

Registered number: 2366640

PENNON GROUP PLC

**ANNUAL REPORT
AND
ACCOUNTS 2005**



PENNON GROUP PLC OPERATES AND INVESTS IN THE AREAS OF WATER AND SEWERAGE SERVICES AND WASTE MANAGEMENT. IT HAS ASSETS OF £2.7 BILLION AND EMPLOYS AROUND 2,600 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

- Turnover up 17.6% to £554.2 million
- Operating profit up 9.1% to £151.5 million*
- Profit before tax up 10.9% to £87.4 million*
- Earnings per share up 9.4% to 63.1p**
- Dividend per share up 4.9% to 43.0p

* Before net exceptional items in 2004/05 of £0.1 million (income of £5.0 million less costs of £4.9 million; 2003/04 cost £6.5 million)

** Before deferred tax and exceptional items. Basic earnings per share are 54.6p.

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•• CHAIRMAN'S STATEMENT

Ken Harvey – Chairman – Pennon Group Plc

THE GROUP HAS DELIVERED EXCELLENT RESULTS THIS YEAR. THEY DEMONSTRATE FURTHER PROFITABLE GROWTH AND AFFIRM OUR STRATEGY OF FOCUSING ON OUR TWO KEY BUSINESSES, SOUTH WEST WATER LIMITED AND VIRIDOR WASTE LIMITED.

•• FINANCIAL OVERVIEW

Group turnover rose by 17.6% to £554.2 million, due mainly to increased revenue generated by the Ofwat approved tariff increases in South West Water and from another year of strong trading by Viridor Waste.

Before exceptional items and goodwill, operating profit increased by 9.1% to £151.5 million, profit before tax increased by 10.9% to £87.4 million and earnings per share (before deferred tax) saw an increase of 9.4% to 63.1p.

The Directors are recommending a final dividend of 29.2p per share, a 5.0% increase in line with the Board's previously stated progressive dividend policy. Together with the interim dividend of 13.8p, this will result in a total dividend for the year of 43.0p, a 4.9% increase on the total dividend for the previous year.

As confirmed at the time of the Group's interim results in December 2004, the Board intends to continue to increase the Group dividend in real terms, at least up to 2009/10 and following its successful re-introduction two years ago, the Board also intends to offer shareholders a scrip dividend alternative.

•• SOUTH WEST WATER LIMITED

The year was dominated by the final stages of the Periodic Review process for the period 2005-2010. This culminated in Ofwat confirming average price increases of around 25% in real terms over the five year period.

A great deal of time, energy and expertise was devoted to the whole Review process throughout which South West Water endeavoured to strike the right balance between value for money investment, financeability and customer affordability. This was achieved against a backdrop of acknowledging that further price increases were inevitable in order that the company would be able to meet Governmental and regulatory requirements.

The Final Determination represents another very tough challenge for South West Water, but the company has already instigated a number of restructuring and organisational initiatives aimed at delivering the demanding efficiency targets imposed.

During the year, South West Water continued to provide high levels of product and customer service whilst the successful delivery of its environmental enhancement programme continued to ensure the region is able to boast some of Europe's finest bathing waters, beaches and rivers.

Excellent progress was also made in the area of water mains rehabilitation where the company's enhanced programme delivered record lengths of renovated water mains.

Another creditable success during the year was South West Water's progress within the 2003/04 Ofwat 'Overall Performance Assessment', which saw the company achieve one of the best performance improvements of all the sector companies.

•• VIRIDOR WASTE LIMITED

Viridor Waste delivered strong financial performance during the year with turnover showing a 35.6% increase and operating profit before goodwill a 31.3% increase.

Since 2000/01, operating profit before goodwill has grown at a compound rate of 22.8% per annum, with approximately 12% from organic income streams and the remainder via acquisitions.

The previous year's acquisition, Churngold Holdings Limited, has been fully integrated into the business and was earnings enhancing after goodwill amortisation one year earlier than predicted at acquisition.

Thames Waste Management Limited was acquired in April 2004 and this too has been fully integrated into the business and is performing well ahead of forecasts. Both acquisitions reinforced Viridor Waste's stated strategy of capitalising on its strong position in the landfill waste disposal market, exploiting opportunities in renewable energy from landfill gas and pursuing profitable opportunities in line with the Government's developing waste strategy.

In addition to its existing activities, Viridor Waste is developing a range of new technologies at various locations throughout the UK in anticipation of the importance of technology as councils endeavour to meet their European Landfill Directive targets via the diversion of an increasing proportion of municipal waste from landfill sites.

•• STRATEGY AND PROSPECTS

The Board's priority continues to be the creation of shareholder value via its strategic focus on water and sewerage services and waste management. The Group financial results for the year are testament to the Board's strategy of focusing on these key business areas and underpin its resolve to continue its existing progressive dividend policy of increasing the Group dividend in real terms until at least 2009/10.

The Board is confident that South West Water will successfully deliver the regulatory challenges imposed for the K4 period – 2005-2010 and significantly increase its regulatory asset value up to 2010. Viridor Waste's successful philosophy of creating long-term sustainable profit growth is expected to continue as it pursues its previously stated strategy.

•• BEST PRACTICE

The Pennon Group prides itself in being in the vanguard of change, especially in the areas of innovation and best practice. Indeed, the Group has received many accolades for various elements of its business including its 'green' credentials, its progress in the area of corporate responsibility and financial reporting.

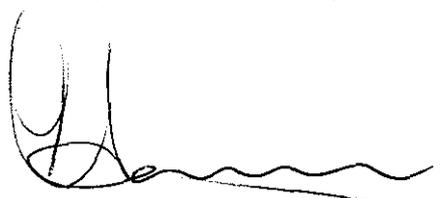
For financial years beginning 1 April 2005, Directors of UK quoted companies are required to provide an Operating and Financial Review (OFR) in their Annual Reports. Whilst Pennon is not required to provide an OFR in this Annual Report, it has decided to provide further information about the Group and its business in an OFR format. The aim is to achieve the principal objectives of the OFR which are designed to assist investors in assessing the strategies adopted by the Company and the potential for those strategies to be achieved.

The OFR reporting standards have been confirmed only very recently. Whilst the Company has endeavoured to take them into account, the OFR produced for this Annual Report, although being comprehensive, will not be totally compliant with the full reporting standards.

Preparations for the adoption of International Financial Reporting Standards (IFRS) are well underway. These come into effect from 1 April 2005 and the principal differences between the previous UK and international accounting standards likely to impact on the Group are detailed on pages 86 to 88.

•• EMPLOYEES

Throughout the many structural and organisational changes that have taken place within the Group over the years, our employees have adapted to change, adopted new working practices and philosophies and have always performed superbly to ensure the Group remains profitable, successful and a leading player in its sector. I thank them and my fellow Directors most sincerely for their unstinting support and loyalty which has helped the Group achieve its goals yet again.



KEN HARVEY, Chairman, Pennon Group Plc
23 June 2005

•• BUSINESS REVIEW

Bob Baty – Chief Executive – South West Water Limited

IN A YEAR DOMINATED BY THE FINAL STAGES OF THE PERIODIC REVIEW PROCESS FOR THE PERIOD 2005 – 2010, SOUTH WEST WATER CONTINUED TO DELIVER EXCELLENT FINANCIAL PERFORMANCE, FIRST CLASS LEVELS OF PRODUCT AND CUSTOMER SERVICE AND OUTPERFORMED CHALLENGING REGULATORY TARGETS.

•• SOUTH WEST WATER LIMITED

The company's turnover increased by 6.2% from £291.8 million to £309.8 million with Ofwat approved tariff increases accounting for £21.2 million of the increase together with 7,300 new customer connections and incremental commercial sales. 25,400 customers switched from an unmeasured to a measured charging basis offsetting the turnover increase by £6.3 million.

South West Water's operating profit increased by £2.8 million to £121.7 million before the exceptional restructuring charge of £3.4 million. Operating costs increased by £15.2 million to £188.1 million including £5.7 million for the operation of new capital schemes, inflation of £4.4 million and £9.2 million of other costs mainly pensions, direct cost of sales and bad debts. These costs were offset by efficiency savings of £4.1 million.

An ongoing programme of restructuring and continuous improvement in order to reduce significantly overhead and operating costs is in progress. The company, which has an excellent track record in this area, has since 1995 reduced base costs by £50.1 million.

In line with regulatory requirements, capital expenditure remained at virtually the same level as the previous year at £141.9 million. £66.1 million was invested in water supply improvements, including water mains renovation, water treatment works enhancement and leakage control. Ofwat's latest report on leakage noted that South West Water continues to be one of the leading companies in managing water leakage and continues to deliver results in line with the regulatory leakage target. Over 600 kilometres of water mains were laid, replaced or refurbished during the year, a major increase on the previous year. Drinking water quality is at an all time high and the region features the highest proportion of high quality rivers in England.

Waste water investment expenditure totalled £75.8 million for the year. Commissioning of the Ilsham Valley Pumping Station in Torbay commenced in early April 2004 and its operation signalled the completion of the final major project in the company's 15 year original 'Clean Sweep' coastal sewage treatment improvement programme. 'Clean Sweep' has transformed the coastal environment around the South West and 81% of the region's bathing waters now meet the stringent EU guideline standards and 98% of bathing waters conform with EU mandatory standards. These quality achievements are amongst the very best in the UK.

The successful delivery of both coastal water and river water quality improvement programmes has been a pivotal factor in the region's attainment of higher levels of environmental enhancement in support of economic prosperity.

A further measure of the company's success has been its progress within the 2003/04 Ofwat 'Overall Performance Assessment' which has seen South West Water achieve one of the largest performance improvements during the year as capital expenditure, previously constrained in a range of business areas whilst the coastal clean-up was delivered, is now being invested in other areas.

In December 2004, Ofwat announced its Final Determination on price level increases for the period 2005 – 2010, which confirmed average price increases of around 25% in real terms over the five year period. Throughout the Periodic Review process, South West Water endeavoured to strike the right balance between value for money investment, financeability and customer affordability whilst acknowledging that further price increases were inevitable in order that the company would be able to meet the Governmental and regulatory demands.

The Determination represents a very tough challenge for the company, but one it has accepted and will overcome. It has already implemented a number of reorganisational and restructuring initiatives in order to attain the demanding efficiency targets imposed, including a manpower reduction programme which will see employee levels reduced by 100 over the period.

•• BUSINESS REVIEW

Colin Drummond – Chief Executive – Viridor Waste Limited

VIRIDOR WASTE DELIVERED FURTHER STRONG 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
- pursuing profitable opportunities arising from the Government's developing waste strategy.

Financial results for the year were particularly strong. Turnover at £248.3 million increased by 35.6% on the previous year. Operating profit before goodwill at £29.8 million increased by 31.3% driven by good performance from the underlying landfill, power generation and collection businesses and the positive impact of the Thames Waste Management Limited acquisition. Since 2000/01 operating profit before goodwill has grown at a compound rate of 22.8% per annum, of which around 12% has been organic, with the rest being achieved through acquisitions. Profit before tax in the year at £18.0 million increased by 22.4% on the previous year. This financial performance reflects the success of Viridor Waste's focused strategy.

The previous year's acquisition, Churngold Holdings Limited – now renamed Viridor Waste (Bristol Holdings) Limited – has been fully integrated into the business and was earnings enhancing after goodwill amortisation, one year ahead of forecast at the time of acquisition.

In April 2004, Viridor Waste acquired Thames Waste Management – now renamed Viridor Waste (Thames) Limited – for £30.8 million. This company comprised one operational landfill of four million cubic metres of consented void strategically located within the M25 motorway near Sutton, Surrey, 5 megawatts (MW) of landfill gas power generation capacity and four liquid treatment facilities together with an associated tanker fleet. This acquisition also included a contract to handle the disposal of Thames Water's sewage sludge. Since acquisition, it has won a similar contract with Southern Water. This acquisition has also now been fully integrated into the business and was earnings enhancing after integration costs and goodwill amortisation, one year ahead of forecast.

During the year Viridor Waste gained planning approval for an additional 3 million cubic metres of void, along with associated recycling and composting at its strategic landfill at Heathfield in Devon. After taking account of this and usage of 5 million cubic metres plus other minor gains and losses, Viridor Waste's consented void was 80 million cubic metres at 31 March 2005.

Landfill inputs excluding cover were 4 million tonnes including Thames Waste Management. (Excluding the effect of the Thames Waste Management acquisition, volumes on a like-for-like basis increased 2% on the previous year). Revenues per tonne were 10% up. In July 2004, the disposal of various types of hazardous waste to non-hazardous landfills was banned which resulted in particularly strong landfill volumes and prices in the first half of the year in advance of the ban.

During the year, Viridor Waste brought a further 7MW of landfill gas power generation on stream 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). This brings the company's total capacity (excluding a small amount handled by third party subcontractors) to 52MW compared with 28MW in 2002 before the introduction of the ROCs scheme. Approximately 56% of this capacity benefits from ROCs.

During the year, the Government, as part of its developing waste strategy, announced specific targets for the diversion of municipal waste from landfill in the period up to 2020, along with a system of penalties for councils who fail to meet their targets. These targets flow from the European Landfill Directive. There are no specific targets for other waste streams such as industrial, commercial and construction/demolition waste which account for roughly two thirds of the landfill market. This may be expected to lead to a decline in the total volumes of waste going to landfill in the long-term. However, with only around six years consented landfill capacity in the UK (according to Environment Agency estimates), and with new consents becoming increasingly difficult to obtain, Viridor Waste's 80 million cubic metres of consented void are expected to become an increasingly valuable resource.

At the same time, municipal landfill diversion creates new opportunities as councils seek to let long-term integrated waste management contracts in order to meet their diversion targets and avoid penalties. These contracts will often attract Private Finance Initiative (PFI) funding. Viridor Waste believes there may be significant opportunities in these contracts, subject to a fair sharing of risk between councils and contractors and is pursuing them in a selective manner. During the year, the company commenced its first such contract with West Sussex County Council and it has performed well.

Viridor Waste is also exploring a range of new technologies with Government financial assistance (DEFRA/London Recycling Fund), in partnership with its council customers. It has opened in-vessel composting plants at Heathfield (Devon) and Beddington (Surrey) whilst others are under construction at Lackford (Suffolk) and Broadpath (Devon). The company has also gained planning permission and financial assistance from the London Recycling Fund for a mechanical/biological treatment plant at its Beddington landfill. Such technologies are likely to become more important as councils strive to meet their diversion targets.

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 corporate responsibility report. Viridor Waste is pleased to report that it gained ISO 14001 accreditation at a further two centres during the year, bringing the site accreditation total to 35 centres covering 100 operational sites.

•• OPERATING & FINANCIAL REVIEW

THE PENNON BOARD'S PRIORITY IS THE CREATION OF SHAREHOLDER VALUE THROUGH ITS STRATEGIC FOCUS ON WATER AND SEWERAGE SERVICES AND WASTE MANAGEMENT.

