture of effective control and risk management is embedded within the organisation and that the Group is in a position to react appropriately to new risks as they arise.

After the end of each financial year, both the Board and the Audit Committee receive a report from the Group General Counsel & Company Secretary on overall internal control compliance by the Group. An evaluation of the effectiveness of internal control is then undertaken initially by the Audit Committee and then reported on to the Board for final evaluation. For 2003/04, both the Committee and the Board were satisfied with the effectiveness of the internal control process and its operation.

■ Internal Financial Control

The Directors are responsible for the Group's system of internal financial control. A system can only provide reasonable and not absolute assurance against material mis-statement or loss.

There is an established internal control framework which comprises:

(a) a clearly defined structure which delegates an appropriate level of authority, responsibility and accountability, including responsibility for internal financial control, to management of operating units;

(b) a comprehensive budgeting and reporting function with an annual budget approved by the Board of Directors, which also monitors monthly achieved results and updated forecasts for the year against budget;

(c) documented financial control procedures. Managers of operating units are required to confirm annually that they have adequate financial controls in operation and to report all material areas of financial risk. Compliance with procedures is reviewed by the Company's internal audit function; and

(d) an investment appraisal process for evaluating proposals for all major capital expenditure and acquisitions, with defined levels of approval and a system for monitoring the progress of capital projects.

The Audit Committee regularly reviews the operation and effectiveness of this framework.

Treasury activities

The Group's treasury operations are managed in accordance with policies established by the Board. Major transactions are individually approved by the Board. Treasury activities are reported to the Board and are subject to review by internal audit.

Financial instruments are used to raise finance and to manage risk. The Group does not engage in speculative activity.

The principal financial risks faced by the Group relate to interest rate and counterparty risk. Further details are included in note 27 to the Accounts.

Going concern

The Directors consider, after making appropriate enquiries, that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Directors' responsibilities statement

The Directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and the Group as at the end of the financial year and of the profit or loss of the Group for the financial year.

In preparing the financial statements, appropriate accounting policies have been used and consistently applied and reasonable and prudent judgements and estimates have been made. All relevant accounting standards which the Directors consider to be applicable have been followed.

The Directors have responsibility for ensuring that accounting records are kept which disclose with reasonable accuracy the financial position of the Company and the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985. They are responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Relations with shareholders

The Company maintains a regular dialogue with its institutional shareholders and has a well developed investor relations programme. During the year meetings with institutional shareholders were held and were attended by the Group Director of Finance and the Company's Investor Relations Manager and, on certain occasions, the Chairman, the Chief Executive of South West Water Limited and the Chief Executive of Viridor Waste Limited also attended. The Board encourages the participation of shareholders at the annual general meeting and complies with the provisions of the Combined Code in respect of relations with shareholders.



By Order of the Board

K D WOODIER, Group General Counsel & Company Secretary

24 June 2004

Report of the Directors

The Directors submit their report and audited financial statements for the year ended 31 March 2004.

Principal activity and business review

The principal activities of the Company and its subsidiaries ('the Group') continue to be the provision of water and sewerage services and waste management. Further information regarding the Group, including important events and its progress during the year, events since the year end and likely future developments is contained in the Chairman's statement, in the Business review and in the Financial review on pages 2 to 15.

The principal subsidiaries of the Company are listed in note 29 to the financial statements on page 57.

Financial results and dividend

Group profit on ordinary activities after taxation was £61.5 million. The Directors recommend a final dividend of 27.8p per ordinary share to shareholders on the register on 9 July 2004, making a total for the year of 41.0p, the cost of which would be £51.1 million, leaving a retained surplus of £10.4 million to be transferred to reserves.

The Financial review on pages 12 to 15 analyses the results in more detail and sets out other financial information, including the Directors' opinion on asset values.

Directors

Ms D A Nichols and Mr G D Connell were appointed as Non-executive Directors on 12 June 2003 and 1 October 2003 respectively. Following his appointment by the Board, Mr G D Connell is due to retire at the annual general meeting and offers himself for election. A resolution for his election will be proposed at the annual general meeting.

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

A list of all the Directors during the year is set out in the emoluments table on page 22. Further details relating to the Directors and their service contracts are set out on pages 17, 20 and 21 and details of the Directors' interests in shares of the Company are given on pages 23 and 24.

Employment policies and employee involvement

Details are set out in the Business review on pages 8 and 9.

Research and development

Research and development activities within the Group during the year amounted to £0.1 million (2002/03 £0.1 million).

Donations

During the year charitable donations amounting to £50,000 were made. Details relating to charitable and other donations are set out in the Business review on pages 10 and 11. No political donations were made.

Tax status

The Company is not a close company within the meaning of the Income and Corporation Taxes Act 1988.

Payments to suppliers

Details are set out in the Financial review on page 15.

Substantial shareholdings

Details are set out in the Shareholder information section on page 67.

Auditors

PricewaterhouseCoopers LLP were appointed auditors until the conclusion of the fifteenth annual general meeting. A resolution for their re-appointment upon the recommendation of the Audit Committee of the Board will be proposed at the annual general meeting and the auditors have indicated their willingness to continue in office.

Appointed business

South West Water Limited is required to publish additional financial information relating to the 'appointed business' as water and sewerage undertaker in accordance with the Instrument of Appointment from the Secretary of State for the Environment. A copy of this information will be available from 15 July 2004 upon application to the Company Secretary at Peninsula House, Rydon Lane, Exeter EX2 7HR.

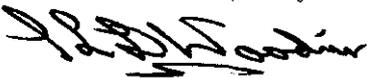
Annual general meeting

The fifteenth annual general meeting will be held at the Plymouth Pavilions, Millbay Road, Plymouth, Devon PL1 3LF on 29 July 2004 at 11.00am.

In addition to routine business, resolutions will be proposed at the annual general meeting to:

- renew the existing authorities to issue a limited number of shares and to purchase up to 10% of the issued share capital;
- seek authority to make political donations under the Political Parties, Elections and Referendums Act 2000;
- elect Mr G D Connell as a Director of the Company;
- seek approval to amend the rules of the Pennon Group Restricted Share Plan to permit the Company to make an award of up to 150% of participants' basic salary in the calendar year 2004 (the maximum being 75% at present) because an award was not made the previous year due to the existence of unpublished price sensitive information.

Details of the resolutions are set out in the Notice of Meeting which is circulated separately to the Annual Report.



By Order of the Board

K D WOODIER, Group General Counsel & Company Secretary

24 June 2004

Independent auditors' report

Independent auditors' report to the members of Pennon Group Plc

We have audited the financial statements which comprise the Group profit and loss account, the Group balance sheet, the Company balance sheet, the Group cash flow statement, the accounting policies and the related notes. We have also audited the disclosures required by Part 3 of Schedule 7A to the Companies Act 1985 contained in the Directors' remuneration report ('the auditable part').

Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and accounting standards are set out in the Directors' responsibilities statement. The Directors are also responsible for preparing the Directors' remuneration report.

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

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the auditable part of the Directors' remuneration report have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions is not disclosed.

We read the other information contained in the Annual Report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. The other information comprises only the Chairman's statement, the Business review, the Financial review, the unaudited part of the Directors' remuneration report, the statement of compliance on corporate governance and the Report of the Directors.

We review whether the statement of compliance on corporate governance reflects the Company's compliance with the seven provisions of the Combined Code issued in June 1998 specified for our review by the Listing Rules of the Financial Services Authority and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or to form an opinion on the effectiveness of the Company's or Group's corporate governance procedures or its risk and control procedures.

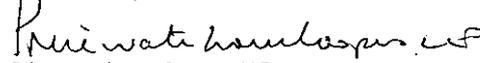
Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the auditable part of the Directors' remuneration report. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the auditable part of the Directors' remuneration report are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Company and the Group at 31 March 2004 and of the profit and cash flows of the Group for the year then ended, have been properly prepared in accordance with the Companies Act 1985 and those parts of the Directors' remuneration report required by Part 3 of Schedule 7A to the Companies Act 1985 have been properly prepared in accordance with the Companies Act 1985.


PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors
Bristol

24 June 2004

Group profit and loss account

for the year ended 31 March 2004

	Notes	Before exceptional item 2004 £m	Exceptional item 2004 £m	Total 2004 £m	2003 £m
Turnover					
Continuing operations		455.1	-	455.1	417.2
Acquisitions		16.2	-	16.2	-
Total turnover	2	471.3	-	471.3	417.2
Operating costs	3	(335.0)	(6.5)	(341.5)	(290.2)
Group operating profit					
Continuing operations		135.7	(6.5)	129.2	127.0
Acquisitions		0.6	-	0.6	-
Total Group operating profit	2	136.3	(6.5)	129.8	127.0
Share of operating loss in:					
Joint venture		(0.3)	-	(0.3)	(0.1)
Associate		-	-	-	(0.6)
Total operating profit		136.0	(6.5)	129.5	126.3
Net interest payable	5	(57.2)	-	(57.2)	(52.1)
Profit on ordinary activities before taxation					
Tax on profit on ordinary activities	6	(10.8)	-	(10.8)	(17.1)
Profit on ordinary activities after taxation					
Dividends	8	(51.1)	-	(51.1)	(144.3)
Retained surplus/(deficit) transferred to/(from) reserves	24	16.9	(6.5)	10.4	(87.2)
Earnings per share					
9					
Before exceptional item and deferred tax:					
Adjusted basic				57.7p	55.0p
Adjusted diluted				57.3p	54.8p
After exceptional item and deferred tax:					
Basic				49.8p	44.3p
Diluted				49.5p	44.2p
Dividend per share	8			41.0p	109.1p

All operating activities are continuing operations.