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•• INTRODUCTION

For financial years beginning on or after 1 April 2005, directors of quoted companies are required to provide an Operating and Financial Review (OFR) in their Annual Reports in accordance with the requirements of the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005. Whilst Pennon Group is not required to provide an OFR in this Annual Report, it has decided to provide further information about the Group and its businesses in an OFR format with a view to achieving the principal objectives of the OFR which are to assist investors to assess the strategies adopted by the Company and the potential for those strategies to succeed.

The Accounting Standards Board (ASB) is the body appointed by the Secretary of State to provide a statement of standard reporting practice which relates to OFRs. The ASB has only recently produced a reporting standard in relation to OFRs and, whilst the Company has sought to take into account the requirements of the reporting standard, the Directors have not drafted this OFR with a view to it being compliant with the reporting standard. The Company will produce an OFR in its 2006 Annual Report which is compliant with the requirements of the reporting standard.

Certain terms used throughout this OFR are explained/defined in the Interpretation section on page 35 and in the Glossary section on page 36.

• Forward looking statements

This OFR contains forward looking statements regarding the financial position, results of operations, cash flows, dividends, financing plans, business strategies, operating efficiencies, capital and other expenditures, competitive positions, growth opportunities, plans and objectives of management and other matters. These forward looking statements, including, without

limitation, those relating to the future business prospects, revenues, working capital, liquidity, capital needs, interest costs and income in relation to the Pennon Group and its subsidiaries, wherever they occur in this OFR, are necessarily based on assumptions reflecting the views of Pennon Group and its subsidiary companies, as appropriate. They involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward looking statements. Such forward looking statements should, therefore, be considered in light of relevant factors, including those set out in the section entitled 'Risks and uncertainties' on page 23.

•• OVERVIEW AND STRATEGY

• Pennon Group

Pennon Group Plc (Pennon Group) operates and invests in the areas of water and sewerage services and waste management. It has assets of £2.7 billion and employs around 2,600 people. It has two main subsidiaries – South West Water Limited (South West Water) and Viridor Waste Limited (Viridor Waste).

The Board's priority, as set out in its Mission Statement, is the creation of shareholder value through its strategic focus on water and sewerage services and waste management. It aims to be a pre-eminent operator in these business areas to ensure the hallmarks of quality, efficiency and reliability which will help to meet the three key goals of:

- Satisfying Customers
- Enhancing the Environment
- Adding value for Shareholders, Employees and the Regional Community.

•• OPERATING & FINANCIAL REVIEW

• South West Water

South West Water is the licensed water and sewerage service provider for Devon, Cornwall and parts of Dorset and Somerset. It serves a region of nearly 10,300 square kilometres with 1.6 million residents and around eight million annual visitors. It supplies over 455 million litres of treated water per day through 15,000 kilometres of water mains and then disposes of around 265 million litres of waste water each day via 9,000 kilometres of public sewers.

The asset base of South West Water comprises:

Distribution mains	15,000 kms
Sewers	9,000 kms
Impounding reservoirs	16
Water treatment works	39
Waste water treatment works	614
– including works with ultra violet treatment	52
Combined sewer overflows	1,061

The company has successfully delivered the largest capital programme per capita of any of the privatised water and sewerage companies with a particular focus on improving coastal waste water treatment and disposal. The region currently has 143 EU designated bathing waters, almost one third of the total in England and Wales.

South West Water expects to create value through delivering the regulatory contract agreed with Ofwat, the water regulator, the size and content of which is reviewed at five-yearly intervals. As well as determining outputs, Ofwat sets prices, inter-alia, to enable efficient companies to earn a reasonable rate of return on their assets. In the K4 Determination, which covers the period from April 2005 to March 2010, Ofwat assumed that the equity cost of capital for all companies is 7.7% real after tax with an overall weighted average cost of capital of 5.1% real after tax. Ofwat's Determination allows for further investment by South West Water to improve the quality of water and sewerage services. This is expected to result in the company's regulatory asset value increasing from around £1.95 billion in March 2005 to circa £2.6 billion in March 2010, thereby enlarging the base on which the return to shareholders is calculated.

Additional value may be created where South West Water outperforms Ofwat's assumptions by, for example, delivering services at lower operating and/or capital costs than Ofwat assumed, and/or financing the investment programme at lower costs than Ofwat assumed.

The successful delivery of a restructuring and continuous improvement programme over the K3 regulatory period (2000 – 2005) to significantly reduce overhead and operating costs, ensured that South West Water outperformed the demanding operational and capital efficiency targets imposed by Ofwat. In K3, the company also grew its regulatory asset value ahead of the increase in net debt.

• Viridor Waste

Viridor Waste is a leading provider of essential waste treatment, recycling and disposal services in the UK. It has core competencies in landfill disposal and generation of electricity from landfill gas. It has a waste collection fleet focusing primarily on the industrial and commercial market and a clinical waste incinerator. It also operates materials recycling facilities, waste transfer stations, civic amenity sites and composting facilities in a number of regions in the UK.

The asset base of Viridor Waste comprises:

Landfill sites – operational	20
Landfill sites – non-operational	
with planning	3
Power generation plants	19
Transport depots	23
Collection vehicles	270
Waste transfer stations	18
Incineration plant	1
Materials recycling facilities (MRF)	12
Glass recycling plants	2
Glass recycling depots	5
Waste treatment plants	6
Composting sites	5
Civic amenity sites	43

Map here

Viridor Waste's strategy is to add value by:

- 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
- pursuing profitable opportunities arising from the Government's developing waste strategy.

Viridor Waste's landfill market consists of municipal, commercial and industrial wastes along with contaminated soils and certain other special types of waste. Landfill is currently the major final disposal route for these wastes.

As a result of the measures taken by the Government to encourage recycling and comply with the requirements of the EU Landfill Directive, the amount of bio-degradable municipal waste in the UK as a whole going to landfill can be expected to decline gradually. Municipal waste is around one third of Viridor Waste's landfill market. However, although there are regional variations, according to the Environment Agency's (EA) most recent estimates, there remains the equivalent of only around six years' overall consented landfill capacity in the UK as a whole and new planning permissions are difficult to achieve, particularly for green-field sites. In view of the above, the Directors believe that consented landfill void will remain an increasingly valuable resource.

Viridor Waste is one of the largest landfill site operators in the UK with a total consented landfill capacity of approximately 80 million cubic metres. The company is at present filling this at a rate of approximately 5 million cubic metres per annum which results in an average remaining life of 16 years at current rates of fill – significantly longer than the industry as a whole. This capacity is located as shown on the map opposite.

Gas produced from decomposing waste on landfilled sites (landfill gas) is increasingly used to generate electricity. It is a form of renewable energy and now represents over 25% of the UK's total renewable energy generation. The Government's strategy is to increase the percentage of electricity generated from renewable sources from the current figure of under 4% to a target of 10% in 2010 and 15% in 2015 with an aspiration of 20% in 2020. To meet this target, the Government has introduced premium pricing regimes, most recently renewable obligation certificates (ROCs), to encourage all eligible forms of renewable energy including landfill gas. This has facilitated Viridor Waste in increasing its total generation capacity to a current 52MW, compared with 28MW in March 2002 prior to the introduction of ROCs.

To take advantage of opportunities presented by the Government's developing waste strategy, Viridor Waste is pursuing composting, civic amenity or household waste recycling sites (HWRS) and other recycling opportunities. These may be combined in integrated waste management contracts.

•• OPERATING & FINANCIAL REVIEW

In pursuing its strategy, Viridor Waste seeks to grow its waste management business, both organically and through acquisition. It has continued to be an active participant in the consolidation of the UK waste market to date and, since October 2001, has made seven acquisitions in the waste sector for an aggregate consideration of approximately £104 million. They have been integrated into the Viridor Waste group. The most recent acquisition was Thames Waste Management Limited from RWE Umwelt AG, details of which are set out in the Chief Executive's Business review.

As a result of this focused strategy, Viridor Waste's turnover (including landfill tax) has grown from £106.1 million to £248.3 million over the period 2001 to 2005. Its operating profit (before amortisation of goodwill) has increased from £13.1 million to £29.8 million, a compound annual growth rate of 22.8%. This has been the result of organic growth of the underlying business of around 12% per annum and the beneficial impact of recent acquisitions.

•• DIVIDEND POLICY

The Group is committed to a progressive dividend policy under which it expects to increase the dividend payable to shareholders in real terms each year, barring unforeseen circumstances, at least up to the end of the K4 period in 2010.

A scrip dividend alternative is available to shareholders enabling them to acquire new shares issued by the Company without incurring dealing costs. The scrip take-up has resulted in 876,879 new shares being issued in April 2004 in respect of the 2003/04 interim dividend and 2,274,426 shares being issued in October 2004, in respect of the 2003/04 final dividend. The total value of the scrip take-up during the year was £22.8 million.

•• SOUTH WEST WATER REGULATORY & COMPETITIVE ENVIRONMENT

• Licences

In 1989, the UK Government appointed companies (appointees) to provide water and waste water services (the Appointments). Economic regulation pursuant to the Appointments is the responsibility of the water regulator Ofwat.

The Appointments impose conditions which Ofwat enforces, along with the appointees' principal duties under the Water Industry Act. An Appointment may be terminated on 25 years notice by the Secretary of State, with more immediate revocation in certain specified circumstances (including, for example, failure to comply with an enforcement order made by Ofwat).

The water industry is also subject to Government direction and legislation in relation to investment requirements and social policy (for example the protection of vulnerable customers). From a customer interest perspective, water industry activities are also reviewed by WaterVoice, part of Ofwat, which is being replaced by a separate statutory body, the Consumer Council for Water.

• Price cap regulation

Ofwat regulates water and waste water charges by determining the maximum increase in charges which a company can impose in any year. The water regulator conducts a Periodic Review and sets price limits every five years. Prices are set by reference to inflation as measured by the index of retail prices (RPI) plus an adjustment factor known as 'K' which is specific for each company and which can vary for each year of the Review period. The size of a company's 'K' factor (which can be positive, negative or zero) reflects the scale of its capital investment programme, the cost of capital determined by the water regulator and its operational and environmental obligations offset by assumed efficiency improvements required of the company. Ofwat has instituted a system of 'comparative competition' and compares South West Water's performance on a wide range of parameters, including efficiency, customer service, and environmental performance. Operating cost comparisons are used by Ofwat to determine the level of efficiency improvement which might be achieved at each Periodic Review. Other parameters enable Ofwat to compare and publish details on South West Water's customer service performance compared to other water companies.

Companies are incentivised to be efficient both in terms of their operating costs and in the implementation of their capital expenditure programme. The benefit of any efficiency savings achieved through effective management in excess of those assumed by the water regulator is retained by the companies for a period generally of five years, after which time the benefit is passed to customers. The cost of any underperformance due to poor management is borne by the companies.

Companies are also incentivised to provide a high quality service and penalised if they provide a poor quality service by means of an adjustment to the 'K' factor at the subsequent Periodic Review.

Unexpected costs or savings arising from changes in certain regulatory assumptions or legal requirements during a Periodic Review period are recorded by South West Water and may be in certain circumstances agreed by Ofwat. This process, known as 'logging up and down', allows prices to be adjusted up or down at the next Periodic Review to compensate for the unexpected change. In addition, in certain circumstances, where the change is material, the company can request, and Ofwat can instigate, a re-setting of its price limits (K factors) during the five-year period, known as an 'interim determination of 'K'' (IDoK).

The K factors for the period 2005 – 2010 for South West Water were determined by Ofwat in its Final K4 Determination of December 2004 as set out below:

Year	Ofwat Final Determination K factor %
2005/06	12.5
2006/07	9.8
2007/08	9.8
2008/09	1.7
2009/10	1.4
Average	6.9

The K4 Determination provides for total capital expenditure of £762 million (2002/03 prices) over the five year period. The price limits are intended to enable South West Water to:

- Continue to maintain a safe, reliable water supply to customers and effective treatment and disposal of sewage, including increasing activity to maintain its pipes, sewers and sewage treatment works
- Implement new odour control measures at priority sites
- Meet the demands of new and existing customers for a reliable water supply and sewerage service

- Install 113,000 optional domestic customer water meters by 2009/10
- Deliver required drinking water and environmental quality improvements including:
 - renovation of more than 3,200 kms of water distribution mains
 - improvements at 14 water treatment works to improve treated tap water
 - phosphorous removal at nine sewage treatment works
 - work to address 49 unsatisfactory intermittent discharges
- Resolve or mitigate problems identified in the company's plan where overloaded sewers cause flooding inside properties
- Maintain access to capital markets to finance delivery of these outputs at a reasonable cost.

In setting price limits for South West Water, Ofwat assumed the following efficiency improvements:

- Average annual operating efficiency improvements of 2.5% (water) and 2.0% (sewerage)
- Capital maintenance efficiency improvements of 5.0% (water) and 8.7% (sewerage)
- Capital enhancement efficiency improvements of 5.0% (water) and 16.4% (sewerage).

• Environment/quality regulation

The water industry in the UK is subject to substantial domestic and EU regulation, placing significant statutory obligations on South West Water with regard to amongst other things, the quality of treated water. Examples of relevant EU directives include the Drinking Water Directive, the Bathing Water Directive and the Urban Waste Water Treatment Directive. The Water Framework Directive was incorporated in 2003 into UK law and is intended to rationalise EU water legislation providing a framework for the protection of and improvement in the quality of water resources together with the promotion of sustainable water consumption. To comply with the Water Framework Directive, member states will have to achieve the challenging target of 'good' status for ground water, river water, as well as estuarine and coastal water by the end of 2015.

•• OPERATING & FINANCIAL REVIEW

Environmental regulation for water and waste water in England is primarily the responsibility of the Secretary of State for Environment, Food and Rural Affairs, together with, among others:

- the Environment Agency (EA) which is responsible for the licensing of water abstraction and the regulation of discharges to controlled waters, including discharges from waste water treatment works
- the Drinking Water Inspectorate (DWI) which sets and enforces drinking water quality standards.

• Competition

South West Water is the licensed appointee for the provision of water and sewerage services primarily in Devon, Cornwall and small parts of Dorset and Somerset. As the licensed undertaker, it has no direct competition for the provision of these services to the vast majority of its customers. The Government is introducing a new regime whereby customers using more than 50Ml per year can contract with alternative suppliers for water supply. South West Water has only 42 customers in this category, whose aggregate water charges account for less than 2% of its total turnover.

•• VIRIDOR WASTE REGULATORY & COMPETITIVE ENVIRONMENT

The UK is required under the EU Landfill Directive to reduce the amount of biodegradable municipal waste going to landfill sites as follows:

- to 75% of 1995 level by 2010
- to 50% of 1995 level by 2013
- to 35% of 1995 level by 2020

Municipal waste accounts for only around one third of waste going to landfill in the UK.

The alternatives to landfill sites for final waste disposal in the UK are currently limited. In order to meet the requirements of the Landfill Directive, local authorities have been set statutory targets by the Government for the recycling of household waste and must also implement strategies for the diversion of biodegradable municipal waste from landfill.

Each waste disposal authority has been allocated an allowance of the amount of biodegradable waste it may dispose of to landfill for the years 2005 to 2020. These allowances are designed to ensure that the UK as a whole

achieves the requirements of the EU Landfill Directive. Subject to some constraints, local authorities can carry forward or trade under the Landfill Allowance Trading Scheme (LATS) allowances. Any authority exceeding its allocation without such an allowance faces a penalty of £150 per tonne in addition to the cost of disposing of the waste. This is expected to result in the introduction of alternative disposal processes at higher cost than current routes.

The Government introduced landfill tax as a further incentive to divert waste from landfill sites. Landfill tax applies to all waste disposed at a licensed landfill site, unless the waste is specifically exempt, such as soil from historically contaminated sites. Landfill tax is chargeable by weight. For inert waste, landfill tax is chargeable at £2 per tonne. A standard rate of £18 per tonne currently applies to all other taxable waste which is due to rise by at least £3 per tonne per annum in the next few years, to reach a medium to long term rate of £35 per tonne.

• Planning for landfill sites

All waste management facilities including the development of new landfill sites and expansion of existing landfill sites are subject to planning permission from the relevant local authority. Landfill (and hazardous waste facilities) also require a Pollution, Prevention and Control (PPC) permit from the EA.

Viridor Waste believes that good environmental management is important in winning future planning consent. It has achieved ISO 14001 (Environmental Management Systems) accreditation at all of its key sites.

Planning applications are subject to a rigorous assessment by the local authority who will consider them against the backdrop of the local waste policy development plans that it has compiled for its area. Applications have to address a wide range of issues, and the EA is a statutory consultee in this process.

• Landfill gas power generation

Landfill gas power generation is a form of renewable energy and it is Government policy to increase the proportion of electricity generated from renewable sources from just over 4% currently to 10% by 2010 and to 15% by 2015. Historically, renewable energy projects were supported by the Government through the Non Fossil Fuel Obligation (NFFO) scheme. Fixed price RPI indexed contracts with terms of up to 15 years were awarded to the most competitive renewable projects in

five tranches of bidding. Since April 2002, no new contracts have been awarded under the NFFO regime which has been replaced by the ROCs regime.

The overall price for electricity supplied under ROCs is currently higher than that achieved under the most recent NFFO scheme to encourage new generation.

• Integrated waste management contracts and the role of Private Finance Initiatives (PFIs) in the waste management industry

In order to assist in meeting their landfill diversion targets, local authorities are seeking to let integrated waste management contracts covering a range of activities often including HWRS, composting, recycling, waste transfer and bulk transport and final disposal (both incineration and landfill). In a number of instances, these will be financed under the PFI regime.

Under this regime, local authorities apply to the Government for funding for capital projects which fall within the eligibility criteria. Successful applicants receive cash funds (known as PFI credits), which do not have to be repaid and can be used by the local authority to fund a proportion of the capital and operating expenditures needed for the project.

Considerable investment (potentially as high as £30 billion by 2020 as estimated by the Institution of Civil Engineers) is required by the UK to meet municipal landfill diversion targets.

Viridor Waste secured and began servicing a 25-year Recycling and Waste Transfer PFI contract for West Sussex County Council in April 2004. The contract, designed to deliver a 45% recycling rate by 2015, involves the provision of 14 new or improved recycling and waste handling facilities and is supported by £25 million of PFI credits.

Viridor Waste recognises that there is a range of risks associated with entering into such contracts, which are often for a 25-year term. However, subject to a careful assessment of the risks on a contract by contract basis, the company will seek to secure such contracts.

• Waste regulation environment

EU directives and related UK legislation, as well as planning and licensing, are referred to above.

The EA and Scottish Environment Protection Agency (SEPA) monitor performance against permit conditions and general environmental law. Breaches are subject to prosecutions. The EA and SEPA can also require the

operator to undertake upgrades to ensure future compliance and, where a pollution incident has occurred, require clean-up action to be undertaken.

Waste facilities are also subject to the same regulations as other industries, including health and safety, control of goods hazardous to health and the Working Time Directive. In addition, the transport of waste is subject to specific controls.

•• CUSTOMER /SUPPLIER RELATIONSHIPS

The Group recognises that maintaining long-term relationships with customers and suppliers is key to achieving its strategic objectives. Further details of supplier relationships are set out in the supplier and contractors section of this OFR on page 28.

• South West Water

No single customer accounts for more than 1.0% of turnover. No supplier (revenue) accounts for more than 2.8% of turnover and South West Water sources all its purchases from competitive markets.

• Viridor Waste

Local authorities are the largest single customer group accounting in total for 30% of turnover. No individual authority accounts for more than 4%. Viridor Waste's ROC contracts account for 5% of turnover.

No supplier accounts for more than 1% of Viridor Waste's turnover. The company sources from competitive markets.

•• TECHNOLOGICAL CHANGES

• South West Water

South West Water uses a wide range of proven technologies with research work being progressed within UK Water Industry Research Ltd (UKWIR) and other service providers.

• Viridor Waste

The waste industry has not been characterised by rapid technological change. However, landfill diversion targets are encouraging the search for alternative waste treatment technologies. Viridor Waste is actively pursuing new composting and treatment technologies with Government financial assistance as noted in the Business review section.

•• OPERATING & FINANCIAL REVIEW

•• KEY PERFORMANCE INDICATORS (KPIs)

Key Performance Indicators (KPIs) used by the Directors to assess performance against their stated objectives are as follows:

• South West Water

Growth in Regulatory Asset Value

Regulatory Asset Value (RAV) is the financial base on which Ofwat allows a rate of return and sets prices. The opening RAV is adjusted for projected capital and infrastructure renewals expenditure, grants and contributions, infrastructure renewals charge and current cost depreciation together with the efficiency allowance from the previous regulatory period. Each component is projected for each year by Ofwat at the Periodic Review. The RAV is adjusted annually for Retail Price Index movements. At each Determination, RAV is restated for outputs under-delivered, the logging-up of new obligations and the effect of construction price inflation on capital and infrastructure expenditure. A full explanation is given in the Ofwat letter to Regulatory Directors RD07/05, which is available on the Ofwat website – www.ofwat.gov.uk

The RAV at 31 March 2005, as published in RD07/05, amounted to £1.95 billion, indexed to 2004/05 year end prices. The previously reported RAV for 31 March 2004 was £1.71 billion at 2002/03 year end prices. The movements include the incorporation of changes in construction prices in the K3 period, £81 million, and RPI indexation estimated at around £87 million.

Graph here

The RAVs up to 2003/04 are based upon South West Water's estimation of using COPI indexation. The 2004/05 RAV is the Ofwat opening position for K4 at 1 April 2005.

Operating profit

Operating profit is used as a key measure of the performance of South West Water. The company achieved an operating profit of £121.7 million in 2004/05, up £2.8 million on 2003/04. For the five year period 2001 to 2005, operating profit was as follows:

Year ended 31 March	2001	2002	2003	2004	2005
	£m	£m	£m	£m	£m
	107.3	107.0	111.5	118.9	121.7

Overall Performance Assessment

Overall Performance Assessment (OPA) has been devised by Ofwat as a comparative tool to measure companies' performance. The OPA assigns scores to performance in areas such as customer service and complaint handling, billing, debt collection, asset serviceability, environmental compliance and quality of drinking water delivered.

The data is collated for 12 month periods, part calendar year and part financial year and other than assessed customer service, which is produced by Ofwat and WaterVoice South West, incorporated in the June Return to Ofwat. The final OPA assessment is published as part of Ofwat's Annual Report on 'Levels of Service for the Water Industry in England and Wales', usually in the autumn.

South West Water scored 374 OPA points out of a maximum of 438 in 2003/04 and was tenth out of the 10 water and sewerage companies. However, only 20 points in total separated the bottom five companies and South West Water achieved one of the largest performance improvements of any of the water companies during the year. This was because capital expenditure, previously constrained whilst the coastal clean-up was delivered, has now been directed to address other areas. A further significant performance improvement has been achieved in 2004/05.

Graph here

Drinking water compliance

During 2004, South West Water improved its overall compliance with the drinking water quality regulations with 99.95% of its regulatory tests meeting the required standards.

Graph here

• Viridor Waste

Operating profit and profit before taxation (PBT)

Operating profit and PBT are used as key measures of the performance of Viridor Waste. Data on these is set out in the Financial position section of the OFR on pages 28 and 29 and set out in the table below for the five year period 2001 to 2005.

The table also sets out the Compound Annual Growth Rate (CAGR) (22.8% for operating profit and 11.4% for PBT) being the rate of growth between 2001 and 2005 expressed as a single average figure over the period.

Year ended 31 March	2001 £m	2002 £m	2003 £m	2004 £m	2005 £m	CAGR 2001 - 05
Operating profit before goodwill amortisation	13.1	15.2	19.1	22.7	29.8	22.8%
Profit before taxation	11.7	13.5	14.2	14.7	18.0	11.4%
Return on equity investment after corporate overheads	6.1%	7.1%	7.4%	7.5%	9.2%	-

Return on equity investment

Return on equity investment is also used as a key measure of the performance of Viridor Waste and represents profit before taxation expressed as a percentage on the amount of Pennon Group's equity investment in Viridor Waste, which amounted to £195.2 million at 31 March 2005. This is also set out in the table below.

Consented landfill void

As at 31 March 2005, Viridor Waste had a consented void capacity of 80 million cubic metres. This can be reconciled to the disclosed consented void capacity in last year's Annual Report, as follows:

	million cubic metres
As at 31 March 2004	79
Planning gains (net)	2
Acquisition	4
Used in the period	(5)
As at 31 March 2005	80

Landfill gas electricity generation capacity

Electricity generated is sold to electricity suppliers, usually under NFFO contracts or under short-term contracts with ROCs.

As at 31 March 2005, Viridor Waste had 52MW of generating capacity, an increase of 7MW over the 45MW disclosed in the Annual Report last year.

Graph here

Graph here

•• OPERATING & FINANCIAL REVIEW

•• CORPORATE RESPONSIBILITY

Pennon Group strives to achieve the appropriate balance between all its stakeholders, the environment and the needs of the Group.

One of the Group's key objectives is to maintain its reputation for integrity and fair dealing, which it considers is fundamental to the long-term well-being of the Group and its key stakeholders. The Group has a social and ethical policy which covers the key areas of finance, employees, customers and suppliers, community, management responsibility and communications.

The Group also has a 'Whistleblowing' policy which is reviewed regularly and supports its approach to ethical employment practices 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.

To benchmark its performance, the Group participates in the Dow Jones Sustainability Indexes, the Business in the Communities Environmental Index and is listed in the FTSE4Good Index. Further details are set out in the Group's annual corporate responsibility report.

Logos here

• Employees

The Directors believe that the strategies set out at the beginning of this OFR depend inter alia on the businesses' ability to attract and retain appropriately qualified and motivated employees, provide them with a safe working environment and the necessary training and development to fulfil their roles.

South West Water

In preparation for the challenges of the K4 period 2005 – 2010, South West Water has undertaken a major internal reorganisation including the establishment of a new asset management function, which it is anticipated will produce a more efficient approach to its asset investment and provide improved performance information about the company's assets. A major programme of familiarisation and training has been undertaken for those directly or indirectly affected by the changes. The reorganisation also enables the company to release a number of employees on early retirement or voluntary severance terms to assist with meeting the demanding efficiency targets arising from the K4 Determination. This process will continue throughout K4, with a directly employed labour force target of 1,300 by 2010.

Occupational health and safety remain key elements of South West Water's assessment of risk management. Following privatisation, the company set out to build an occupational health and safety culture in partnership with a number of stakeholders including trade unions, regulators, other water companies and construction partners, which has been introduced into all parts of the supply chain. South West Water's reportable accident rate of 12.5 accidents per 1,000 employees in 2004/05 compared with 17.5 per 1,000 employees in 2003/04, is a significant improvement, particularly as over the past two years better reporting systems have given rise to more accurate reporting of accidents arising from greater awareness amongst supervisors and managers. Training in skills acquisition and health and safety continues to ensure that employees have the knowledge and expertise to undertake their jobs to the best of their ability. In partnership with other water companies, South West Water leads 'Clear Water 2010', a national 10 year occupational health programme which has already demonstrated a significant reduction in work related ill health not reflected in other industrial sectors.

Viridor Waste

Viridor Waste is pursuing a number of occupational health and safety initiatives. Its reportable accident rate per 1,000 employees of 13.2 in 2004/05 (14.3 in 2003/04) continues to fall and has done so for two consecutive years, comparing favourably with industry averages. The company has recruited additional health and safety professionals during the year and is also raising the level of training and support available to its staff.

A significant challenge to Viridor Waste is the Road Transport (Working Time) Directive (RTD) which will limit Light Goods Vehicle (LGV) drivers' hours. Consequently, it will be necessary to employ more drivers despite a UK-wide shortage. The company is in discussions with the trade unions to mitigate the impact of the RTD on both the drivers and the company. Viridor Waste is also piloting training programmes with a view to aiding driver retention.

• The environment

The Directors believe that sound environmental performance is critical to the success of both South West Water and Viridor Waste. The Group has a long established environmental policy, as set out in its annual corporate responsibility report.

Both subsidiaries are subject to significant regulation and must comply with the high standards set by the EA to minimise their impact on the environment. Both are responsible for the treatment and disposal of society's waste in a carefully controlled and highly engineered manner. The companies acknowledge the importance of environmental sustainability and have taken measures to ensure that their operations are undertaken to enhance the environment whenever possible and minimise any adverse impact.

The Group is a major generator of renewable energy which supports the Government's objective to reduce greenhouse gas emissions. In 2004/05, the Group generated 365 GWh, which was the equivalent of 133% of the Group's total energy consumption.

South West Water

Water resources

In 2004/05, South West Water abstracted 177,279 ML of raw water from its 81 licensed abstraction locations which have a total licensed volume of 384,466 ML. The abstraction locations are either reservoirs, rivers or groundwater sources known as aquifers. This raw water is treated to a high standard before being put into supply for customers' use.

The company continues to invest in its distribution network and has consistently met its Ofwat leakage reduction target of 84ML/d (84 ML/d in 2003/04). During 2004/05, it rehabilitated almost 570 kms of water mains, a major increase on the previous year.

Waste water disposal

In 2004, the company improved its compliance with the standards set by the EA. The percentage population served by compliant waste water treatment works improved to 99.0% (98.7% in 2003).