There were no recognised gains or losses, other than the profit for the year, in 2004 and 2003.

There is no difference between the profits as reported and those profits on a historical basis.

The notes on pages 34 to 65 form part of these financial statements.

Balance sheets

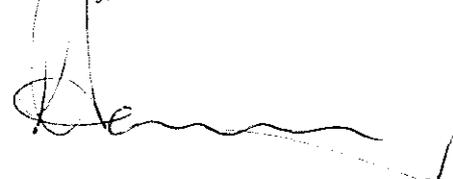
at 31 March 2004

	Notes	Group		Company	
		2004 £m	2003 £m	2004 £m	2003 £m
Fixed assets					
Intangible assets	12	47.6	37.6	-	-
Tangible assets	13	2,141.1	2,046.4	0.2	0.2
Investments	14	3.6	1.9	932.0	928.7
		2,192.3	2,085.9	932.2	928.9
Current assets					
Stocks	15	4.5	4.0	-	-
Debtors: amounts falling due after more than one year	16	5.0	5.5	230.8	175.4
Debtors: amounts falling due within one year	17	92.3	82.1	25.8	58.9
Investments	18	253.7	182.4	-	-
Cash at bank and in hand		14.0	8.6	-	-
		369.5	282.6	256.6	234.3
Current liabilities					
Creditors: amounts falling due within one year	19	(293.6)	(265.1)	(476.1)	(402.2)
Net current assets/(liabilities)		75.9	17.5	(219.5)	(167.9)
Total assets less current liabilities					
Creditors: amounts falling due after more than one year	20	(1,234.9)	(1,083.3)	(158.7)	(233.7)
Provisions for liabilities and charges	21	(94.0)	(90.6)	(0.1)	(0.3)
Deferred income	22	(38.7)	(39.4)	-	-
Net assets	2	900.6	890.1	553.9	527.0
Capital and reserves					
Called-up share capital	23	137.9	137.2	137.9	137.2
Share premium account	24	154.2	152.8	154.2	152.8
Profit and loss account	24	608.5	600.1	261.8	237.0
Shareholders' funds	25	900.6	890.1	553.9	527.0

The notes on pages 34 to 65 form part of these financial statements.

Approved by the Board on 24 June 2004 and signed on its behalf by:

K G Harvey, Chairman



Group cash flow statement

for the year ended 31 March 2004

	Notes	2004 £m	2003 £m
Net cash inflow from operating activities	32(a)	215.1	198.9
Returns on investments and servicing of finance	32(b)	(41.3)	(42.9)
Taxation		(0.1)	-
Capital expenditure and financial investment	32(b)	(179.2)	(198.2)
Acquisitions	32(b)	(20.0)	(37.2)
Equity dividends paid		(47.0)	(147.3)
<hr/>			
Net cash outflow before use of liquid resources and financing		(72.5)	(226.7)
Management of liquid resources	32(b)	(62.1)	67.6
Financing	32(b)	156.3	140.7
<hr/>			
Increase/(decrease) in cash in year	32(c)	21.7	(18.4)

Notes to the financial statements

1. Accounting policies

The following paragraphs describe the main policies:

(a) Accounting convention

The financial statements have been prepared under the historical cost convention and in compliance with all applicable accounting standards, the requirements of the Financial Services Authority and, except for the treatment of grants and contributions on infrastructure assets, with the Companies Act 1985. An explanation of this departure from the requirements of the Companies Act 1985 is given in note 1(h) below.

(b) Basis of consolidation

The Group financial statements include the results of the Company and its subsidiary undertakings, each made up to 31 March 2004, together with the attributable share of results and reserves of joint ventures and associated undertakings on the basis of their latest financial statements. The results of any undertakings acquired or disposed of during the year are included for the periods of ownership.

(c) Turnover

Turnover, excluding Value Added Tax, represents the income receivable in the ordinary course of business for goods and services provided.

(d) Landfill tax

Landfill tax is included within both turnover and operating costs.

(e) Intangible fixed assets and amortisation

From 1 April 1998 goodwill arising from the acquisition of subsidiary, joint venture and associated undertakings, representing the excess of the purchase consideration over the fair value of net assets acquired, is capitalised and classified as an asset on the balance sheet. Where goodwill has a finite economic life, it is amortised evenly over that period. For acquisitions before 1 April 1998 goodwill arising was written off directly to Group reserves.

When a subsidiary, joint venture or associated undertaking is sold, the profit or loss on disposal is determined after including the attributable amount of unamortised goodwill or the goodwill previously written off to Group reserves.

(f) Tangible fixed assets and depreciation

i Infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls)

Infrastructure assets comprise a network that, as a whole, is intended to be maintained in perpetuity at a specified level of service by the continuing replacement and refurbishment of its components.

Expenditure on infrastructure assets relating to increases in capacity or enhancement of the network, in accordance with defined standards of service and to the maintenance of the operating capacity of the network, is treated as an addition and included at cost after deducting grants and contributions.

The depreciation charge on infrastructure assets represents the level of annual expenditure required to maintain the operating capacity of the network and is calculated from an independently certified asset management plan.

1. Accounting policies *continued*

(f) Tangible fixed assets and depreciation *continued*

ii Landfill sites

Landfill sites are included at cost less accumulated depreciation. The cost of a landfill site is depreciated over its estimated operational life taking account of the usage of void space. Cost includes acquisition and development expenses.

iii Other assets (including properties, overground plant and equipment)

Other assets are stated at cost less accumulated depreciation.

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives, which are principally as follows:

<i>Leasehold buildings</i>	<i>Over the period of the lease</i>
<i>Freehold buildings</i>	<i>30-60 years</i>
<i>Operational structures</i>	<i>40-80 years</i>
<i>Fixed plant</i>	<i>20-40 years</i>
<i>Vehicles, mobile plant and computers</i>	<i>3-10 years</i>

Assets in the course of construction are not depreciated until commissioned.

The cost of assets includes directly attributable labour and overhead costs that are incremental to the Group.

(g) Leased assets

Assets held under finance leases are included in the balance sheet as tangible fixed assets at their equivalent capital value and are depreciated over their estimated economic lives or the finance lease period, whichever is the shorter. The corresponding liability is recorded as a creditor. The interest element of the rental costs is charged against profits, using the actuarial method, over the period of the lease.

Rental costs arising under operating leases are charged against profits in the year they are incurred.

(h) Grants and contributions

Grants and contributions receivable in respect of capital expenditure on non-infrastructure assets are included in the balance sheet as deferred income and are released to profits over the depreciable lives of the assets to which they relate.

Grants and contributions receivable relating to infrastructure assets have been deducted from the cost of tangible fixed assets. This is not in accordance with the Companies Act 1985 which requires tangible fixed assets to be shown at cost and hence grants and contributions as deferred income. This departure from the requirements of the Companies Act 1985 is, in the opinion of the Directors, necessary for the financial statements to show a true and fair view as while a provision is made for depreciation of infrastructure assets, these assets do not have determinable finite lives and therefore no basis exists on which to recognise grants and contributions as deferred income. The effect of this treatment on the value of tangible fixed assets is disclosed in note 13.

Grants and contributions receivable in respect of expenditure charged against profits in the year have been included in the profit and loss account.

1. Accounting policies *continued*

(i) Investments

Listed investments held as current assets are stated at the lower of cost and net realisable value.

Short-dated unlisted securities held as current assets are stated at cost plus accrued income.

(j) Fixed asset investment in own shares and impairment

Shares acquired under the Employee Share Ownership Plan, a discretionary trust, are recognised on the balance sheet at cost of acquisition less impairment, being the charge to profits over the period to which the employees' performance relates.

(k) Stocks

Stocks are stated at the lower of cost and net realisable value. Cost includes labour, materials and an element of overheads.

(l) Pension costs

The expected cost of pensions in respect of the Group's defined benefit pension schemes is charged against profits so as to spread evenly the cost of pensions over the service lives of employees in the schemes. A pension surplus (or deficit) is released (or charged) to profits using the straight line method, over the average remaining service lives of employees in the scheme.

Pension costs for the Group's defined contribution schemes are charged against profits in the year in which they are incurred.

The financial statements reflect, as set out in note 30, only the disclosure requirements of Financial Reporting Standard 17 'Retirement Benefits'.

(m) Research and development expenditure

Research and development expenditure is charged against profits in the year in which it is incurred.

(n) Taxation

Tax payable on profits for the year is provided at current rates. Tax deferred or accelerated as a result of timing differences between the treatment of certain items for taxation and for accounting purposes is provided in full. Where the effect of the time value of money is material the current amount of the reversals of tax deferred is discounted to its present value. The unwinding of the discount to present value is included in the tax charge.

Deferred tax assets are recognised to the extent that it is regarded as more likely than not that there will be suitable taxable profits against which the deferred tax asset can be recovered in future periods.

1. Accounting policies *continued*

(o) Environmental and landfill restoration costs

Provisions for restoration, aftercare and environmental control costs are made when an obligation arises. Where the obligation recognised as a provision gives access to future economic benefits, a tangible fixed asset is recognised. Provisions are otherwise charged against profits.

Where the effect of the time value of money is material, the current amount of the provision is the present value of the expenditures expected to be required to settle obligations. The unwinding of the discount to present value is included as a financial item within net interest payable.

(p) Financial instruments

Derivative financial instruments are used to hedge interest rate risks. All such hedging instruments, including interest differentials which arise, are matched with their underlying hedged item.