For future years the company aims to maintain 99.0% as a minimum.

This high level of compliance is a major contributor to the region having a significant proportion of the finest bathing waters, beaches and rivers in the UK. In 2004, 98% of the region's 143 bathing waters achieved EU mandatory standards and 81% the more stringent guideline standards.

South West Water's region also has the highest percentage length of high quality rivers in England.

Viridor Waste

The most significant positive environmental impacts of Viridor Waste's operations arise from the safe and efficient disposal of society's waste materials, increased resource and energy efficiency from its recycling and recovery operations, the generation of renewable energy from non-fossil fuels and the restoration of despoiled landscapes such as disused mineral workings through the controlled deposit of waste materials. Significant negative impacts include transportation and associated emissions, methane production (where not harnessed), leachate production and potential local impacts such as dust, noise, litter and odour.

Viridor Waste operates an environmental management system (EMS) across all of its operational centres. 35 of these (covering 100 operational facilities) are accredited to the formal ISO 14001 standard. Viridor Waste developed and introduced its own EMS in the early 1990s recognising the growing importance of measuring and monitoring the environmental impact of its operations. This has allowed targets to be set and met to maximise positive environmental impacts and reduce negative impacts, thus resulting in continuous improvement in environmental performance.

Viridor Waste was the first UK waste company to achieve ISO 14001 accreditation across all major operational sites. It has also played a leading role in developing and adopting the environmental performance indicators for the waste industry as promoted by the Green Alliance.

•• OPERATING & FINANCIAL REVIEW

The amount of waste recycled by the company increased over the year to 780,129 tonnes (454,786 tonnes in 2003/04).

• Incidents and prosecutions

Whilst from time to time incidents do occur at operational sites, both South West Water and Viridor Waste endeavour to manage their operational activities to minimise the occurrence and impact of such incidents.

South West Water

The number of incidents classified by the EA as 'Category Two' (significant pollution incidents) in 2004/05 was reduced to four compared with 18 in 2003/04.

During the year, the company was convicted on 12 occasions for environmental offences and fined a total of £51,200, compared with 14 convictions and £49,000 in fines in 2003/04. The company has strategies in place to reduce incidents which lead to prosecutions. This process has been shared with the EA.

Viridor Waste

Viridor Waste had no EA 'Category Two' pollution incidents during the year but was convicted for seven offences at one site and fined £42,500. The company has put in place an action plan to address the issues which gave rise to the prosecutions. These convictions followed several years without any pollution incident convictions.

• Social and community issues

The Group believes in supporting the communities in which it operates. This is achieved through carefully targeted sponsorship and charitable donations to social and community groups, channelled primarily through the following initiatives:

- *Pennon Charitable Donations* – £50,000 was given during the year primarily to charities operating in Devon and Cornwall. The average size of donation was £500 which can make a significant impact on services provided by organisations. In addition, a further £50,000 was donated to the Tsunami appeal.
- *South West Water Community Sponsorship* – £73,000 was given during the year to a wide range of local groups and organisations including employee charity fund raising teams.
- *Landfill Tax Credit Scheme (LTCS)* – enables Viridor Waste to provide significant funding in areas within 10 miles of a landfill, thereby providing long-term social and environmental benefits to local communities. During the year, £3.9 million of funds were awarded. Since the inception of the Scheme in 1996, over £42 million has been distributed to environmental bodies, providing essential funding for more than 1,250 projects ranging from village hall repairs to protecting vital habitats. Following the recent Government changes to the LTCS, which created a new biodiversity category qualifying for funding, several showcase projects have been funded including the Avon Wildlife Trust's purchase of Prior's Wood, North Somerset and founding sponsorship of Manchester's 'Green Streets' campaign.
- *Pennon Environmental Fund Committee* – the Committee was established with the aim of advising Viridor Waste on the application of some landfill tax credits within primarily Devon and Cornwall. Whilst the recent changes to the LTCS have significantly reduced the amount of funding available £63,000 was allocated during the year based upon the recommendations of the Committee.
- *The South West Water Special Assistance Fund* – the Fund was established to provide help to customers endeavouring 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 for applications for help are made by an independent panel.

•• CURRENT PERFORMANCE AND FUTURE DEVELOPMENT

• Group overview

In 2004/05 Group turnover rose 17.6% to £554.2 million (2003/04 £471.3 million). Before net exceptional items of £0.1 million comprising £5.0 million now received from a business disposal in 1998 (2003/04 nil) less abortive acquisition costs of £1.5 million (2003/04 £6.5 million) and £3.4 million restructuring costs in South West Water (2003/04 nil), Group operating profit before goodwill was up by 9.1% to £151.5 million (2003/04 £138.8 million), Group profit before tax was up 10.9% to £87.4 million (2003/04 £78.8 million) and earnings per share before deferred tax rose 9.4% to 63.1p (2003/04 57.7p). Group capital expenditure was £188.4 million (2003/04 £170.0 million).

• South West Water

South West Water turnover rose by £18.0 million to £309.8 million. Approved tariff increases amounted to £21.2 million. Customers switching from unmeasured to metered charging caused a reduction of £6.3 million in turnover. Other factors contributed a net total of £3.1 million, including 7,300 new customer connections and increased commercial sales offset by an estimated £2.4 million reduction in measured demand, as the summer of 2004 did not match the high temperatures of the previous year.

South West Water's operating profit rose 2.4% to £121.7 million before the exceptional item of £3.4 million. Operating costs, including depreciation, increased by £15.2 million to £188.1 million. Additional costs from new capital schemes of £5.7 million, inflation of £4.4 million and other cost increases of £9.2 million (mainly pensions, direct cost of sales and bad debts), were offset by £4.1 million of efficiency savings. Some six years ago, South West Water established a restructuring and continuous improvement programme to reduce significantly overhead and operating costs. Its successful delivery ensured that it outperformed the demanding operational and capital efficiency targets imposed by Ofwat for the K3 regulatory period (2000 – 2005). South West Water has announced plans for further restructuring to contribute towards the additional efficiencies required over the K4 period (2005 – 2010), including a £13 million per annum reduction in base operating costs by 2010. An exceptional charge of £3.4 million has been made in respect of the associated restructuring costs.

Capital expenditure increased by 1.9% to £141.9 million. £66.1 million was invested in water supply improvements including water mains renovation, water treatment works enhancement and leakage control. Ofwat's latest report on leakage notes that South West Water continues to be one of the leading companies in managing water leakage and is delivering results in line with Ofwat's leakage target. Over 600 kms of water mains were laid, replaced or refurbished during the year, a major increase on 2003/04. Drinking water quality is at an all time high and the region features the highest proportion of high quality rivers in England.

Waste water investment expenditure totalled £75.8 million. Commissioning of the Ilsham Valley pumping station in Torbay commenced in April 2004 and its operation signalled the completion of the final major project in the company's 15 year original 'Clean Sweep' coastal sewage treatment programme. 'Clean Sweep' has transformed the coastal environment around the South West. 98% of bathing waters conform with EU mandatory standards and 81% of the region's bathing waters now meet the tougher EU guideline standards. This compares with only 47% of the region's bathing waters achieving the guideline standards six years ago.

• Viridor Waste

Viridor Waste has continued to trade strongly, building on the growth achieved over the past several years. Turnover rose by 35.6% (£65.2 million) to £248.3 million in 2004/05. Acquisitions accounted for £40.2 million of the increase and underlying business £25.0 million. Landfill tax within turnover increased by £8.2 million.

Viridor Waste's operating profit before goodwill amortisation rose by 31.3% to £29.8 million (£26.3 million after goodwill amortisation), compared with £22.7 million (£20.2 million after goodwill amortisation) in 2003/04. The increase was driven by good performance from landfill, power generation and collection businesses and the positive impact of the West Sussex integrated waste contract together with the Thames Waste Management acquisition. Since 2000/01, operating profit before goodwill has grown at a compound rate of 22.8% per annum, of which around 12% has been organic with the rest being achieved through acquisitions. Earnings before interest, tax, depreciation and amortisation (EBITDA) grew from £43.2 million to £56.0 million. Capital expenditure for the year was £45.8 million (2003/04 £30.5 million).

•• OPERATING & FINANCIAL REVIEW

Total landfill disposal volumes increased by 10% to 4.0 million tonnes, due mainly to the Thames Waste acquisition. Volumes on a like for like basis rose by 2%. Total gate fees per tonne rose by 10%.

Viridor Waste's total power generation capacity has increased by a further 16% in the year, most of which has been introduced under ROCs and underpins the strong profit growth achieved. 56% of Viridor Waste's output benefits from ROCs.

• Trends and factors likely to impact future prospects

South West Water

The key factor affecting South West Water's performance over the next few years is the K4 Determination concluded in December 2004. As noted on page 12, this sets price limits for the next five years and determines the investment outputs to be delivered by South West Water over this period.

South West Water is confident that it can deliver the efficiency improvements assumed over this period and deliver the required investment programme.

Prospects beyond 2010 depend primarily on the next Periodic Review and subsequent price Determination. This is expected to take account of further investment requirements flowing from EU directives and other legislation and the continuing need to maintain the serviceability of the existing asset base and set further regulatory driven efficiency targets.

Viridor Waste

Consented landfill capacity is expected to continue to rise in value due to rising costs caused by planning restrictions, tightening regulation and the demand for higher standards. The availability of permitted landfill void is limited. According to the EA's most recent estimate, there is around six years consented capacity in the UK.

At the same time the implementation of the Landfill Directive (via LATS and other regulations), the continued roll-out of the Pollution Prevention and Control (PPC) permitting regime, the Government's National Waste Strategy (currently under review) and landfill tax increases are all likely to encourage diversion of waste streams away from landfill towards treatment and recycling, where available. This will mostly affect municipal waste, which is approximately one third of the current landfill market.

Future prospects for the landfill gas generation business depend significantly on Government policy for renewable energy generation. The ROCs system is the Government's main policy measure to encourage the development of electricity generation using renewable energy sources such as landfill gas. During 2005, the Government is carrying out a review of the ROCs system. It has stated that this review will not affect existing accredited schemes.

•• RESOURCES

• South West Water

Human resources

South West Water has an experienced management team and utilises remuneration and incentive policies focusing on financial and operational targets. The company has invested significant sums over many years to ensure that its staff have the skills and competencies to undertake their roles. NVQ training for operators and craftsmen is carried out to ensure that basic skills are in place and health and safety requirements are met. Office-based staff are offered a range of training including assistance to obtain professional qualifications. Managers are encouraged to extend their knowledge and skills through participation in company-wide programmes as well as bespoke external courses. All training activity is undertaken under the 'Investor in People' standard and is closely aligned with business requirements.

The company uses financial incentivisation arrangements as appropriate to each group of workers and job satisfaction is supported by encouraging role changes wherever possible around the company to help employees gain broad experience of business activities.

Staff turnover is well below the national average. The company as a 'good employer' has been introducing a number of 'Family Friendly' policies, which exceed statutory requirements. External recruitment is proving to be more difficult in a national climate of high employment and increased competition for staff locally from new organisations in the region. Regular benchmarking of salary levels is carried out and the additional benefits of working for the company compared to others are emphasised. Work is also to be undertaken to further facilitate recruitment through the company's website.

Water resource position

South West Water on a five year basis prepares a Water Resources Plan for a range of climate change and demand scenarios. The Plan indicates that no new reservoirs are required before 2030 but investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.

At 27 March 2005, reservoir storage levels were 80.8% compared to 83.4% at 27 March 2004.

Systems

South West Water relies on a range of sophisticated financial, asset management and operational systems. They are upgraded and renewed as necessary to ensure reliability, efficiency and operational effectiveness. Back-up and standby arrangements are in place in the event of damage, failure or other disruption.

• Viridor Waste

Human resources

The company employs a comprehensive range of technical and professional managerial personnel, supervisory, administrative and clerical, semi-skilled and unskilled. Many are vocationally trained and have extensive operational experience. Membership of relevant trade and professional bodies is widespread and is encouraged.

Industry reputation/expertise

Viridor Waste is an active member of the Environmental Services Association, the leading trade body and senior staff are involved in leading positions on industry committees providing Government departments with economic and technical information.

The company has a good track record in gaining planning consents and PPC permits for landfill capacity and waste management facilities.

As one of the fastest growing and strongest performing businesses in the waste industry in recent years, Viridor Waste's record of business and environmental performance, service delivery and regulatory compliance is strong.

•• RISKS AND UNCERTAINTIES

• Risk factors relating to the Group

It may not be possible to continue to sustain the same level of earnings and growth of the Group as in the past

There is a risk to shareholder value if the Group is not able to continue to grow its key businesses and continue to produce sustainable earnings growth. Successfully achieving these objectives is dependent upon the correct strategy being pursued by strong and able management within the Group as well as on external factors. The Group has maintained earnings and has successfully grown both South West Water and Viridor Waste and intends to continue to create shareholder value through its strategic focus on water and sewerage services and waste management. In particular, the Board has confidence that South West Water will successfully deliver the new K4 regulatory contract and significantly grow its regulatory asset value to 2010, whilst Viridor Waste's successful strategy of creating long-term sustainable profit growth is expected to continue through capitalising on its landfill asset base, exploiting its landfill gas power generation potential and pursuing profitable opportunities in line with the Government's developing waste strategy.

• Risk factors relating to the Group's water and waste water business

Price controls over the turnover of the Group's regulated business could adversely affect profitability

Ofwat's price Determination may adversely affect South West Water for a number of reasons including an inadequate cost of capital allowance. There is also a risk that regulatory assumptions concerning operating expenses, required capital expenditure and revenue forecasts may prove to be unrealistic. However, South West Water has a track record of meeting Ofwat's expectations in the last two Periodic Review periods (K2 and K3) and expects to be able to meet the expectations of the latest Determination for the K4 period (2005 – 2010).

The outcome of future Periodic Review processes (post 2010) will affect the Group's turnover and profitability.

•• OPERATING & FINANCIAL REVIEW

Failure to deliver the capital investment programme could adversely affect profitability

South West Water requires significant capital expenditure for additions to and replacement of plant and equipment for its water distribution and waste water facilities and networks. The price limits set by Ofwat for the K4 period take into account the level of capital expenditure expected to be incurred and the associated funding costs. In the event of under-performance, the water regulator could intervene to re-set price limits at lower levels.

The company may be unable to raise sufficient funds to finance its functions

Historically, the Group has financed expenditure from cash flows from operations and from debt financing. In setting price limits, the water regulator has a duty to ensure that a company can finance its functions. Whilst there can be no assurance that cash flows from operations will not decline or that additional debt financing or other sources of capital would be available to meet these requirements, the Group's policy is to ensure that it has committed facilities available for at least 12 months anticipated net cash requirement.

If South West Water is unable to secure the anticipated capital efficiencies associated with the capital programme, or the programme falls behind schedule for other reasons, the profitability of the Group may suffer. The water regulator may factor such failure into future price reviews. In addition, the Group's ability to meet regulatory and environmental performance standards could be adversely affected by the failure to deliver the capital programme on time. This could result in the potential for fines or other sanctions imposed by either the water regulator or the courts including loss of South West Water's Licence. The company has a track record of delivering its capital programme in accordance with regulatory requirements.

Failure to deliver operating cost savings implicit in the regulatory review could adversely affect profitability

Operating cost savings to be achieved during the current K4 period are implicit in the regulatory review. In line with South West Water's track record, the Board remains confident of delivering the assumed operating cost savings. However, should operational performance deteriorate, the Group's profitability could suffer and the water regulator could seek to impose higher efficiency targets as part of future price reviews.

Environmental regulations and quality standards could increase the Group's costs and adversely affect profitability

Various environmental and consumer protection, health and safety laws and regulations govern the company's waste water and water distribution businesses. These laws and regulations establish, amongst other things, quality standards for drinking water, effluent treatment (including sewage sludge disposal) and discharges into the environment which affect South West Water's operations. In addition, South West Water is required to obtain various environmental permissions from regulatory agencies for its operations. South West Water endeavours to comply with all regulatory standards but cannot guarantee that it will be in total compliance at all times with these laws and regulations.

Environmental laws and regulations are complex and change frequently. These laws, and their enforcement, have tended to become more stringent over time. Whilst South West Water has budgeted for future capital and operating expenditures to achieve compliance with current and known future changes in law and regulations, it is possible that new or stricter standards could be imposed that will raise South West Water's capital and operating expenditures by requiring modifications to its assets. It is also possible that future legislation will impose constraints on existing water abstractions requiring South West Water to source alternative water supplies. These costs are recoverable in part or in whole through the regulatory process of setting appropriate future price limits. In the event of these being significant, South West Water could apply to Ofwat for a revision of its price limits through an Interim Determination of K (IDoK).

Contamination to water supplies could adversely affect profitability

Water supplies may be subject to contamination, including contamination from naturally occurring compounds and pollution resulting from man-made sources. In the event that one or more of the company's water supplies is contaminated and it is unable to substitute a water supply from an uncontaminated water source, or to adequately treat the contaminated water source in a cost-effective manner, there may be an adverse effect on its reputation, operating results and financial position. Some or all of these costs may be recoverable through future price reviews. South West Water could also be held liable for human exposure to hazardous substances in its water supplies or other environmental damage. The Group maintains insurance policies in relation to these risks, although there can be no assurance that all or any of the costs associated with these risks would be covered or that coverage will continue to be available in the future.

Non-recovery of customer debt could adversely affect profitability

The company is responsible for the billing, cash collection and debt management activities for around 760,000 domestic and business water and waste water customers. The Water Industry Act 1997 prohibits the disconnection of a domestic water supply for non-payment. Non-recovery of debt is therefore a risk to the Group and may cause the Group's profitability to suffer, although allowance is made by the water regulator in the Determination for his estimate of debt deemed to be irrecoverable. In addition to existing strategies, South West Water is implementing new initiatives to improve and secure cash collection, including the use of charging orders. However, there can be no assurance that the amount allowed by the water regulator is adequate. Provision was made in the last Periodic Review for companies to make an application for an Interim Determination of prices in the event of a significant shortfall.

Other potential liabilities/risks

A failure of the equipment operated by South West Water could lead to the escape of water or waste water including sewage effluent and result in damage to third party property or personal injury. In such circumstances, South West Water may incur liability to those third parties. South West Water could also be prosecuted by the EA and/or be required to undertake costly upgrades.

A water shortage due to a severe drought could reduce the water supply available to customers, which could have a material impact on the profitability of South West Water. The company does have in place a number of schemes to maintain water resources (such as pumped storage for certain reservoirs) and has a number of water conservation measures which are applied on an ongoing basis.

Meter option take-up

Higher than national average water charges within the South West Water area have encouraged many customers to change from an unmeasured rateable value based charging system to a payment based on volume of water used as measured by a meter. Properties constructed since 1989 do not have a rateable value assessment and are therefore only charged by the volume of water used. Most customers in properties built prior to 1989 can choose to opt for meter charges. In doing so they have an option to switch back to rateable value payment within 12 months of meter installation. The rate at which customers elect to switch to volume payment is estimated at each Periodic Review.

Current rates of customers opting to change, align with the estimates made at the last Review which allows for some 65% of customers to pay by measured charges by 2010, compared with around 48% of such customers with meters at 31 March 2005. However, it is possible that a higher proportion of customers could switch to a measured supply than allowed for and this could have an adverse impact on the company's revenues. As referred to in the price cap regulation section on page 12, an IDoK may be used to at least partially recover any revenue losses if they exceed the prescribed materiality threshold.

• Risk factors relating to the waste management business

Increases in landfill costs may not be recovered through price increases

The raising of environmental standards is leading to a gradual increase in landfill costs in general. Particular areas of cost increases include site engineering (which results in increased depreciation), leachate management, landfill gas management and general site management. Companies such as Viridor Waste with landfills engineered to modern standards and who have good environmental control systems, should incur lower than average increases in costs. However, there remains a risk that rising standards may generate higher treatment and disposal costs than currently assumed.

Municipal waste contracts typically last for a number of years; they usually have price increases under formulae related to inflation as measured by the retail price index in the UK (RPI) and in some cases take into account specific legislative or technical changes. Prices for other types of waste depend more on local markets and competitive conditions. Viridor Waste's experience over several years is that prices in general have risen at least fast enough to cover cost increases in the areas where it operates. There is a risk that landfill prices may not rise sufficiently in all locations to recover recent and projected cost increases.

Not all landfills may meet the standards of the Integrated Pollution Prevention and Control (IPPC) Directive and the Landfill Directive, or requirements may be imposed which would impact on the economics of landfill

Landfills (and other industrial processes) in the UK are subject to a new permitting regime pursuant to the Pollution Prevention and Control (England and Wales) Regulations 2000 (PPC Regulations). Existing landfills

•• OPERATING & FINANCIAL REVIEW

opened before July 2001 operate under waste management licences. In the future, they (and landfills opened since July 2001) will require a PPC permit granted under the PPC regulations. The replacement of waste management licences with PPC permits is occurring in a series of application tranches due to run through to 2007. PPC permits are expected to impose higher standards and costs in general. At the same time, it is possible that some current landfills may fail to obtain a PPC permit and will therefore have to seek to agree a closure plan with the EA or SEPA.

The net result of this is that after a transitional period, it is expected that the average technical and operational standards of landfill in the UK will improve and it is possible that the number of landfills may decrease.

Viridor Waste believes that its own key landfills are generally well placed to obtain PPC permits. However, it is not possible to prejudge the EA's or SEPA's decision on this and it is possible that some sites may not achieve permits or that more onerous conditions may be imposed by those permits. Were a landfill not to achieve the necessary permits it would have to cease operation with consequent loss in profits.

Under both waste management licences and PPC Permits, landfills require expenditure on restoration when the site is closed and subsequently on aftercare (maintenance, supervision, monitoring and management of gas and leachate levels) long after the landfilling activities have ceased. The EA or SEPA will only grant a full or partial PPC permit or waste management licence surrender once it is satisfied that the landfill is inert and no longer poses any environmental risk. There may still be a risk of liability arising from any residual contamination following the surrender of the PPC permit. Landfill licences or permits cannot be surrendered during the aftercare period.

The UK Government's waste strategy (including municipal landfill diversion targets and increases in landfill tax) stemming from the Landfill Directive, may lead to a reduction in volumes of waste being disposed of via landfill

Viridor Waste focuses on the disposal of municipal, industrial and commercial, construction and demolition waste. Of this, around one third (26 million tonnes) of the UK total for these waste streams is municipal (of which approximately two thirds is biodegradable municipal waste (BMW)). These figures are based on estimates from DEFRA, the EA, SEPA and HM Revenue & Customs.

Assuming the EU Landfill Directive targets are met, the total amount of BMW permitted to be landfilled from 2020 will be around 10 million tonnes per annum (depending on the precise interpretation of the Directive). If there is no change in other waste streams, this would still leave a substantial landfill market in 2020. This should be seen in the context of an EA estimate of a current consented landfill capacity UK-wide of around six years.

Whilst to date Viridor Waste has seen its landfill volumes slowly increasing, the combined effect of the various Government measures may reduce waste to landfill in the future.

Pricing and other risks relating to renewable energy

Without a pricing mechanism such as ROCs as identified on page 14, further investment in renewables would not generally be economic. The Government has made a strong commitment to renewables which are key to meeting the long-term carbon reduction strategy set out in the energy white paper and the UK's 2010 targets for carbon dioxide reductions under the Kyoto Protocol. Renewables are also important in minimising the UK's increasing reliance on imported energy. Nevertheless, there remains a risk that the Government may change the current regime. The Government is currently undertaking a review of the ROCs. It has stated that current schemes which benefit from ROCs will not cease to be eligible. It is recognised that the recent expansion in landfill gas generation would not have taken place without such subsidy. However, it is consulting on whether new landfill gas schemes, after a transitional period, should have reduced eligibility.

The value of ROCs is increased by the sharing of the buy-out price monies among holders of ROCs and is therefore dependent on the financial strength of those suppliers who opt to pay the buy-out price. There is a risk that the insolvency of a licensed electricity supplier could lead to a drop in the value of the ROCs which Viridor Waste sells to licensed suppliers.

A landfill gas project must be able to collect and burn sufficient gas to produce electricity. Ultimately, the volume of gas generated will depend on the amount and composition of the waste landfilled. For example, if the amount of BMW diverted away from landfill is increased in the future in accordance with the EU Landfill Directive obligations, the total biodegradable component of the waste going to landfill will affect volumes of landfill gas

produced. It is therefore possible that the gas obtained will not be available either in the amounts or of the calorific value required to make a project cost effective.

The current planning regime may restrict the availability of future waste treatment facilities

Achievement of the Government's targets for waste management is critically dependent on the planning system delivering sufficient waste treatment facilities. Obtaining planning permission for any type of waste treatment facility is difficult and will represent a major challenge for the waste management industry.

Viridor Waste may be unable to recruit/retain adequate numbers of staff with the necessary skills

Good quality staff with the required technical skills and certification are essential in the waste industry. Viridor Waste recognises that there is a risk of losing staff to competitors and seeks to address this by its employment policies.

• **Other Group risks**

Pensions costs may increase due to factors outside the Group's control

The Group has 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. Pennon Group set up a defined contribution scheme in July 2003 for new entrants to Viridor Waste and employees from certain acquired waste companies.

The triennial actuarial valuation of the Group defined benefit schemes at 1 April 2004 indicated a scheme deficit which resulted in additional annual costs of around £5.5 million under the SSAP 24 accounting policy.

Under Financial Reporting Standard 17 'Retirement Benefits', the Group pension schemes had net liabilities at 31 March 2005 of £55.7 million, a similar level to that reported under FRS 17 at 31 March 2004. A sound investment performance has been offset by an increase in liabilities as reflected in the recent actuarial valuation. The net liabilities represent circa 4.5% of the Group's total market capitalisation as at 31 March 2005.

The future costs of defined benefit schemes are subject to a number of factors including:

- The returns achieved on pension fund investments
- Movements in interest rates and inflation
- Pensioner longevity.

Insurance

The Group manages property and third party risks by the purchase of insurance policies from the insurance market. The Group's insurance brokers assist in sourcing appropriate insurance cover from insurance companies that have good credit ratings. Main insurance policies cover property, business interruption, public liability, environmental pollution and employers' liability. There are three tiers of insurance for most policies. The first tier is self-insurance in the form of a moderate deductible. The second tier is covered by the Group's subsidiary, Peninsula Insurance Limited (PIL). PIL insures the layer of risk between the deductible and the cover provided by external insurers. The third tier of risk is placed with the external insurance market.

•• **RELATIONSHIPS**

• **South West Water**

Regulatory relationships

South West Water views relationships with regulators, Government, customer representative bodies and its customers as central to its operations.

South West Water maintains a continuing dialogue with Ofwat, the EA and DWI in addition to making the prescribed reports of data and activity. It also inputs into national dialogue on developing issues through its representation at Water UK, the industry trade body.

South West Water works with WaterVoice South West and will work with its successor, the Consumer Council for Water, to ensure that customer issues and concerns are addressed and a full understanding of the company's activities is maintained. South West Water adopts a proactive policy of informing its customers through its customer newspaper, 'Waterlevel', and through regular press releases and media briefings.

•• OPERATING & FINANCIAL REVIEW

David Dupont – Group Director of Finance – Pennon Group Plc

Suppliers and contractors

South West Water's procurement strategy is focused on the pro-active management of around 50 key and strategic suppliers who account for the large majority of expenditure. Regular meetings are held to manage performance and to identify and deliver 'continuous improvement' opportunities for further reducing cost while improving performance and service levels. This includes some eight 'strategic partners' responsible for significant areas of outsourced services including capital delivery, water distribution, sewer management and customer service. Management of these strategic partners is co-ordinated by the Contract Strategy Group including key members of South West Water's Executive Management Team.

South West Water has robust pre-qualification and tender procedures included within the Company's ISO 9001 Quality Management system delivering best practice and ensuring compliance with EU procurement regulations. Qualification and tender processes take full account of environmental, social and ethical factors providing a comprehensive approach to the management of corporate responsibility through the supply chain.

Supplier forums

Engagement of suppliers is the challenge faced by South West Water, arising from the Periodic Review process. It is reinforced through supplier forums where representatives of supplier organisations are invited to a sharing of details related to the size, shape and nature of the future capital investment programme.

Financiers

South West Water is financed from a number of sources. These include relationship banks who have provided long-term finance lease facilities and also provide shorter-term facilities for periods of up to five years. A further important source of low cost medium to long-term funding is the European Investment Bank (EIB). The EIB is able to lend proportionately more to South West Water because Cornwall is regarded by the EIB (and EU) as having particular economic difficulties due to high unemployment and low income. The EIB has recently agreed to extend a further £70 million of funding for the K4 period.

• Viridor Waste

All waste management facilities require planning permission, whilst landfill (and certain other facilities) also require a waste management licence or a PPC permit, issued and enforced by the EA. Viridor Waste maintains a positive working relationship with the EA, proactively liaising on and managing issues at both a site-specific and strategic level. Likewise, with regard to obtaining planning consents for new or extended facilities, Viridor Waste proactively consults and openly communicates with local communities and other key stakeholders throughout the planning application process in order to respond to concerns and to maximise the chances of gaining consent.

A 'good neighbour' attitude exists at all facilities managed by Viridor Waste with local liaison groups consisting of locally elected representatives of the community meeting regularly to be consulted about the company's plans and operating procedures. Liaison groups also include representatives of the EA and the relevant planning authority.