2. Segmental analysis

	2004 £m	2003 £m
Turnover		
<i>Continuing operations</i>		
Water and sewerage	291.8	270.2
Waste management	183.1	152.3
Other	7.3	5.2
Less intra-group trading	(10.9)	(10.5)
Group total	471.3	417.2
Group operating profit		
<i>Continuing operations before exceptional item and goodwill amortisation</i>		
Water and sewerage	118.9	111.5
Waste management	22.7	19.1
Other	(2.8)	(2.1)
Total continuing operations before exceptional item and goodwill amortisation	138.8	128.5
Group operating profit		
<i>Continuing operations after exceptional item and goodwill amortisation</i>		
Water and sewerage	118.9	111.5
Waste management	20.2	17.6
Other	(9.3)	(2.1)
Group total	129.8	127.0
Profit on ordinary activities before taxation		
<i>Continuing operations</i>		
Water and sewerage	70.1	67.1
Waste management	14.7	14.2
Other	(12.5)	(7.1)
Group total	72.3	74.2

	Net assets/(liabilities)		Employees (average number)	
	2004 £m	2003 £m	2004	2003
<i>Continuing operations</i>				
Water and sewerage	896.0	909.3	1,341	1,343
Waste management	97.9	95.7	895	685
Other, including intra-group trading	(93.3)	(114.9)	39	35
Group totals	900.6	890.1	2,275	2,063

Water and sewerage business comprises the regulated water and sewerage services undertaken by South West Water Limited.

2. Segmental analysis *continued*

Net liabilities of other continuing operations include parent company financing of business acquisitions. Profit before tax of other continuing operations is shown after interest arising thereon.

Separate disclosure by geographical origin and destination is not shown since the operations of the Group are substantially located in the United Kingdom.

There are no employees working outside the United Kingdom (2003 none).

3. Operating costs

	Continuing operations £m	Acquisitions £m	Total 2004 £m	Total 2003 £m
Manpower costs (note 10)	53.8	4.1	57.9	46.1
Raw materials and consumables	29.4	6.4	35.8	28.1
Rentals under operating leases:				
Hire of plant and machinery	3.5	–	3.5	3.1
Other operating leases	3.1	0.1	3.2	3.2
Research and development expenditure	0.1	–	0.1	0.1
Other external charges	68.1	2.3	70.4	52.9
Amortisation of intangible fixed assets	2.0	0.5	2.5	1.5
Depreciation:				
On owned assets	66.2	0.6	66.8	62.2
On assets held under finance leases	18.6	0.7	19.3	17.6
Profit on disposal of tangible fixed assets	(1.7)	–	(1.7)	(0.8)
Deferred income released to profits	(1.2)	–	(1.2)	(1.2)
Other operating charges	84.0	0.9	84.9	77.4
	325.9	15.6	341.5	290.2

Operating costs include the exceptional item set out in note 4.

Fees payable to the Group's auditors

	2004 £000	2003 £000
Audit services		
Statutory audit	250	246
Regulatory audit and reporting	116	25
Other assurance services	740	72
Tax services		
Compliance services	35	25
Advisory services	219	40
Other services	385	–

Included within the statutory audit fee above is an amount of £46,000 (2003 £47,000) for the Company's audit.

Regulatory audit and reporting is higher than the corresponding amount for 2003 as the auditors were engaged in the audit of South West Water Limited's Periodic Review submission to Ofwat during the year.

Other assurance services and tax advisory services include costs relating to the abortive acquisition of the landfill operations of Shanks Group Plc.

Other services represent fees for consulting services in relation to Viridor Waste Limited's successful bid for a Private Finance Initiative contract with West Sussex County Council.

Notes to the financial statements

5. Exceptional item

	2004 £m	2003 £m
Operating profit is after charging:		
Abortive acquisition costs	6.5	–

The exceptional item is the cost incurred relating to the abortive acquisition of the UK landfill and landfill gas operations of Shanks Group Plc where discussions were terminated on 25 May 2004. Total abortive costs are estimated at £9.0 million with the balance of exceptional costs of £2.5 million to be recognised in 2005.

5. Net interest payable

	2004 £m	2003 £m
Interest payable:		
Bank loans and overdrafts	(18.8)	(16.5)
Other loans	(16.7)	(16.5)
Interest element of finance lease rentals	(29.6)	(28.1)
Other finance costs	(0.5)	(0.2)
	(65.6)	(61.3)
Interest receivable:		
Listed redeemable securities	0.2	0.3
Other investments (as defined in note 18)	9.2	9.7
	9.4	10.0
Unwinding of discount in provisions	(1.0)	(0.8)
Net interest payable	(57.2)	(52.1)

6. Tax on profit on ordinary activities

(a) Analysis of charge for the year

	2004 £m	2003 £m
<i>Current tax:</i>		
UK corporation tax at 30%:		
Current year	12.8	5.8
Prior year	(5.3)	(2.4)
Total current tax (note 6(b))	7.5	3.4
<i>Deferred tax:</i>		
Origination and reversal of timing differences	16.2	17.2
Increase in discount	(12.9)	(3.5)
Total deferred tax (note 21)	3.3	13.7
Tax on profit on ordinary activities	10.8	17.1

6. Tax on profit on ordinary activities *continued*

(b) Factors affecting tax charge for the year

The tax assessed for the period is lower than the standard rate of corporation tax in the UK (30%). The differences are explained below:

	2004 £m	2003 £m
Profit on ordinary activities before tax	72.3	74.2
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK (30%)	21.7	22.3
<i>Effects of:</i>		
Expenses not deductible for tax purposes	5.9	3.1
Capital allowances for year in excess of depreciation	(15.3)	(19.3)
Other timing differences	0.5	(0.3)
Adjustments to tax charge in respect of prior year	(5.3)	(2.4)
Current tax charge for year (note 6(a))	7.5	3.4

The discounted deferred tax liability and the amount charged to the profit and loss account are affected by changes in medium and long term interest rates.

7. Profit of parent company

	2004 £m	2003 £m
Profit on ordinary activities after taxation dealt with in the accounts of the parent company	74.6	77.8

As permitted by section 230 of the Companies Act 1985, no profit and loss account is presented for the Company.

8. Dividends

	2004 £m	2003 £m
Special interim dividend of 70.0p per share paid 1 October 2002	-	95.9
Interim dividend of 13.2p (2003 12.6p) per share paid 8 April 2004	16.4	15.6
Proposed final dividend of 27.8p (2003 26.5p) per share payable 1 October 2004	34.7	32.8
	51.1	144.3

9. Earnings per share

	2004			2003		
	Profit after tax £m	Earnings per share Basic p	Diluted p	Profit after tax £m	Earnings per share Basic p	Diluted p
Adjusted earnings:						
Profit on ordinary activities after taxation	61.5	49.8	49.5	57.1	44.3	44.2
Exceptional item	6.5	5.3	5.2	–	–	–
Deferred tax	3.3	2.6	2.6	13.7	10.7	10.6
Adjusted earnings before exceptional item and deferred tax	71.3	57.7	57.3	70.8	55.0	54.8

Adjusted earnings per share have been calculated to exclude the impact of the exceptional item and deferred tax on the results, as these items can have a distorting effect on earnings from year to year and therefore warrant separate consideration.

The calculation of earnings per share is based on the profit on ordinary activities after taxation divided by the weighted average number of ordinary shares in issue during the year of 123.5 million (2003 128.8 million).

All share options with an exercise price lower than the average market price of the Company's shares during the year have been included in the calculation of diluted earnings per share. The weighted average number of shares in issue during the year, taking account of the dilutive effect of share options, was 124.3 million (2003 129.3 million).

10. Employees and employment costs

The average number of persons (including Directors) employed by the Group was 2,275 (2003 2,063).

	Continuing operations £m	Acquisitions £m	Total 2004 £m	Total 2003 £m
<i>Employment costs comprise:</i>				
Wages and salaries	51.6	3.6	55.2	48.9
Social security costs	4.0	0.4	4.4	3.5
Pension costs	7.0	0.1	7.1	3.2
Total employment costs	62.6	4.1	66.7	55.6
<i>Charged as follows:</i>				
Manpower costs (note 3)	53.8	4.1	57.9	46.1
Capital schemes	8.5	–	8.5	9.4
Restructuring provision	0.3	–	0.3	0.1
	62.6	4.1	66.7	55.6

11. Directors' emoluments

	2004 £000	2003 Restated £000
Executive Directors:		
Salary	490	441
Performance related bonus payable	153	141
Other emoluments	51	48
Payments in respect of tax liability from supplementary pension arrangements	86	57
Non-executive Directors	262	253
Total emoluments	1,042	940

The above performance related bonus payable represents the cash element. In addition, Directors receive a conditional award of shares for a matching amount which is subject to a future service criterion, as described in the Directors' remuneration report on pages 18 to 24. This is a change to the presentation previously adopted and 2003 has been restated accordingly.

The emoluments of the highest paid Director were £300,000 (2003 £273,000).

Total gains made by Directors on the exercise of share options were £4,000 (2003 £2,000).

Total emoluments include £427,000 (2003 £414,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2004 and 31 March 2003 retirement benefits were accruing to three Directors under defined benefit pension schemes. The accrued pension entitlement at 31 March 2004 under defined benefit schemes of the highest paid Director was £57,000 (2003 £49,000). No pension contributions were payable to defined contribution schemes in 2004 or 2003.

More detailed information concerning Directors' emoluments, shareholdings and share options is shown in the Directors' remuneration report on pages 18 to 24.

12. Intangible fixed assets

	Goodwill 2004 £m
Cost:	
At 1 April 2003	39.2
Additions	12.5
At 31 March 2004	51.7
Amortisation:	
At 1 April 2003	1.6
Charge for year	2.5
At 31 March 2004	4.1
Net book value:	
At 31 March 2004	47.6
At 31 March 2003	37.6

All goodwill is amortised evenly over the Directors' estimate of useful economic life, which is 20 years.

13. Tangible fixed assets

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Group Total 2004 £m	Company Total 2004 £m
Cost:							
At 1 April 2003	182.3	1,030.3	567.4	763.7	83.8	2,627.5	0.3
Arising on acquisitions	7.4	–	–	6.6	0.4	14.4	–
Additions	15.7	51.1	6.2	40.8	56.2	170.0	0.1
Grants and contributions	–	(0.8)	–	–	–	(0.8)	–
Disposals	(1.5)	(0.7)	–	(8.2)	–	(10.4)	(0.1)
Transfers/reclassifications	2.1	23.6	(15.9)	54.1	(63.9)	–	–
At 31 March 2004	206.0	1,103.5	557.7	857.0	76.5	2,800.7	0.3
Depreciation:							
At 1 April 2003	68.1	113.7	101.5	297.8	–	581.1	0.1
Charge for year	12.6	14.2	10.1	50.8	–	87.7	0.1
Disposals	(0.3)	(0.7)	–	(8.2)	–	(9.2)	(0.1)
At 31 March 2004	80.4	127.2	111.6	340.4	–	659.6	0.1
Net book value:							
At 31 March 2004	125.6	976.3	446.1	516.6	76.5	2,141.1	0.2
At 31 March 2003	114.2	916.6	465.9	465.9	83.8	2,046.4	0.2
Assets held under finance leases included above:							
Cost: At 31 March 2004	–	147.6	315.0	222.2	32.6	717.4	–
Depreciation: Charge for year	–	1.8	5.5	12.0	–	19.3	–
Depreciation: At 31 March 2004	–	8.7	43.5	97.2	–	149.4	–

Tangible fixed assets of the Company comprise fixed and mobile plant, vehicles and computers.

The cost of land and buildings and of operational properties includes non-depreciable land of £11.7 million (2003 £7.7 million) and £9.3 million (2003 £9.3 million) respectively.

The net book value of land and buildings comprises:

	2004 £m	2003 £m
Freehold	78.1	72.4
Long leasehold	34.1	33.1
Short leasehold	13.4	8.7
	125.6	114.2

Long leasehold land and buildings have an unexpired term of not less than 50 years (this is a reclassification for 2003).

13. Tangible fixed assets *continued*

The net book value of infrastructure assets is stated after deducting £47.0 million (2003 £46.2 million) grants and contributions.

The net book value of infrastructure assets includes £13.8 million (2003 £11.6 million) for the accumulated difference between expenditure on maintaining operating capacity and depreciation charges. Expenditure in the year was £16.4 million (2003 £15.8 million).

Out of the total depreciation charge for the Group of £87.7 million (2003 £81.4 million), £1.6 million (2003 £1.6 million) has been charged to capital projects and £86.1 million (2003 £79.8 million) against profits.

14. Fixed asset investments

	Subsidiary undertakings £m	Own shares £m	Other investments £m	Total investments 2004 £m
<i>Group</i>				
At 1 April 2003	–	1.3	0.6	1.9
Additions	–	0.6	2.0	2.6
Provision for impairment	–	(0.9)	–	(0.9)
At 31 March 2004	–	1.0	2.6	3.6
<i>Company</i>				
At 1 April 2003	928.1	0.6	–	928.7
Additions	3.7	0.2	–	3.9
Disposals	–	(0.1)	–	(0.1)
Provision for impairment	–	(0.5)	–	(0.5)
At 31 March 2004	931.8	0.2	–	932.0

All investments are in shares except other investments for the Group which includes £2.6 million loans at 31 March 2004 (2003 £0.6 million).

A Long Term Incentive Plan is operated for senior management of the Group. Awards under the Plan, involving the release of ordinary shares in the Company to participants, is dependent upon the performance condition being met. Shares are also held as part of an Annual Incentive Bonus Plan operated for senior management of the Group. Awards under the Plan involve the release of ordinary shares in the Company to participants usually conditional upon continuous service with the Company for a period of three years from the award. The shares described above are released out of an Employee Share Ownership Plan, a discretionary trust, established to facilitate the operation of the incentive plans. More information on the operation of the incentive plans is included in the Directors' remuneration report on pages 18 to 24.

During the year the trustees of the Employee Share Ownership Plan purchased 101,000 of the Company's ordinary shares financed through non-interest bearing advances made by sponsoring Group companies (2003 nil).

The market value of the 531,000 ordinary shares (2003 485,000) held as Group investments at 31 March 2004 was £3.7 million (2003 £3.2 million). 153,000 of those shares (2003 170,000) held as Company investments had a market value of £1.1 million at 31 March 2004 (2003 £1.1 million). The costs of the Long Term Incentive Plan are recognised as a provision for impairment and are charged within employment cost to profits over the period of its operation. The costs of the Annual Incentive Bonus Plan are charged within employment costs in the year of the award.

Details of principal subsidiary, joint venture and associated undertakings of the Group are set out in note 29.

Notes to the financial statements

15. Stocks

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Raw materials and consumables	4.1	3.5	-	-
Work in progress	0.4	0.5	-	-
	4.5	4.0	-	-

16. Debtors: amounts falling due after more than one year

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Amounts owed by subsidiary undertakings	-	-	229.4	173.9
Other debtors	1.1	1.2	1.0	1.1
Prepayments for pension costs	3.9	4.3	0.2	0.4
Deferred tax (note 21)	-	-	0.2	-
	5.0	5.5	230.8	175.4

17. Debtors: amounts falling due within one year

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Trade debtors	61.5	59.0	-	-
Amounts owed by subsidiary undertakings	-	-	24.5	58.1
Amounts owed by joint venture	1.4	1.7	-	-
Other debtors	5.6	1.7	1.0	0.5
Prepayments for pension costs	0.7	1.2	0.3	0.3
Other prepayments and accrued income	23.1	18.5	-	-
	92.3	82.1	25.8	58.9

18. Current asset investments

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Listed investments	4.2	4.1	–	–
Other investments:				
Overnight deposits	13.5	4.3	–	–
Other	236.0	174.0	–	–
	249.5	178.3	–	–
	253.7	182.4	–	–

At 31 March 2004 the market value of listed investments was £4.2 million (2003 £4.2 million).

Other investments include certificates of deposit and other deposits of £173.6 million (2003 £170.1 million) made to counter-indemnify letters of credit by financial institutions to lessors in order to secure rental obligations (note 26).

19. Creditors: amounts falling due within one year

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Loans:				
Bank loans and overdrafts	7.0	14.1	7.3	19.1
Short-term loans	53.0	30.0	53.0	–
European Investment Bank loans	14.5	13.6	–	–
Unsecured loan stock notes	12.2	14.4	12.2	14.4
	86.7	72.1	72.5	33.5
Obligations under finance leases	20.3	24.3	–	–
Trade creditors	53.4	60.6	0.8	0.1
Amounts owed to subsidiary undertakings	–	–	342.9	314.5
Amounts owed to joint venture	0.5	0.1	–	–
Other creditors	21.1	13.9	5.2	4.7
Corporation tax	15.7	8.1	–	–
Other taxation and social security	17.0	16.1	0.3	0.2
Accruals and deferred income	27.8	21.5	3.3	0.8
Interim dividend	16.4	15.6	16.4	15.6
Proposed final dividend	34.7	32.8	34.7	32.8
	293.6	265.1	476.1	402.2

20. Creditors: amounts falling due after more than one year

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Loans:				
Sterling bond (repayable February 2012)	150.0	150.0	150.0	150.0
European Investment Bank loans	181.1	135.6	-	-
Other bank loans	160.4	100.0	-	50.0
	491.5	385.6	150.0	200.0
Obligations under finance leases	743.3	697.6	-	-
Amounts owed to subsidiary undertakings	-	-	8.7	33.7
Other creditors	0.1	0.1	-	-
	1,234.9	1,083.3	158.7	233.7

21. Provisions for liabilities and charges

	Deferred tax £m	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Group Total 2004 £m	Company Restructuring 2004 £m
At 1 April 2003	60.0	27.1	0.8	2.7	90.6	0.3
Charged against profits	3.3	3.2	0.4	0.2	7.1	(0.1)
Arising on acquisitions	-	1.1	-	-	1.1	-
Utilised during year	-	(3.4)	(0.8)	(0.6)	(4.8)	(0.1)
At 31 March 2004	63.3	28.0	0.4	2.3	94.0	0.1

Environmental and landfill restoration provisions will be utilised over the period from 2005 to beyond 2050. The provisions have been established assuming current waste management technology based upon estimated costs at future prices which have been discounted to present value. The restructuring provisions principally relate to severance costs which are expected to be incurred in the next financial year. Other provisions include an onerous operating lease commitment which will unwind over the period to 2017 and £1.0 million for the decommissioning of an operational site in the water and sewerage business in 2005.

Deferred taxation

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Accelerated capital allowances	275.4	257.4	-	-
Other timing differences	(6.2)	(4.4)	(0.2)	-
Undiscounted provision/(asset) for deferred tax	269.2	253.0	(0.2)	-
Discount	(205.9)	(193.0)	-	-
Discounted provision/(asset) for deferred tax	63.3	60.0	(0.2)	-
Provision at 1 April 2003	60.0	-	-	-
Deferred tax charge/(credit) in profit and loss account for year	3.3	-	(0.2)	-
Provision/(asset) at 31 March 2004	63.3	-	(0.2)	-

The Company deferred tax asset is included within debtors falling due after more than one year (note 16).