•• FINANCIAL POSITION

• Analysis of the Group's financial position

The Group's financial results showed growth in both turnover and profit before tax from continuing operations.

Turnover and operating profit

Turnover rose by 17.6% to £554.2 million. South West Water turnover was £309.8 million, up 6.2% on 2003/04, principally resulting from the additional increase in tariffs approved by the water regulator. Turnover for Viridor Waste at £248.3 million was 35.6% up on 2003/04. The acquisitions accounted for £40.2 million of the increase and underlying business £25.0 million. Landfill tax within turnover increased by £8.2 million.

Group operating profit before the exceptional items increased by £11.7 million. South West Water achieved a £121.7 million operating profit, up £2.8 million on 2003/04. Viridor Waste contributed £26.3 million (after goodwill amortisation of £3.5 million), up £6.1 million on 2003/04 and representing 18.4% of the operating profit of the Group in 2004/05 (2003/04 15.6%).

There were three exceptional items during the year:

- Costs of £1.5 million (2003/04 £6.5 million) 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.
- Restructuring costs in South West Water of £3.4 million (2003/04 nil).
- Profit of £5.0 million (2003/04 nil) relating to the balance of proceeds due from the 1998 disposal of the Group's interest in Societa Italo Britannica dell'Acqua Srl (SIBA).

Group earnings before interest, taxation, depreciation and goodwill amortisation (EBITDA) amounted to £243.9 million before the exceptional items (2003/04 £222.0 million) including South West Water £187.8 million (2003/04 £181.7 million) and Viridor Waste £56.0 million (2003/04 £43.2 million).

Total Group operating costs were £406.2 million excluding the exceptional items, (2003/04 £335.0 million) and included the following major categories of expenditure:

	£m
Depreciation and goodwill amortisation	98.6
Manpower	73.1
Landfill tax	56.7
Raw materials and consumables	18.6
Property costs	17.1
Transport	15.7
Power	10.3
Abstraction and discharge consent costs	7.4
Statutory operating licences and royalties	6.9
Lease rentals – plant and machinery	4.8

Offsetting the above power costs was revenue from power generation of £17.6 million.

Finance costs

Net interest payable was £60.7 million (2003/04 £57.2 million), which was 2.4 times covered by Group operating profits in both years.

Gross interest payable was £74.0 million. Gross interest receivable of £13.3 million was derived from the investment of temporarily surplus funds.

Net interest payable represents a rate of 5.5% when measured against average net debt (2003/04 5.5%).

Profit before tax

Profit before tax was £87.4 million before the exceptional items, £8.6 million up on 2003/04, an increase of 10.9%.

Viridor Waste achieved a pre-tax return on investment in 2004/05 of 9.2% (2003/04 7.5%).

Taxation

The corporation taxation charge for the year was £18.7 million (2003/04 £10.8 million). The deferred tax charge for the year was £10.8 million (2003/04 £3.3 million).

Earnings per share

Earnings per share before deferred tax and the exceptional items increased by 9.4% to 63.1p. Basic earnings per share increased 9.6% to 54.6p.

Dividends and retained earnings

The Directors recommend the payment of a final dividend of 29.2p per share for the year ended 31 March 2005. Together with the interim dividend of 13.8p per share paid on 7 April 2005, this makes a total dividend for the year of 43.0p per share, an increase of 4.9% on the dividend for 2003/04.

The dividend of 43.0p per share results in a dividend cover of 1.4 times.

The total cost of the interim dividend and recommended final dividend of the Company is £55.1 million. The retained surplus of £13.7 million has been transferred to reserves.

•• OPERATING & FINANCIAL REVIEW

International Financial Reporting Standards

Preparation for the adoption of International Financial Reporting Standards (IFRS) in 2005/06 is under way. The principal differences between current UK and International Accounting Standards likely to impact on the Group are detailed on pages 86 to 88. The overall net impact will be to reduce Group reported net assets. The adoption of IFRS and the reduction in reported net assets do not affect current dividend policy, compliance with debt covenants, or underlying cash flow.

Investment

Capital expenditure by the Group on tangible fixed assets was £188.4 million (2003/04 £170.0 million). The major categories of expenditure comprised:

South West Water

	£m
Water mains renovation	34.8
Water supply leakage control	7.9
Water treatment works	3.7
Sewage treatment works	42.8
Sewerage	25.0
Sewage sludge treatment	2.2

Viridor Waste

	£m
Landfill	21.7
Power generation	3.8
Collection	2.8

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.

Payments to suppliers

It is the Group's payment policy for the year ending 31 March 2006 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 2004/05 and the amount owed to its trade creditors at 31 March 2005, was 30 days.

Share capital

During the year, the nominal value of the Company's issued ordinary share capital increased from £137.9 million to £142.0 million. The weighted average number of shares in issue during the year was 126.0 million (2003/04 123.5 million).

The value of net assets per share at book value at 31 March 2005 was 733p.

Permission was obtained from shareholders at the Annual General Meeting in July 2004 to purchase up to 10% of the Company's ordinary share capital. Renewal of the authority will be sought at the July 2005 Annual General Meeting.

• Accounting policies critical to understanding the performance and financial position

Pennon Group's Principal Accounting Policies are set out on pages 54 to 56. To apply certain of these policies, management is required to make estimates and assumptions that affect reported profit, assets and liabilities. Actual outcomes could differ from those calculated based on estimates or assumptions.

Pennon Group believes that the accounting policies outlined below are the critical policies where changes in the estimates and assumptions made could have a significant impact on the consolidated financial statements.

Landfill costs

The estimation of landfill reserves is of particular importance in assessing landfill costs, since the cost of a landfill site is depreciated over its estimated operational life taking into account the usage of void space. The

Group's estimates of landfill reserves are regularly reviewed and updated during the financial year for usage and other events (for example site extensions). Estimates are also subject to physical review by external advisors. A number of factors impact on the value of landfill reserves, including the available landfill space, future capital expenditure and operating costs. The valuation is subject to revision as these factors change.

Carrying value of long-life assets

The Group's accounting policy for tangible fixed assets is detailed in note 1(f) of the consolidated financial statements. The carrying value of tangible fixed assets as at 31 March 2005 was £2,248 million. In the year ended 31 March 2005, additions to tangible fixed assets totalled £188 million and the depreciation charge was £96 million. The estimated useful economic lives of fixed assets are based on management's judgement and experience. When management identifies that actual useful lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of fixed asset investment to the Group, variations between actual and estimated useful lives could impact operating results both positively and negatively. Historically, few changes to estimated useful lives have been required.

Revenue recognition

The Group recognises revenue generally at the time of delivery. Payments received in advance of revenue recognition are recorded as deferred revenue.

In South West Water's case, the Group raises bills and recognises revenue in accordance with its entitlement to receive revenue in line with the limits established by the Periodic Review price setting process. For water and waste water customers with water meters, income recognised is dependent upon the volume supplied including an estimate of the sales value of units supplied between the date of the last meter reading and the year end. Estimated usage is based on historic data, judgement and assumptions; actual results could differ from these estimates which would result in operating revenue being adjusted in the period that the revision to the estimates is determined.

Accounting for provisions and contingencies

The Group is subject to a number of claims incidental to the normal course of its business, relating to and including commercial, contractual and employment matters, which are handled and defended in the ordinary course of business. The Group routinely assesses the likelihood of any adverse judgments or outcomes to these matters as well as ranges of probable estimated losses. Reasonable estimates involve judgments made by management after considering information including notifications, settlements, estimates performed by independent parties and outside counsel, available facts, identification of other potentially responsible parties and their ability to contribute and prior experience. A provision is recognised when it is probable that an obligation exists for which a reliable estimate can be made after careful analysis of the individual matter. The required provision may change in the future due to new developments and as additional information becomes available. Matters that are either possible obligations or do not meet the recognition criteria for a provision are disclosed, unless the possibility of transferring economic benefits is remote.

Depreciation

Fixed assets excluding landfill sites are depreciated using the straight-line method. The cost of a landfill site is depreciated over its estimated operational life taking into account the usage of void space.

Renewals accounting

The depreciation charge for infrastructure assets is the estimated level of annual expenditure to maintain the operating capability of the network which is based on South West Water's Asset Management Plan which has been certified by W S Atkins Limited, an independent infrastructure management consultant approved by Ofwat. Variations between actual infrastructure spend and estimated spend are included in the balance sheet, with the principle being to 'equalise' the effect of annual spend variations on the charge to the profit and loss account. Changes in the plan assumptions (including judgements relating to the condition and performance of infrastructure assets) could give rise to a different operating profit.

•• OPERATING & FINANCIAL REVIEW

Restoration and aftercare

Restoration and aftercare provisions are recognised in the financial statements at the net present value of the future expenditure required to settle the Group's restoration and aftercare obligations. The discount implicit in recognising the restoration and aftercare liability is unwound over the life of the provision and is included in the profit and loss account as a financial item within the net interest charge. Where a provision gives access to future economic benefits, an asset is recognised and depreciated in accordance with the Group's depreciation policy.

The measurement of restoration and aftercare provisions involves the use of estimates and assumptions such as the discount rate used to determine the net present value of the liability. The estimated cost of restoration and aftercare is based on engineering estimates and reports from independent advisors. In addition, the payment dates of expected restoration and aftercare costs are uncertain and are based on economic assumptions surrounding the useful economic lives of the assets concerned.

Impairments

The Group reviews its assets for impairment if there is an indication that the carrying amount may not be recoverable. Impairment reviews compare the carrying value of an income generating unit with its recoverable amount. The recoverable amount is the higher of the net realisable value and the estimated value in use. Value in use is based on the net present value of expected future pre-tax cash flows. Impairment reviews may cover all operating segments.

Long-term assumptions are used to determine the net present value of future cash flows for use in impairment reviews. Particular assumptions which impact the calculations are discount rates and the terminal value of assets and income streams.

Deferred tax

The Group accounts for deferred tax on a discounted basis, as permitted by UK GAAP. The deferred tax provision as at 31 March 2005 was £72.4 million. The balance sheet provision is discounted using the rate of interest at the balance sheet date on UK gilts with similar

maturity dates to those of the deferred tax assets and liabilities. The Group uses long-term UK gilt rates to reflect the long-life nature of infrastructure and operational assets. A deferred tax asset is regarded as recoverable and therefore recognised only when, on the basis of available evidence, it is regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted. Changes to management's view of the recoverability of deferred tax assets could give rise to different tax charges.

Provision for doubtful debts

At each balance sheet date, each subsidiary evaluates the collectability of trade debtors and records provisions for doubtful debts based on experience. For example, comparisons of the relative age of accounts and consideration of actual write-off history. The actual level of debt collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively. As at 31 March 2005, the Group's gross trade debtors were £88 million.

Goodwill

The Group records all assets and liabilities acquired in business acquisitions, including goodwill, at fair value. Goodwill is amortised by equal annual instalments over the estimated useful life of 20 years. Goodwill is assessed for impairment whenever events or circumstances might indicate that it may be impaired. As at 31 March 2005, the net book value of goodwill was £63.0 million and the amortisation charge for the year then ended was £3.5 million. The initial goodwill recorded and subsequent impairment analyses require management to make subjective judgements concerning the fair value of reporting units.

Pensions

The Group operates defined benefit schemes plus a defined contribution section. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years.

The pension cost under SSAP 24 is assessed in accordance with the advice of an independent qualified actuary based on the latest actuarial valuation and assumptions determined by the actuary. The assumptions are based on information supplied to the actuary by the Company,

supplemented by discussions between the actuary and management. The assumptions are disclosed in note 33 of the consolidated financial statements.

• Capital structure

Overall position

With year end net debt of £1,119 million, the Group year end debt to equity ratio was 119% (2003/04 119%). The Directors believe this reflects an appropriate balance sheet structure for the underlying businesses.

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 2005, the limit was £2.6 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.

South West Water

South West Water's debt to regulatory asset value (RAV) was circa 53% at 31 March 2005, just below Ofwat's 'optimum range' of 55% – 65%. The scale of the forthcoming K4 investment programme means that this ratio is expected to progressively increase during the next five years.

Viridor Waste

Viridor Waste is funded by a combination of Pennon Group equity and debt (raised by Pennon Group and direct borrowings by Viridor Waste). At the year end, Viridor Waste's net debt stood at £131 million, equivalent to 2.3 times EBITDA. Viridor Waste's net debt is expected to increase substantially in 2005/06 with capital investment to meet the requirements of its West Sussex PFI contract and also developments at a number of its existing operational sites which will facilitate growth in 2006/07 onwards.

The Board believes that South West Water and Viridor Waste have adequate debt capacity for currently anticipated investment requirements, with an appropriate margin to provide for currently unforeseen opportunities/adverse movements.

The Group continues to explore options to optimise funding for the K4 period. These options could include additional funding from the sources noted above as well as other opportunities.

• Treasury policies and objectives

The Group's treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages interest rate risk. It operates within policies approved by the Board and does not undertake any speculative trading activity.

• Debt profile

At 31 March 2005, loans and finance lease obligations were £1,422 million and the Group held current asset investments and cash of £303 million. Net borrowings increased by £45 million during the year to £1,119 million, principally as a result of the payment of dividends, the cost of acquisitions of £29 million and capital expenditure of £183 million.

A somewhat larger increase in net debt is projected in 2005/06 reflecting a significant increase in the South West Water capital programme to meet regulatory targets in December 2005, requirements of Viridor Waste's West Sussex PFI contract and investment for growth.

During 2004/05, the Group secured £65 million additional term loans and £190 million additional revolving credit facilities. In addition, the Group drew down £57 million additional financing under existing finance lease arrangements.

Pennon Group debt has a maturity of 0 – 29 years with an average maturity of 15 years. The major components of debt finance are:

- Finance leasing – £824 million
- EIB loans – £181 million
- Bank bilateral debt – £255 million
- 2012 Bond – £150 million

Interest Rate Management

Interest costs of £61 million equated to an average interest rate of 5.5%.

The Group's exposure to interest rate movements is managed by the use of interest rate derivatives. The Board policy is that in any one year at least 50% of net debt is fixed. Interest rate swaps are used to manage the mix of fixed and floating rates. Relatively low interest rates have resulted in the Group fixing 70% of existing net debt up to 31 March 2006, and 50% up to 31 March 2010. The notional principal amounts of the interest rate

•• OPERATING & FINANCIAL REVIEW

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 30 to the financial statements.

The impact of future interest rate changes is expected to be mitigated by the proportion of debt held at fixed rates as noted above.

Refinancing risk management

Refinancing risk is managed under the Group Policy that no more than 20% of Group net debt is permitted to mature in any financial year.

Counterparty risk management

Surplus funds of the Group are usually placed in short-term fixed interest deposits or the overnight money markets. All deposits are with counterparties that have credit ratings that are approved by the Board.