22. Deferred income

	Forward interest rate swaps (note 27) £m	Grants and contributions £m	Group Total 2004 £m	Forward interest rate swaps (note 27) £m	Grants and contributions £m	Group Total 2003 £m
At 1 April 2003:						
Amount to be released:						
After more than one year	18.2	21.2	39.4	18.2	22.4	40.6
Within one year	-	1.3	1.3	-	1.3	1.3
	18.2	22.5	40.7	18.2	23.7	41.9
Additions	-	0.5	0.5	-	-	-
Released to profits	-	(1.2)	(1.2)	-	(1.2)	(1.2)
At 31 March 2004:	18.2	21.8	40.0	18.2	22.5	40.7
Amount to be released:						
Within one year	-	(1.3)	(1.3)	-	(1.3)	(1.3)
After more than one year	18.2	20.5	38.7	18.2	21.2	39.4

23. Called-up share capital

	2004 £m	2003 £m
Authorised		
157,657,600 Ordinary shares of £1.11 each	175.0	175.0
Allotted, called-up and fully paid		
124,284,779 Ordinary shares of £1.11 each (2003 123,629,373)	137.9	137.2
Ordinary shares allotted during the year		
In lieu of £1.3 million cash (2003 nil) under scrip dividend alternative	202,015	-
For consideration of £2.1 million under the Company's Sharesave Scheme (2003 £1.4 million to Pennon Trustee Limited on behalf of employees who exercised their options)	453,391	168,851
	655,406	168,851

23. Called-up share capital *continued*

Share options

Outstanding options to subscribe for shares of £1.11 each under the Company's share option schemes are:

Nature of scheme	Date granted and subscription price fully paid	Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
			2004	2003
Sharesave	8 July 1997 556p	2000 – 2004	52	59
	7 July 1998 775p	2001 – 2005	9	34
	6 July 1999 825p	2002 – 2006	22	23
	5 July 2000 461p	2003 – 2007	262	738
	4 July 2001 489p	2004 – 2008	172	186
	9 July 2002 566p	2005 – 2009	215	246
	8 July 2003 530p	2006 – 2010	476	–
Executive	6 Jan 1995 503p	1998 – 2005	6	6
			1,214	1,292

A performance target applies to the exercise of the Executive Scheme options whereby an increase in earnings per share in excess of the Retail Prices Index movement over the period March 1994 to date of exercise must be achieved.

At 31 March 2004 there were 1,084 participants in the Sharesave Scheme (2003 1,146) and one in the Executive Scheme (2003 one).

Options granted to Directors, included above, are shown in the Directors' remuneration report on pages 18 to 24.

24. Reserves

	Group and Company share premium account	Profit and loss account	
	£m	Group £m	Company £m
At 1 April 2003	152.8	600.1	237.0
Retained surplus for year	–	10.4	23.5
Adjustment for shares issued under the scrip dividend alternative	(0.2)	1.3	1.3
Premium on shares issued under the Sharesave Scheme	1.6	–	–
Goodwill arising on previously acquired business (note 28)	–	(3.3)	–
At 31 March 2004	154.2	608.5	261.8

The cumulative value of goodwill at 31 March 2004 resulting from acquisitions, which has been written off to reserves, is £126.6 million (2003 £123.3 million).

The Group and the Company have taken advantage of the exemption provided in Urgent Issues Task Force Abstract 17 not to recognise a cost arising from the award of discounted Company shares to employees under the Sharesave Scheme.

25. Statement of movements in shareholders' funds

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Profit on ordinary activities after taxation	61.5	57.1	74.6	77.8
Dividends	(51.1)	(144.3)	(51.1)	(144.3)
	10.4	(87.2)	23.5	(66.5)
Adjustment for shares issued under the scrip dividend alternative	1.3	-	1.3	-
Shares issued for cash consideration	2.1	1.4	2.1	1.4
Adjustment for shares issued under the Sharesave Scheme through Employee Share Ownership Trust	-	(0.3)	-	(0.3)
Goodwill arising on previously acquired business (note 28)	(3.3)	-	-	-
Shareholders' funds (equity interest):				
Addition/(reduction) for year	10.5	(86.1)	26.9	(65.4)
At 1 April	890.1	976.2	527.0	592.4
At 31 March	900.6	890.1	553.9	527.0

26. Loans and other borrowings

Loans

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Repayable:				
Over five years	281.9	240.9	150.0	150.0
Over two and up to five years	194.8	30.2	-	-
Over one and up to two years	14.8	114.5	-	50.0
Falling due after more than one year (note 20)	491.5	385.6	150.0	200.0
Falling due within one year (note 19)	86.7	72.1	72.5	33.5
	578.2	457.7	222.5	233.5

£3.8 million floating rate unsecured guaranteed loan stock notes, repayable at par in 2009 or on notice being given by the noteholders, were issued in the year. £3.7 million was to satisfy contingent consideration payable in connection with the December 1997 acquisition of Terry Adams Limited (note 28) and £0.1 million in settlement of accrued consideration.

26. Loans and other borrowings *continued*

Obligations under finance leases

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Repayable:				
Over five years	663.5	629.7	-	-
Over two and up to five years	55.6	44.9	-	-
Over one and up to two years	24.2	23.0	-	-
Falling due after more than one year (note 20)	743.3	697.6	-	-
Falling due within one year (note 19)	20.3	24.3	-	-
	763.6	721.9	-	-

Included above are accrued finance charges arising on obligations under finance leases totalling £96.0 million (2003 £88.0 million), of which £15.6 million (2003 £20.5 million) is repayable within one year.

Loans and obligations under finance leases

Included above are instalment debts, of which any part falls due for repayment after five years, and non-instalment debts due after five years:

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Loans	310.0	250.0	150.0	150.0
Obligations under finance leases	763.6	721.3	-	-
	1,073.6	971.3	150.0	150.0

The rates of interest payable on loans and other borrowings, any part of which is due after five years, range between 3.4% and 10.6% (2003 3.5% and 11.3%) and are repayable over the period 2005 to 2035.

Within obligations under finance leases, South West Water Limited has:

- (a) utilised finance lease facilities of £180.0 million at 31 March 2004 (2003 £180.0 million) for certain water and sewerage business tangible fixed assets;
- (b) deposited amounts, equal to the present value of rental obligations arising from those finance leases, with United Kingdom financial institutions, to counter-indemnify the letters of credit issued by those financial institutions to the lessors in order to secure those rental obligations.

These deposited funds, which totalled £144.9 million at 31 March 2004 (2003 £144.9 million), together with interest earned thereon, may be used to settle the rental obligations under those finance leases. If the finance leases terminate due to the insolvency of the financial institutions which have issued the letters of credit, no liability will fall on South West Water, or any Pennon Group company.

The rentals payable under the finance leases will vary if interest rates, or effective tax rates, change.

26. Loans and other borrowings *continued*

Borrowing facilities

Undrawn committed borrowing facilities of £80.0 million were available to the Group at 31 March 2004 which expire as follows:

	2004 £m	2003 £m
Within one year or less	–	30.0
Over two years	80.0	–
	80.0	30.0

In addition, the Group has short-term uncommitted bank facilities of £145.0 million.

27. Financial instruments

Disclosures on financial and treasury policies are also included in the Corporate governance and internal control section on pages 25 to 27.

Interest rate and currency profile of financial assets and liabilities

After taking into account interest rate swaps entered into by the Group, the interest rate profile of the Group's financial assets and liabilities was:

	Financial assets		Financial liabilities	
	2004 £m	2003 £m	2004 £m	2003 £m
Floating rate	262.6	187.7	(668.5)	(549.2)
Fixed rate	6.1	4.3	(673.3)	(630.4)
On which no interest is paid	2.7	0.8	(19.6)	(19.9)
	271.4	192.8	(1,361.4)	(1,199.5)
Which is included in:				
Net debt	267.7	191.0	(1,341.8)	(1,179.6)
Provisions for liabilities and charges	–	–	(1.3)	(1.7)
Deferred income	–	–	(18.2)	(18.2)
Other long-term monetary assets/(liabilities)	3.7	1.8	(0.1)	–
	271.4	192.8	(1,361.4)	(1,199.5)
Fixed rate financial assets and liabilities:				
Weighted average interest rate	6.1%	6.3%	6.5%	6.7%
Weighted average period for which rate is fixed	2.6 years	1.1 years	2.8 years	3.9 years
Range of interest rates	4.2% to 8.0%	3.5% to 8.0%	4.3% to 11.3%	4.3% to 11.3%
Financial assets and liabilities on which no interest is paid:				
Weighted average period until maturity	–	–	14.2 years	15.2 years

All financial assets and liabilities are denominated in sterling.

Notes to the financial statements

27. Financial instruments *continued*

The floating rate financial assets earn interest, in some cases fixed in advance for periods up to twelve months, based on short term money market rates.

The floating rate financial liabilities bear interest at rates, in some cases fixed in advance for periods up to twelve months, related to the London Inter Bank Offer Rate (LIBOR) or equivalent. The range of interest rates applying at 31 March 2004 was 3.4% to 5.0% (2003 3.2% to 4.9%).

The maturity profile of floating rate and fixed rate financial liabilities is shown in note 26. Other financial liabilities fall due for payment principally after five years.

Interest rate swaps are used to manage the mix of fixed and floating rates to ensure at least 50% of net debt is at fixed rate:

at 31 March 2004 62% of net debt was at fixed rate (2003 63%);

at 31 March 2004 interest rate swaps to hedge financial liabilities with a notional principal value of £490.0 million existed with a weighted average maturity of 1.3 years (2003 £435.0 million, with 2.2 years) to swap from floating to fixed rate; and

at 31 March 2004 floating rate interest rate swaps, to hedge financial liabilities with a notional principal value of £200.0 million, existed to swap LIBOR to European Inter Bank Offer Rate (EURIBOR) with commencement dates between 1 April 2006 and 1 April 2010 and maturing on 31 March 2030 (2003 £200.0 million). The settlement of £18.2 million which was received when these swaps were entered into during December 1999 has been deferred (note 22) and will be matched with interest charges on the underlying hedged debt over the period of the swaps.

The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and are not, therefore, an exposure for the Group.

Financial assets and liabilities exclude short term debtors and creditors (other than loans and obligations under finance leases falling due within one year).

Fair values of financial assets and liabilities

Fair values are established at a specific point in time, based on relevant market information and the character of the financial instrument, using estimates that are subjective in nature.

	2004		2003	
	Book value £m	Fair value £m	Book value £m	Fair value Restated £m
Financial assets:				
Current asset investments	253.7	253.8	182.4	182.5
Cash at bank	14.0	14.0	8.6	8.6
Other	3.7	3.8	1.8	1.8
	271.4	271.6	192.8	192.9
Financial liabilities:				
Short-term debt	(107.0)	(107.4)	(96.4)	(96.2)
Long-term debt	(1,234.8)	(1,226.3)	(1,083.2)	(1,118.5)
Other	(1.4)	(1.4)	(1.7)	(1.7)
	(1,343.2)	(1,335.1)	(1,181.3)	(1,216.4)
Derivative financial instruments (used to manage interest rate profile):				
Interest rate swaps	(18.2)	(6.1)	(18.2)	(16.6)

Market values, where available, have been used to determine fair values. The fair value of floating rate loans and obligations under finance leases have been estimated by discounting cash flows at prevailing rates which is a change to the method previously adopted. 2003 has been restated accordingly from £1,244.7 million to £1,216.4 million. Other floating rate liabilities, floating rate current asset investments and cash at bank are assumed to have a fair value equal to book value.

27. Financial instruments *continued*

Hedging interest rate exposures

The Group uses derivative financial instruments to manage certain interest rate risks. The unrecognised gains and losses on such instruments are:

	Gains £m	Losses £m	2004 Total net gains £m	Gains £m	Losses £m	2003 Total net gains £m
Unrecognised gains and losses on hedges:						
At 1 April	12.4	(10.8)	1.6	5.8	(3.7)	2.1
Of which recognised in current year	0.4	(5.8)	(5.4)	0.2	(2.1)	(1.9)
	12.0	(5.0)	7.0	5.6	(1.6)	4.0
Arising and not recognised in current year	1.7	3.4	5.1	6.8	(9.2)	(2.4)
At 31 March	13.7	(1.6)	12.1	12.4	(10.8)	1.6
Expected to be recognised:						
In next year	1.0	(1.4)	(0.4)	0.4	(5.8)	(5.4)
Thereafter	12.7	(0.2)	12.5	12.0	(5.0)	7.0
	13.7	(1.6)	12.1	12.4	(10.8)	1.6

Gains and losses on hedging instruments are matched with their underlying hedged item.

28. Acquisitions

The terms of the agreement with the other shareholders of Enviro-Logic Limited (now renamed Peninsula Water Limited) provided for an option for Pennon Group Plc to acquire full ownership of the company after five years. The option was taken up on 6 May 2003 and no consideration was payable. Net overdraft balances acquired were £0.1 million.

On 5 June 2003 the entire issued share capital of Churngold Holdings Limited (now renamed Viridor Waste (Bristol Holdings) Limited) was purchased by Viridor Waste Management Limited for a cash consideration of £19.8 million, including costs of £0.1 million. The acquisition was accounted for using the acquisition method and provisional goodwill arising on the acquisition amounting to £12.5 million, has been capitalised and will be amortised over 20 years.

The profit after tax of Churngold Holdings Limited amounted to £0.2 million for the period from 1 June 2002 to 4 June 2003.

28. Acquisitions *continued*

The operating assets and liabilities of the acquisition were:

	Book value £m	Accounting policy harmonisation £m	Provisional revaluation adjustment £m	Other adjustments £m	Provisional fair value to the Group £m
Tangible fixed assets	19.2	(0.1)	(6.0)	–	13.1
Debtors: amounts falling due within one year	3.8	–	–	–	3.8
Bank overdrafts	(0.1)	–	–	–	(0.1)
Creditors: amounts falling due within one year	(6.1)	–	–	(0.7)	(6.8)
Creditors: amounts falling due after one year	(1.6)	–	–	–	(1.6)
Provisions for liabilities and charges	(0.6)	(0.5)	–	–	(1.1)
	14.6	(0.6)	(6.0)	(0.7)	7.3

Accounting policy harmonisation in respect of tangible fixed assets related to the alignment of asset lives with Group policy and for provisions for liabilities and charges, the recognition of environmental obligations. The provisional revaluation adjustment recognises the value of acquired tangible fixed assets to the Group. Other adjustments include additional creditors for taxation following a reassessment of the taxation affairs of the company for pre-acquisition periods.

The acquisition of Terry Adams Limited on 12 December 1997 provided for contingent consideration with a maximum of £28.0 million, linked to planning approval of landfill sites, which was not included in the acquisition cost. At 31 March 2003, £14.5 million remained as contingently payable. During the year, £3.7 million of that contingent consideration was settled through the issue of loan stock notes (note 26). The fair value to the Group of the landfill acquired, based on projected discounted cash flows, amounted to £0.4 million. Goodwill arising on the acquisition amounting to £3.3 million has been written off to Group reserves.

The operating assets acquired were :

	Book value £m	Revaluation adjustment £m	Fair value to the Group £m
Tangible fixed assets	–	0.4	0.4

During the year £1.2 million fair value acquisition accruals and provisions were established (2003 £5.1 million), £0.7 million were utilised (2003 £1.5 million), £1.4 million were released (2003 nil), and at 31 March 2004 £12.8 million (2003 £13.7 million) were carried forward.

29. Principal subsidiary and joint venture undertakings

Subsidiary undertakings

	Country of incorporation, registration and principal operations
Water and sewerage	
South West Water Limited*	England
Peninsula Leasing Limited	England
Peninsula Properties (Exeter) Limited	England
Waste management	
Viridor Waste Limited*	England
Viridor Waste Disposal Limited	England
VWM (Scotland) Limited	Scotland
Viridor Waste Exeter Limited	England
Dragon Waste Limited	England
Viridor Waste Hampshire Limited	England
Viridor Waste Management Limited	England
Viridor EnviroScot Limited	Scotland
Viridor Parkwood Holdings Limited	British Virgin Islands ¹
Parkwood Group Limited	England
Viridor Richardson Limited	England
Viridor Waste (Bristol Holdings) Limited	England
Viridor Waste (Bristol) Limited	England
Viridor Waste Suffolk Limited	England
Other	
Peninsula Insurance Limited*	Guernsey
Peninsula Water Limited*	England

* Indicates the shares are held directly by the Company. ¹ Operations are carried out in England.

All shares in issue are ordinary shares. The subsidiary undertakings are wholly-owned, except Dragon Waste Limited where 81% of the ordinary shares are held by Viridor Waste Limited.

Joint venture

	Share capital in issue	Percentage held	Activity
Echo South West Limited	100,000 A ordinary shares 100,000 B ordinary shares	100% –	Customer contact management

Shares in Echo South West Limited are held by South West Water Limited.

30. Pensions

The Group operates a number of pension schemes including a defined contribution section within the main scheme. The assets of the Group's pension schemes are held in separate trustee administered funds.

The latest actuarial valuation of the main scheme was as at 31 March 2001. At that date the market value of the scheme's assets was £215.1 million and this was sufficient to cover 109% of the value of benefits that had accrued to members, after allowing for assumed future increases in earnings. The assumptions which have the most significant effect on the results of the valuation are those relating to the rate of return on investments and the rates of increase in earnings and pensions. The valuation assumed that the investment return would be 5.75% per annum for past service and 6.75% per annum for future service, pensionable pay increases would average 3.5% per annum and that present and future pensions would both increase at a rate of 2.5% per annum.

The pension cost of the main defined benefit scheme has been determined on the advice of the independent qualified actuary using the projected unit method. The employers' regular pension cost for the year was 11.5% of pensionable earnings (2003 11.5%). The pension charge for the year ended 31 March 2004 for the main scheme was £5.6 million (2003 £3.1 million) reflecting the advice of the independent qualified actuary to increase employers' contributions to 11.5% (2003 4.8%) of pensionable earnings.

Pension prepayments included as debtors of the Group amount to £4.6 million (2003 £5.5 million), representing the accumulated difference between the Group pension cost and employer contributions paid.

The Group accounts for pension benefits in accordance with Statement of Standard Accounting Practice 24 'Accounting for Pension Costs'. Financial Reporting Standard 17 'Retirement Benefits' (FRS 17) was originally intended to change the basis of accounting for pension benefits from 2003/04 but full implementation has been deferred. Under transitional arrangements applying to FRS 17, certain additional disclosures are still required and these are given below.