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures.

• Cashflows

The net cash inflow from operating activities was £255.3 million (2003/04 £215.1 million). Capital expenditure cash outflow in 2004/05 was £183.0 million, an increase of £1.1 million from £181.9 million in 2003/04. The net cash outflow for acquisitions was £28.6 million (2003/04 outflow of £20.0 million). Equity dividends paid and servicing of net debt involved a cash outflow of £87.4 million (2003/04 £88.3 million). Group net debt increased from £1,074 million at 31 March 2004 to £1,119 million at 31 March 2005. The net cash outflow reflected continuing investment in South West Water and Viridor Waste in excess of depreciation, together with the acquisition of Thames Waste Management for £31 million at the start of the financial year and the payment of dividends.

Overall, the net cash outflow of the Group, before the use of liquid resources and financing, was £35.8 million (2003/04 £71.9 million).

Capital expenditure for existing activities is expected to reduce in 2006/07 onwards but the level of investment is expected to result in the business being cash negative at least up to 2010.

• Liquidity

It is Group policy to ensure that the Group has committed loan facilities equivalent to at least one year's forecast requirements at all times. This is achieved through the use of credit facilities which are utilised as required and re-financed using drawdowns for longer-term facilities.

Payment commitments are expected to be met on the loan refinancing as required during the coming period.

• Internal transfers

For regulatory purposes, South West Water funding is treated as effectively ring-fenced. Funds raised by or for South West Water are used in the appointed business (provision of water and sewerage services) and are not available as long-term funding for the rest of the Group.

• Covenants

Pennon Group and South West Water have entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing and interest cover.

•• INTERPRETATION

• Landfill void space and power generation calculations

The landfill void space figures quoted in this OFR in relation to Viridor Waste are in respect of consented void only (void with planning permission for land filling).

The void space figures are based upon Viridor Waste's most recent assessment of void available to the company for waste and daily cover materials. The void figures have been assessed using pre-settlement levels (based upon the extent of the planning consent), proposed base levels (based upon the terms of the site licence/permit) and existing waste surfaces (determined by survey). These calculations necessarily involve an element of management judgement and are based on certain other assumptions (such as the waste mix profile of a site). However, Viridor Waste is of the opinion that its calculation methodologies are in line with convention typical in the landfill industry. The void actually available at any one time may be different from the figures quoted.

Gas/electricity generating capacity of Viridor Waste is defined by the megawatt capacity of the engines installed on landfill sites through which the gas passes to generate electricity.

Modelling future power generation requires consideration of a number of factors including the waste mass and composition already in place and volumes of gas currently being extracted. In addition, the model requires an assessment of how the current position is expected to change throughout each site's remaining life as an operational landfill and beyond into the aftercare period. Any such assessment requires certain assumptions to be made including in relation to the amount of waste in the site, its biodegradable content, the age of the waste and the likelihood of obtaining a grid connection at an economic cost.

•• OPERATING & FINANCIAL REVIEW

•• GLOSSARY

The following are descriptions of some of the terms used in this OFR:

DEFRA	Department for Environment, Food and Rural Affairs
Determination	The price limits and expenditure plans determined by Ofwat for South West Water for a five year period
DWI	Drinking Water Inspectorate
EA	Environment Agency
GWh	Gigawatt hours
HWRS	Household waste recycling sites
IDoK	Interim Determination of K
ISO 14001	International environmental accreditation standard
June Return	The annual return to Ofwat made by South West Water of its performance during the last financial year
K3	The South West Water Periodic Review period 2000 – 2005
K4	The South West Water Periodic Review period 2005 – 2010
LATS	Local Authority Trading Scheme
LTCS	Landfill Tax Credit Scheme
MI	Megalitres
ML/d	Megalitres per day
MW	Megawatts
MWh	Megawatt hours
NFFO	Non fossil fuel obligation
Ofwat	Office of Water Services
PFI	Private finance initiative
PPC	Pollution, Prevention and Control Permit
Periodic Review	The process of determining the price limits and expenditure plans of South West Water for the next five-year regulatory period
RAV	Regulatory asset value
RPI	The UK Government's Retail Price Index
ROCs	Renewable obligation certificates
SEPA	Scottish Environment Protection Agency
SSAP 24	Statement of Standard Accounting Practice (Pensions)
UK GAAP	UK Generally Accepted Accounting Principles
Water Regulator	The Director General of Water Services


By Order of the Board

KEN WOODIER, Group General Counsel & Company Secretary

23 June 2005

•• BOARD OF DIRECTORS

- **Kenneth George Harvey BSc, CEng, FIEE (64)**
Non-executive Chairman
Was appointed on 1 March 1997. Ken 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 has also been Chairman of a number of limited and private equity funded companies. Currently he is a non-executive director of National Grid Transco Plc.
- **Robert John Baty OBE, FREng, CEng, FICE, FCIWEM, CCMI, ACI Arb (61)**
Chief Executive, South West Water Limited
Was appointed on 1 March 1996. Bob 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*. He is also currently a non-executive director of the Royal Devon & Exeter NHS Foundation Trust.
- **Colin Irwin John Hamilton Drummond MA, MBA, LTCL, CCMI (54)**
Chief Executive, Viridor Waste Limited
Was appointed on 1 April 1992. Prior to joining the Company Colin 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 is Chairman of the Government's Environmental Sector Advisory Group and was a member of the Government's Advisory Committee for Business in the Environment between 2001 and 2003.
- **David Jeremy Dupont MA, MBA (51)**
Group Director of Finance
Was appointed on 2 March 2002. David 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 (47)**
Senior independent Non-executive Director
Was appointed on 1 October 2003. Gerard 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 (59)**
Non-executive Director
Was appointed on 1 May 2000. Kate 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 (61)**
Non-executive Director
Was appointed on 12 June 2003. Dinah 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, chair of the National Forest Company, a board member of Toynbee Housing Association and chair of Toynbee Partnership Housing Association.

•• COMMITTEES OF THE BOARD

- **Audit**
Gerard Connell (Chairman)
Kate Mortimer
Dinah Nichols
- **Nomination**
Ken Harvey (Chairman)
Gerard Connell
Kate Mortimer
Dinah Nichols
- **Company secretary and registered office**
Ken Woodier
Peninsula House, Rydon Lane, Exeter EX2 7HR
Registered in England No 2366640
- **Environment**
Bruce Hewett (Chairman) (co-opted member)
Bob Baty
Colin Drummond
- **Remuneration**
Kate Mortimer (Chairman)
Gerard Connell
Dinah Nichols
- **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. During the year the terms of reference of the Committee were revised to be in accordance with corporate governance best practice and they now also include determining the terms of engagement and remuneration of the Chairman of the Company. The Committee comprises three Non-executive Directors, being Kate Mortimer, who chairs the Committee, Gerard Connell and Dinah Nichols. During the year the Committee met on seven occasions and received advice, or services, that materially assisted the Committee in the consideration of remuneration matters from Ken Harvey (Chairman of the Company), Ken Woodier (Group General Counsel & Company Secretary), Deloitte & Touche LLP – remuneration consultants, (appointed by the Committee) and Hewitt Bacon & Woodrow Limited – pensions and remuneration consultants (appointed by the Committee).

Hewitt Bacon & Woodrow also provided actuarial and investment pensions advice to the Group during the year.

•• GROUP REMUNERATION POLICY

The policy of the Group, which will be applied by the Remuneration Committee in 2005/06 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. The policy in respect of Non-executive Directors is set out on page 41 in the Non-executive Directors' remuneration section.

• 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 was reviewed during the year by Deloitte & Touche at the request of the Remuneration Committee to ensure that it was consistent with the overall Group policy. In 2005/06 (subject to fluctuations in the Company's share price and not taking account of the operation in 2004/05 of the Company's Restricted Share Plan at a level up to 150% of basic salary as this was a 'one off' for the reason stated in section (iii) on page 39 and is not due to mature until 2007/08) it is expected that just over 60% of Directors' potential direct remuneration (i.e. excluding pensions, car benefit and health cover) will be performance related (the same as in 2004/05). It is intended that this balance between performance related and that which is not related to performance will continue.

Bob Baty, with the Board's consent, is a non-executive director of the Royal Devon & Exeter NHS Trust. For this appointment he received a fee of £3,300 in 2004/05 from the Trust and the Board has determined that he may retain such earnings.

(i) Basic salary and benefits – These are set out on page 42 for each Executive Director and are not related to performance. The Committee determines revised salaries, usually on an annual basis, for Executive Directors based upon surveys conducted by external consultants (being a commissioned survey from Deloitte & Touche during 2004/05) and the performance of the individual Executive Directors which the Committee assesses with the advice of Ken Harvey, Chairman. Other benefits, not mentioned below, include contributory pension provision (with four times salary life assurance cover), a fully expensed car (or a cash equivalent alternative) 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 bonus achievable under the Plan for Executive Directors is 80% of basic salary with half of any payment being in the form of shares which must be held for a period of three years before release. 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, apart from continuous service with the Company, 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 performance related bonus award for 2005/06 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 (the references to a percentage bonus relate to a percentage of the annual basic salary of each Executive Director in 2005/06):

Bob Baty

– A bonus of up to a maximum of 20% for outperformance of Group earnings per share against budget and up to 60% bonus calculated by reference to the average bonus earned by the other Executive 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).

Colin Drummond

– A bonus of up to a maximum of 20% for outperformance of Group earnings per share against budget and up to 60% bonus calculated by reference to outperformance of profit before tax of Viridor Waste against budget; and for personal objectives relating to key business targets for Viridor Waste.

David Dupont

– A bonus of up to a maximum of 20% for outperformance of Group earnings per share against budget and up to 60% 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 and Group initiatives.

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 Chairman, Ken Harvey.

(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. In respect of the Executive Directors and certain senior management, no award was made during 2003 because of the existence of unpublished price sensitive information relating to the Company. Therefore, following shareholder approval of a change to the rules of the Restricted Share Plan granted at the Annual General Meeting on 29 July 2004, the Company made 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). For 2005 and 2006 (being the last year in which an award can be made pursuant to the shareholder approval granted in 1997) the Plan reverts to the original award level which 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 shares, 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 then applicable had not been met on each occasion. With regard to the years 2000 and 2001 awards, all of the shares awarded to Directors vested at the end of the restricted period because the performance condition in respect of each award had been met in full. It is expected that some (but not all) of the shares awarded in 2002 to Directors will vest at the end of the three year restricted period in September 2005 because the performance condition has been partially met. For each of the years 2000 to 2004 the performance condition to be satisfied for at least 50% of the award to vest 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.

A description of what percentage of the award vests by reference to the position of the Company in the comparator group above the 50th percentile position is given on page 40.

The comparator group applicable for awards during the year to 31 March 2005 was as follows, with the comparator group applicable to other previous award years being similar in content and size:

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

It is expected that the comparator group applicable to any awards that may be made by the Committee in the current year will be similar in content and size to the above group.

DIRECTORS' REMUNERATION REPORT

The TSR performance condition was applied by the Committee because, based upon advice received previously from remuneration consultants, Meis, 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 total shareholder return of the Company to the other companies in the comparator group is appropriate because the other companies operate in sectors 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 the position equal or closest to but not above the 75th percentile position or a position 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.

In addition, following the canvassing of all Group employees to gauge interest, the Board is proposing to launch a Share Incentive Plan (SIP) this year which will be an all-employee plan where performance conditions will 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:

Bob Baty	26 February 1996
Colin Drummond	5 March 1992
David 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 which applies to Colin Drummond and David Dupont).

Colin Drummond and David Dupont (being subject to the Earnings Cap) are both provided with additional pension benefits under the unapproved funded Supplementary Scheme of the Company 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.

In view of the changes which come into effect as a result of the Pensions Act 2004 and the Finance Act 2004 involving, in particular, the simplification of taxation of pensions, the Remuneration Committee is currently reviewing executive pension provisions.

• Total shareholder return graph

The graph shows the value, over the five year period ending in March 2005, of £100 invested in Pennon Group on 31 March 2000 compared with the value of £100 invested in the FTSE All-Share Utilities (Other) Index. This Index is considered appropriate as it is an equity market index of which the Company is a constituent.

Graph here

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.

• Non-executive Directors and the Chairman

Non-executive Directors' remuneration (excluding the Chairman, Ken Harvey) consisting of fees only set out below, is determined by the Board of Directors (in the absence of the Non-executive Directors) and is usually reviewed biennially, although in 2003/04 it was reviewed after one year to take account of market changes in non-executive directors' fees arising from the impact of the Higgs Review on non-executive directors' duties and obligations. The level of fees was considered again in January 2005 and it was decided to defer the review until September 2005 to take into account the expected further impact of the Higgs Review. In reviewing the fees, the Executive Directors take account of market information on non-executive directors' fees, most recently from Deloitte & Touche who undertook a review at

the request of the Board. The policy to be applied in 2005/06 (which is also currently intended to be applied in each subsequent year) continues to be 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. As referred to earlier, the Chairman's remuneration is now set by the Remuneration Committee. The policy of the Committee to be applied in 2005/06 (which is also currently intended to be applied in each subsequent year) is the same as that of the Executive Directors in reviewing the fees of the Non-executive Directors. In addition to a fee (determined with the advice of and market information from Deloitte & Touche) the Chairman receives car benefit (fully expensed) and health cover. No other benefits or remuneration are received by the Chairman.

The fees of the Non-executive Directors (excluding the Chairman) payable for the full year 2004/05 were made up as follows:

Non-executive Director	Basic fee £000	Audit/Remuneration Committee membership fee (£3,000 per Committee) £000	Chairman of Committee fee £000	Total £000
Gerard Connell	25	6	4	35
Kate Mortimer	25	6	2	33
Dinah Nichols	25	6	—	31

The Non-executive Directors (excluding the Chairman) have contracts for services setting out their terms and conditions of appointment 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:

Director	Date of contract	Expiry of contract
Gerard Connell	30 September 2003	30 September 2006
Kate Mortimer	19 March 2005	30 April 2006
Dinah Nichols	10 June 2003	11 June 2006

The Chairman, Ken Harvey, has a contract for services dated 1 April 2005 which is subject to 12 months' notice. No provision is made for any termination payments under this contract.

The contracts for services of Ken Harvey and Kate Mortimer were revised during the year to reflect corporate governance best practice. The contracts for services of Gerard Connell and Dinah Nichols already reflect corporate governance best practice. The contracts of all the Non-executive Directors (including the Chairman) and those of the Executive Directors are available for inspection at the Company's registered office during normal business hours.

DIRECTORS' REMUNERATION REPORT

The information set out on the remaining pages of this Remuneration Report (pages 42 to 44) has been audited by PricewaterhouseCoopers LLP.