The full actuarial valuation at 31 March 2001 was updated at 31 March 2004 by the independent qualified actuary using the projected unit method, as required by FRS 17. The value of the assets of the schemes has been updated to market value as at 31 March 2004. The demographic assumptions used in calculating the scheme liabilities under FRS 17 remain unchanged from those used in the 31 March 2001 actuarial valuation. The financial assumptions at each year end under FRS 17 were as follows:

	2004 %	2003 %	2002 %
Rate of increase in pensionable pay	3.70	3.50	3.75
Rate of increase for present and future pensions	2.70	2.50	2.75
Rate used to discount scheme liabilities	5.50	5.50	6.00
Inflation	2.70	2.50	2.75

The assets in the schemes and the expected long term rate of return at the year end were:

	2004		2003		2002	
	Return %	Value £m	Return %	Value £m	Return %	Value £m
Equities	7.70	154.6	7.00	119.0	7.75	151.6
Bonds	4.70	38.2	4.50	31.9	5.25	42.5
Other	4.30	8.4	3.50	8.4	5.00	15.6
Total market value of assets		201.2		159.3		209.7
Present value of schemes' liabilities		(278.4)		(244.2)		(216.8)
Deficit in schemes		(77.2)		(84.9)		(7.1)
Related deferred tax asset		23.2		25.5		2.1
Net pension liabilities		(54.0)		(59.4)		(5.0)

30. Pensions *continued*

Had FRS 17 been adopted in the financial statements, the Group's net assets and profit and loss account reserve at 31 March would have been as follows:

	2004 £m	2003 £m
Net assets including prepayments for pension costs and excluding net pension liabilities	900.6	890.1
Prepayments for pension costs	(4.6)	(5.5)
Net pension liabilities	(54.0)	(59.4)
Net assets including net pension liabilities	842.0	825.2
Profit and loss account reserve including prepayments for pension costs and excluding net pension liabilities	608.5	600.1
Prepayments for pension costs	(4.6)	(5.5)
Net pension liabilities	(54.0)	(59.4)
Profit and loss account including net pension liabilities	549.9	535.2

The following amounts would have been recognised in the financial statements for the year ended 31 March 2004:

	2004 £m	2003 £m
Operating profit		
Current service cost	6.3	6.6
Past service cost	0.2	1.7
Total operating charge	6.5	8.3
Other finance (cost)/income		
Expected return on pension schemes' assets	10.0	14.3
Interest on pension schemes' liabilities	(13.4)	(13.0)
Net (cost)/return	(3.4)	1.3
Statement of total recognised gains and losses (STRGL)		
Actual return less expected return on pension schemes' assets	33.1	(61.0)
Experience gains and (losses) arising on schemes' liabilities	4.3	(1.4)
Changes in assumptions underlying the present value of schemes' liabilities	(25.1)	(12.6)
Actuarial gain/(loss) to be recognised in STRGL	12.3	(75.0)

Notes to the financial statements

30. Pensions *continued*

Movement in deficit in schemes during the year

	2004 £m	2003 £m
Deficit at 1 April	(84.9)	(7.1)
Movement in year:		
Current service cost	(6.3)	(6.6)
Contributions	5.3	4.2
Past service cost	(0.2)	(1.7)
Other finance (cost)/return	(3.4)	1.3
Actuarial gain/(loss)	12.3	(75.0)
Deficit at 31 March	(77.2)	(84.9)

History of experience gains and losses

	2004	2003
Difference between the expected and actual return in schemes' assets:		
Amount (£m)	33.1	(61.0)
Percentage of schemes' assets	16.5%	(38.3)%
Experience gains and losses on schemes' liabilities:		
Amount (£m)	4.3	(1.4)
Percentage of the present value of schemes' liabilities	1.5%	(0.6)%
Total amount recognised in statement of total recognised gains and losses:		
Amount (£m)	12.3	(75.0)
Percentage of the present value of schemes' liabilities	4.4%	(30.7)%

31. Commitments and contingent liabilities

	Group		Company	
	2004 £m	2003 £m	2004 £m	2003 £m
Capital commitments				
Contracted but not provided	56.3	58.3	–	–
Commitments under operating leases				
Rentals during the year following the balance sheet date:				
Land and buildings leases expiring:				
Within one year	0.1	0.3	–	–
Between one and five years	0.3	0.2	–	–
After five years	3.4	3.2	–	–
Other leases expiring:				
Within one year	0.1	0.3	–	–
Between one and five years	0.4	0.5	–	–
	4.3	4.5	–	–
Contingent liabilities				
Contractors' claims on capital schemes	0.3	1.5	–	–
Guarantees	41.5	35.4	594.4	533.0
Other	10.8	14.5	10.8	14.5
	52.6	51.4	605.2	547.5

Guarantees by the Company are principally in respect of borrowing facilities of subsidiary undertakings. Guarantees by the Group are principally in respect of performance bonds entered into in the normal course of business. No liability is expected to arise in respect of the guarantees. Other contingent liabilities relate to a possible obligation to pay further consideration in respect of a previously acquired business when the outcome of planning applications is known.

32. Notes to the Group cash flow statement

(a) Reconciliation of Group operating profit to net cash inflow from operating activities

	2004 £m	2003 £m
Group operating profit	129.8	127.0
Depreciation charge	86.1	79.8
Amortisation of intangible fixed assets	2.5	1.5
Provision for impairment of fixed asset investments	0.9	1.4
Deferred income released to profits	(1.2)	(1.2)
Decrease in provisions for liabilities and charges	(2.0)	(2.0)
Increase in stocks	(0.5)	(0.8)
(Increase)/decrease in debtors (amounts falling due within and over one year)	(4.2)	1.1
Increase/(decrease) in creditors (amounts falling due within and over one year)	5.4	(7.1)
Profit on disposal of tangible fixed assets	(1.7)	(0.8)
Net cash inflow from operating activities	215.1	198.9

32. Notes to the Group cash flow statement *continued*

(b) Analysis of cash flows for headings netted in the Group cash flow statement

i Returns on investments and servicing of finance	2004 £m	2003 £m
Interest received	9.4	10.1
Interest paid	(31.9)	(33.8)
Interest element of finance lease rentals	(18.8)	(19.2)
Net cash outflow for returns on investments and servicing of finance	(41.3)	(42.9)

ii Capital expenditure and financial investment	2004 £m	2003 £m
Purchase of tangible fixed assets	(181.9)	(201.7)
Grants and contributions:		
Infrastructure assets	1.4	1.2
Non-infrastructure assets	1.0	0.1
Receipts from disposal of tangible fixed assets	2.9	2.2
Purchase of Company shares by Employee Share Ownership Plan	(0.6)	-
Other investment	(2.0)	-
Net cash outflow for capital expenditure and financial investment	(179.2)	(198.2)

iii Acquisitions	2004 £m	2003 £m
Purchase of businesses	(19.8)	(41.7)
Purchase of interest in joint venture	-	(0.1)
Net (overdrafts)/cash acquired with businesses	(0.2)	4.6
Net cash outflow for acquisitions	(20.0)	(37.2)

iv Management of liquid resources	2004 £m	2003 £m
Purchase of current asset investments	(342.8)	(68.0)
Sale of current asset investments	280.7	135.6
Net cash (outflow)/inflow from management of liquid resources	(62.1)	67.6

32. Notes to the Group cash flow statement *continued*

(b) Analysis of cash flows for headings netted in the Group cash flow statement *continued*

v Financing	2004 £m	2003 £m
Issue of ordinary share capital	2.1	1.4
Adjustment for shares issued under the Sharesave Scheme through Employee Share Ownership Trust	-	(0.3)
	2.1	1.1
Reduction in debt due within one year (other than bank overdrafts)	(16.7)	(19.7)
Increase in debt due after more than one year	140.0	100.0
Finance lease drawdowns	36.4	62.6
Capital element of finance lease rental payments	(5.5)	(3.3)
	154.2	139.6
Net cash inflow from financing	156.3	140.7

(c) Analysis of net debt

	At 1 April 2003 £m	Cash flow £m	Acquisitions (excluding cash items) £m	Non-cash movements £m	At 31 March 2004 £m
Cash at bank and in hand	8.6	5.4	-	-	14.0
Current asset investments:					
Overnight deposits	4.3	9.2	-	-	13.5
Bank overdrafts	(14.1)	7.1	-	-	(7.0)
	(1.2)	21.7	-	-	20.5
Debt due within one year (other than bank overdrafts)	(58.0)	16.7	(3.8)	(34.6)	(79.7)
Debt due after more than one year	(385.6)	(140.0)	(0.4)	34.5	(491.5)
Finance lease obligations	(721.9)	(30.9)	(2.8)	(8.0)	(763.6)
	(1,165.5)	(154.2)	(7.0)	(8.1)	(1,334.8)
Current asset investments:					
Other than overnight deposits	178.1	62.1	-	-	240.2
	(988.6)	(70.4)	(7.0)	(8.1)	(1,074.1)

Non-cash movements include transfers between categories of debt for changing maturities, increased accrued finance charges within finance lease obligations and loan notes issued in settlement of accrued consideration in respect of a previously acquired business.

32. Notes to the Group cash flow statement *continued*

(d) Reconciliation of net cash flow to movement in net debt

	2004 £m	2003 £m
Increase/(decrease) in cash in year	21.7	(18.4)
Cash inflow from increase in debt and finance leasing	(154.2)	(139.6)
Cash outflow/(inflow) from increase/(decrease) in liquid resources	62.1	(67.6)
<hr/>		
Increase in net debt arising from cash flows	(70.4)	(225.6)
Acquisitions (excluding cash items):		
Loan stock notes issued as part consideration for business acquired	(3.7)	-
Loans acquired with business purchase	(0.5)	-
Finance lease obligations acquired with business purchase	(2.8)	(0.3)
Non-cash movements:		
Loan stock notes issued in settlement of accrued consideration	(0.1)	(1.2)
Increase in accrued finance charges on finance lease obligations	(8.0)	(10.2)
<hr/>		
Increase in net debt in the year	(85.5)	(237.3)
Net debt at 1 April	(988.6)	(751.3)
<hr/>		
Net debt at 31 March	(1,074.1)	(988.6)

(e) Purchase of businesses

	2004 £m	2003 £m
Net assets acquired:		
Tangible fixed assets	14.4	17.7
Fixed asset investments: joint venture	-	0.1
Debtors: amounts falling due within one year	4.1	6.2
Cash at bank and in hand	-	4.6
Bank overdrafts	(0.2)	-
Creditors: amounts falling due within one year	(7.5)	(10.3)
Creditors: amounts falling due after more than one year	(2.0)	(0.2)
Provisions for liabilities and charges	(1.1)	(3.7)
<hr/>		
Fair value of net assets acquired	7.7	14.4
Goodwill	15.8	27.4
<hr/>		
	23.5	41.8
<hr/>		
Satisfied by:		
Cash consideration	19.8	41.8
Loan stock notes	3.7	-
<hr/>		
	23.5	41.8

The businesses acquired during the year contributed £2.1 million to the Group's net cash inflow from operating activities, utilised £0.1 million in respect of net returns on investments and servicing of finance and £1.3 million for capital expenditure.

In 2003, the businesses acquired in that year contributed £2.5 million to the Group's net cash inflow from operating activities, utilised £0.5 million for taxation and £0.6 million for capital expenditure.

33. Related party transactions

During the year, the Group purchased services in the ordinary course of business from Echo South West Limited, a joint venture undertaking, at a cost of £7.8 million (2003 £7.5 million) and sold services to Echo South West Limited at a value of £2.5 million (2003 £1.9 million). Amounts owed by and to joint venture undertakings are disclosed in notes 17 and 19. These amounts relate to trading balances except for short term loans of £0.1 million (2003 £0.1 million) included in debtors falling due within one year, note 16.

In the period 1 April to 6 May 2003 the Company advanced £0.1 million to Enviro-Logic Limited (now renamed Peninsula Water Limited), an associated undertaking until that date, to finance trading (2003 £0.7 million).

Five year financial summary

Profit and loss account

	2004 £m	2003 £m	2002 £m	2001 £m	2000 £m
Turnover	471.3	417.2	423.9	435.1	467.0
Group operating profit	129.8	127.0	121.8	128.1	167.1
Share of operating loss in joint venture and associate	(0.3)	(0.7)	(0.5)	(0.4)	(0.4)
Business disposal profit/(loss)	-	-	5.1	(2.1)	-
Net interest payable	(57.2)	(52.1)	(49.0)	(51.4)	(45.0)
Profit on ordinary activities before taxation	72.3	74.2	77.4	74.2	121.7
Tax on profit on ordinary activities	(10.8)	(17.1)	(3.3)	(17.6)	(5.0)
Profit on ordinary activities after taxation	61.5	57.1	74.1	56.6	116.7
Dividends	(51.1)	(144.3)	(51.4)	(49.4)	(65.1)
Retained surplus/(deficit) transferred to/(from) reserves	10.4	(87.2)	22.7	7.2	51.6
Earnings per share (basic):					
Before exceptional items and deferred tax	57.7p	55.0p	53.0p	56.0p	85.9p
Exceptional items	(5.3)p	-	3.7p	(1.6)p	-
Deferred tax	(2.6)p	(10.7)p	(2.4)p	(12.9)p	-
After exceptional items and deferred tax	49.8p	44.3p	54.3p	41.5p	85.9p
Dividend per share	41.0p	109.1p	37.5p	36.0p	47.8p

Capital expenditure

	2004 £m	2003 £m	2002 £m	2001 £m	2000 £m
Acquisitions	19.8	41.8	12.1	0.9	-
Tangible fixed assets	170.0	204.6	186.4	166.5	153.8

Balance sheet

	2004 £m	2003 £m	2002 £m	2001 £m	2000 £m
Fixed assets	2,192.3	2,085.9	1,922.7	1,826.3	1,736.6
Net current assets	75.9	17.5	100.8	101.5	92.8
Non-current liabilities	(1,367.6)	(1,213.3)	(1,047.3)	(1,018.7)	(918.7)
Net assets	900.6	890.1	976.2	909.1	910.7

Number of employees (average for year)

	2004	2003	2002	2001	2000
Water and sewerage business	1,341	1,343	1,485	1,537	1,638
Waste management	895	685	605	453	438
Instrumentation	-	-	421	495	556
Construction services	-	-	-	617	837
Other businesses	39	35	51	55	57
	2,275	2,063	2,562	3,157	3,526

The adoption of Financial Reporting Standard 19 'Deferred Tax' in 2002 resulted in a restatement of 2001 but 2000 has not been restated. Earnings per share from 2001 have been adjusted to separately show the impact of deferred tax.

Financial calendar

Financial year end	31 March
Fifteenth annual general meeting	29 July 2004
2004 Final dividend payable	1 October 2004
2004 Interim results announcement	December 2004
2005 Interim dividend payable	April 2005
2005 Preliminary results announcement	May 2005
Sixteenth annual general meeting	July 2005
2005 Final dividend payable	October 2005

Shareholders' analysis at 31 March 2004

Shares held	Number of shareholders	Percentage of total shareholders	Percentage of ordinary shares
1 – 100	5,997	21.2	0.2
101 – 1,000	17,828	63.0	6.3
1,001 – 5,000	3,803	13.4	5.4
5,001 – 50,000	467	1.7	5.8
50,001 – 100,000	61	0.2	3.6
Over 100,000	140	0.5	78.7
	28,296	100.0	100.0
Category of shareholder			
Individuals	25,273	89.3	10.4
Companies	243	0.9	2.0
Trust companies	4	–	–
Banks, nominees and institutions	2,772	9.8	87.2
Insurance companies	4	–	0.4
	28,296	100.0	100.0

Substantial shareholdings

At 21 June 2004, interests in the issued share capital had been notified by:

AXA Investment Managers	5.64%
Standard Life Group	4.29%
AEGON UK Plc	4.27%
Legal & General Investment Management	3.73%
Zurich Financial Services	3.38%
Landsdowne Partners	3.10%

Further shareholder information may be found at:
www.pennon-group.co.uk

Shareholder services

Share Dealing Service

The low-cost share dealing services offered by Stocktrade enable shareholders to buy and sell shares in the Company on a low-cost basis and to make regular investments in the Company.

Individual Savings Accounts

By holding their shares in the Company in a Mini or a Maxi Individual Savings Account (ISA), shareholders may gain tax advantages. The corporate ISA is administered by Lloyds TSB Registrars.

Scrip Dividend Alternative

A scrip dividend alternative is available to shareholders so that dividends may be received in the form of shares instead of cash. If you would like to receive your dividends in future in the form of shares, an explanatory brochure and mandate form may be obtained from Lloyds TSB Registrars.

Details of the above shareholder services are available from the Company Secretary's Department, telephone: 01392 257977.

Online Portfolio Service

The online portfolio service provided by Lloyds TSB Registrars gives shareholders access to more information on their investments. Details of the portfolio service are available from Lloyds TSB Registrars online at www.shareview.co.uk

E-voting

Shareholders may register the appointment of a proxy for the annual general meeting and any adjournment(s) at www.sharevote.co.uk – a website operated by Lloyds TSB Registrars.

Shareholder information

The Group's role in the community

Information about the Group's role in the community and copies of the Group's Environmental and Social Report may be obtained by writing to us at the address below. This information is also available on the Group's website.

Shareholder enquiries

The Company's share register is maintained by Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6DA. Telephone 0870 600 3953. Please contact them if you have enquiries about your shareholding, including those concerning the following matters:

- change of name or address
- loss of share certificate, dividend or tax voucher
- obtaining a form for dividends to be paid directly to your bank or building society account (tax vouchers will still be sent to your registered address unless you request otherwise)
- obtaining details of the scrip dividend alternative which enables you to receive Pennon shares instead of the cash dividend
- requesting duplicate copies of the annual report and accounts

Lloyds TSB Registrars operate a web based enquiry and portfolio management service for shareholders.
Visit www.shareview.co.uk for details.

Annual general meeting

The 2004 annual general meeting will be held on Thursday 29 July 2004. Further details are set out in the Notice of Meeting sent to all shareholders.

Proxy voting

Appointing a proxy

A proxy form is enclosed with the Notice of Meeting for the annual general meeting and instructions for its use are shown on the form. Proxies must be submitted by 6.00pm on 27 July 2004 to Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6UQ. Details of how to submit your proxy electronically are given below.

Electronic proxy voting

Shareholders may register the appointment of a proxy for the annual general meeting and any adjournment(s) thereof electronically at www.sharevote.co.uk a website operated by the Company's Registrars, Lloyds TSB Registrars. Shareholders are advised to read the terms and conditions shown on the website relating to the use of this facility before appointing a proxy. Any electronic communication sent by a shareholder that is found to contain a computer virus will not be accepted.

Electronic communications facilities are available to all shareholders and those who use them will not be disadvantaged in any way.

The Pennon website

The Pennon website at www.pennon-group.co.uk provides news and details of the Company's activities plus links to Company websites. The shareholder information section contains up-to-date information including the Company's latest results and dividend payment dates and amounts. It also holds historical details and a comprehensive share price information section.

Visit: www.pennon-group.co.uk/shareholder_info/shareprice.asp

General enquiries: Please contact: Mrs Margaret Heeley, Assistant Company Secretary, Pennon Group Plc
Peninsula House, Rydon Lane, Exeter, Devon EX2 7HR. Telephone 01392 443060