• Emoluments of Directors

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

Director	Salary/fees £000	Performance related bonus payable] £000	Other emoluments* £000	Payments related to supplementary pension £000	Total 2005 £000	Total 2004 £000
<i>Chairman:</i>						
Ken Harvey	170	–	20	–	190	164
<i>Executive Directors:</i>						
Bob Baty	200	74**	15	–	289**	234
Colin Drummond	200	68	22	60	350	300
David Dupont	190	67	17	48	322	246
<i>Non-executive Directors:</i>						
Gerard Connell	35	–	–	–	35	16
Kate Mortimer	33	–	–	–	33	31
Dinah Nichols	31	–	–	–	31	24
Total	859	209	74	108	1,250	1,015

** Bob Baty has elected to waive this cash element of his performance related bonus.

* Other emoluments are car benefit and health cover.

† In addition to the performance related cash bonus, Executive Directors are due to receive a conditional award of shares as referred to in a note to (c) 'Incentive Bonus Plan – Deferred Shares' on page 44.

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 2004/05 are shown in the table below:

Director	Increase in accrued pension during 2004/05 (net of inflation) £000 <i>a</i>	Increase in accrued pension during 2004/05 £000 <i>b</i>	Accrued pension at 31 March 2005 £000 <i>c</i>	Transfer value at 31 March 2005 £000 <i>d</i>	Transfer value at 31 March 2004 £000 <i>e</i>	Increase in transfer value (net of Directors' contributions) £000 <i>f</i>	Transfer value of Column a (net of Directors' contributions) £000 <i>g</i>
Bob Baty	21	25	147	2,903	2,316	577	396
Colin Drummond	14	16	73	1,030	768	252	191
David Dupont	12	14	61	744	551	184	139

During the year, the sum of £83,000 was transferred from a former pension scheme by Colin Drummond into the Pennon Group Pension Scheme.

Column *a* above is the increase in accrued pension during 2004/05 (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 2004/05.

Column *c* is the accrued pension at 31 March 2005 payable at normal retirement age.

Column *d* is the transfer value of the accrued pension set out in column *c* as at 31 March 2005.

Column *e* is the transfer value of the accrued pension at the end of the previous financial year on 31 March 2004.

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' REMUNERATION REPORT

• 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 42.

Directors have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the table shown on page 42.

• Directors' share interests

(a) Shareholdings

The number of shares of the Company in which Directors held beneficial interests at 31 March 2005 and 31 March 2004 were:

Director	2005	2004	Director	2005	2004
Bob Baty	49,959	28,722	Ken Harvey	2,644	2,644
Colin Drummond	29,062	14,455	Kate Mortimer	265	256
David Dupont	25,595	15,924			

Additional shares have been acquired by the Directors since 31 March 2005 as follows as a result of participation in Personal Equity Plans, Individual Savings Accounts and the scrip dividend alternative on 7 April 2005:

Bob Baty	45	David Dupont	16
Colin Drummond	34	Kate Mortimer	4

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 2005 and 30 May 2005.

(b) Restricted Share Plan

In addition to the above beneficial interests, the following Directors have or had a contingent interest in the number of shares shown below, representing the maximum number of shares to which they would or have become entitled under the Group's Long Term Incentive Plan with the relevant criterion being met in full.

Director and date of award	Conditional awards held at 1 April 2004	Conditional awards made in year	Market price upon award in year	Vesting in year * **	Value of shares upon vesting (before tax) £	Conditional awards held at 31 March 2005	Date of end of period for qualifying condition to be fulfilled
Bob Baty							
12/9/00	16,174	–	598p	16,174 *	118,070	–	–
11/9/01	16,294	–	622p	16,294 **	131,981	–	–
16/9/02	18,514	–	638p	–	–	18,514	15/9/05
16/9/04	–	37,059	809.5p	–	–	37,059	15/9/07
Colin Drummond							
12/9/00	16,174	–	598p	16,174 *	118,070	–	–
11/9/01	16,294	–	622p	16,294 **	131,981	–	–
16/9/02	18,514	–	638p	–	–	18,514	15/9/05
16/9/04	–	37,059	809.5p	–	–	37,059	15/9/07
David Dupont							
12/9/00	6,842	–	598p	6,842 *	49,947	–	–
11/9/01	7,038	–	622p	7,038 **	57,008	–	–
16/9/02	14,694	–	638p	–	–	14,694	15/9/05
16/9/04	–	35,206	809.5p	–	–	35,206	15/9/07

* The 2000 awards vested on 27 May 2004 at a price of 730p per share because the criterion described in paragraph (iii) on page 39 was met in full.

** The 2001 awards vested on 13 September 2004 at a price of 810p per share because the criterion described in paragraph (iii) on page 39 was met in full.

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, as follows: Bob Baty £16,406; Colin Drummond £16,406; David Dupont £9,813.

It is anticipated that some (but not all) of the shares will vest under the 2002 awards as the performance criterion has been partially met.

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

Director and date of award	Conditional awards held at 1 April 2004	Conditional awards made in year	Market price upon award in year	Vesting in year	Conditional awards held at 31 March 2005	Date of end of period for qualifying condition to be fulfilled
Bob Baty						
26/7/02	7,885	–	652p	–	7,885	25/7/05
25/7/03	6,435	–	652p	–	6,435	24/7/06
28/6/04	–	6,262	778.5p	–	6,262	27/6/07
Colin 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
28/6/04	–	7,579	778.5p	–	7,579	27/6/07
David Dupont						
26/7/02	4,728	–	652p	–	4,728	25/7/05
25/7/03	6,146	–	652p	–	6,146	24/7/06
28/6/04	–	5,834	778.5p	–	5,834	27/6/07

A further conditional award of shares will be made in 2005/06 to the value of the amount of the performance related cash bonus shown in the Emoluments of Directors table on page 42. (Paragraph (ii) on page 38 sets out the provisions relating to the conditional award of shares pursuant to the Incentive Bonus Plan).

During the year, the Directors received dividends on the above shares in accordance with the conditions of the long term incentive element of the Bonus Plan as follows: Bob Baty £7,612; Colin Drummond £8,136; David Dupont £6,080.

It is anticipated that all of the shares will vest under the 2002 awards in 2005/06 as the criterion is expected to be met.

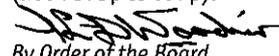
(d) Sharesave Scheme

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 2004	Granted in year	Exercised in year	Market price on exercising	Options held at 31 March 2005	Exercise price	Exercise period/maturity date
Bob Baty							
10/7/01	792	–	792	822p	–	489p	1/9/04 – 1/3/05
8/7/03	1,047	–	–	–	1,047	530p	1/9/06 – 1/3/07
Colin Drummond							
8/7/03	1,745	–	–	–	1,745	530p	1/9/06 – 1/3/07
David 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 2005 was 976p (2004 690.5p) and the range during the year was 677p to 1016p (2004 575p to 697p).


By Order of the Board
KEN WOODIER, Group General Counsel & Company Secretary
23 June 2005

•• 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 main and supporting principles of good corporate governance contained in Section 1 of the new Combined Code issued in July 2003 annexed to the UK Listing Authority Rules have been applied by the Company in practice. Throughout the year, the Company has complied with the provisions of the Combined Code.

•• THE BOARD

The Board of Directors at the end of the year comprised the Chairman, three Executive Directors and three Non-executive Directors. All of the Non-executive Directors are considered to be independent and Gerard Connell is the Senior independent Non-executive Director. The biographies on page 37 demonstrate a broad range of business and financial experience and there is a clear division of responsibilities between the roles of Chairman and the Chief Executives of South West Water and Viridor Waste as recorded in the descriptions of the roles approved by the Board. All Directors are subject to re-election at least every three years.

During the year, the Board met in accordance with its schedule of meetings on 10 occasions and at each meeting all Directors were present with the exception of Gerard Connell on one occasion and Kate Mortimer on two occasions. The Board also held six special meetings during the year at which all Directors were present with the exception of Kate Mortimer on two occasions. 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 and Viridor Waste 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 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 was 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 were then summarised and evaluated by the Group General Counsel & Company Secretary for the Board to consider and determine whether any changes were necessary for the Board to be more effective. Overall performance was considered to be satisfactory but a number of minor issues were identified where changes could be made to improve performance. The Chairman's performance was evaluated separately by the Non-executive Directors, led by the Senior Independent Non-executive Director.

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 Gerard Connell, who has recent and relevant financial experience, and the other members of the Committee were Kate Mortimer and Dinah Nichols. During the year, the Committee met on five occasions and all members were present except Kate Mortimer on one occasion. In discharging its Terms of Reference, the Committee receives reports and meets regularly to in particular:

- monitor the integrity of the financial statements of the Group, including a review of significant reporting judgements, prior to approval by the Board;
- keep under review the effectiveness of the Group's internal controls, including all material financial, operational and compliance controls and risk management systems;
- monitor and review the effectiveness of the Group's internal audit function and approve the annual internal audit plan; review the findings of the internal audit function and review and monitor management's responsiveness to such findings;
- oversee the relationship with the external auditors including their remuneration, appointment, reappointment and removal and in addition monitor their independence and objectivity including the supply of non-audit services; receive internal control reports from the external auditors and meet with them in the absence of management at least once a year to discuss their remit and any issues arising from the audit.

CORPORATE GOVERNANCE AND INTERNAL CONTROL

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. This involves the Group Director of Finance setting out in a report to the Committee reasons for appointing the auditors for any material work and obtaining the approval of the Committee to such appointment which the Committee will only grant if it is satisfied that the auditors' independence and objectivity are safeguarded. This is achieved by reviewing the appointment with the auditors as considered appropriate and receiving from the auditors at the year end a letter setting out how the auditors believe their independence and objectivity have been maintained. 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 partner 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 58. The Executive Directors attend 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 Kate Mortimer and Gerard Connell and Dinah Nichols were the other members of the Committee. The Committee met on seven occasions during the year and all members were present except Gerard Connell on one occasion. The Committee is responsible for determining the remuneration and terms of engagement of the Chairman and 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 38 to 44.

• Nomination Committee

The Nomination Committee was chaired by Ken Harvey and also comprised Kate Mortimer, Dinah Nichols and Gerard Connell. It meets as and when required to select and recommend to the Board suitable candidates for appointment as Executive and Non-executive Directors, determine the nomination process and review succession plans. During the year, it met on two occasions (and all members were present except for Kate Mortimer on one occasion) to review succession plans for the Executive Directors of the Board and senior management and to formally determine the nomination process for Board appointments.

The Terms of Reference of the Audit, Remuneration and Nomination Committees are available upon request to the Company Secretary and are also set out on the Company's website at www.pennon-group.co.uk

• Environment Committee

The Environment Committee was chaired by Bruce Hewett (a co-opted member and former Non-executive Director of the Company) and also comprised the Chief Executives of South West Water and Viridor Waste. The Committee met four times during the year with all members present except for Bruce Hewett 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 corporate responsibility report.

•• INTERNAL CONTROL

Wider aspects of internal control

The Board acknowledges that it is responsible for the Company's system of internal control (including financial control) and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss. There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company that has been in place throughout the year 2004/05 and up to the date of the approval of this Annual Report and Accounts. The Board confirms that it continues to apply procedures in accordance with the 'Guidance on Internal Control' (The Turnbull Guidance) annexed to 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.

Risk identification

A full risk and control assessment is undertaken annually by the management of each business to identify financial and non-financial risks and is continuously updated. Each business 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 subsidiary Boards of South West Water and Viridor Waste 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 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. Details of key risks affecting the Group are set out in the Operating and Financial Review on pages 23 to 27.

•• INTERNAL CONTROL continued

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 to the Board for final evaluation. For 2004/05, both the Committee and the Board were satisfied with the effectiveness of the internal control process and its operation.

Internal control framework

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 and also annually reviews the scope of work, authority and resources of the Company's internal audit function and reports to the Board on such reviews.

•• 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

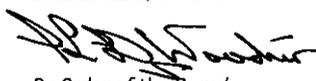
The Directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and the Group as at the end of the financial year and of the profit or loss of the Group for the financial year.

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 and the Chief Executive of Viridor Waste 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. In particular, Non-executive Directors are invited to attend meetings with institutional shareholders and analysts' and brokers' briefings. The Group Director of Finance reports to the Board regularly on major shareholders' views about the Company. The Group Director of Finance also conducts surveys of shareholder opinion, usually on an annual basis, which are evaluated and reported on to the Board.



By Order of the Board

KEN WOODIER, Group General Counsel & Company Secretary

23 June 2005

THE DIRECTORS SUBMIT THEIR REPORT AND AUDITED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2005

•• 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 reviews and in the Operating and Financial Review on pages 2 to 36.

The principal subsidiaries of the Company are listed in note 32 to the financial statements on page 78.

•• FINANCIAL RESULTS AND DIVIDEND

Group profit on ordinary activities after taxation was £68.8 million. The Directors recommend a final dividend of 29.2p per ordinary share to shareholders on the register on 5 August 2005, making a total for the year of 43.0p, the cost of which would be £55.1 million, leaving a retained surplus of £13.7 million to be transferred to reserves.

The Operating and Financial Review on pages 28 to 34 analyses the results in more detail and sets out other financial information, including the Directors' opinion on asset values (page 30).

•• DIRECTORS

Bob Baty, David Dupont and Kate Mortimer are due to retire at the Annual General Meeting and offer themselves for re-election. Resolutions for their re-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 42. Further details relating to the Directors and their service contracts or contracts for services are set out on pages 38 to 44 and details of the Directors' interests in shares of the Company are given on pages 43 and 44.

•• EMPLOYMENT POLICIES AND EMPLOYEE INVOLVEMENT

The Group has a culture of continuous improvement through investment in people at all levels within the Group.

The Company is committed to pursuing equality and diversity in all its employment activities including recruitment, training, career development and promotion and ensuring there is no bias or discrimination in the treatment of people. In particular, the Company welcomes applications for employment from disabled persons and makes special arrangements and adjustments as necessary to ensure that disabled applicants are treated fairly when attending for interview or for pre-employment aptitude tests. Wherever possible, the opportunity is taken to retrain people who become disabled during their employment in order to maintain their employment within the Group.

Employees are consulted regularly about changes which may affect them either through their Trade Union appointed representatives or by means of the elected Staff Council which operates in South West Water for staff employees. These forums, together with regular meetings with particular groups of employees, are used to ensure that employees are kept up to date with the operating and financial performance of the Company. The Group also uses a monthly information cascade process to provide employees with important and up to date information about key events.

The Group encourages share ownership amongst its employees by operating an Inland Revenue approved sharesave scheme open to all eligible employees and intends to launch a Share Incentive Plan (SIP) to further develop this policy.

Further information relating to employee matters is set out in the Operating and Financial Review on page 18.

•• RESEARCH AND DEVELOPMENT

Research and development activities within the Group involving water and waste treatment processes amounted to £0.1 million during the year (2003/04 £0.1 million).

•• DONATIONS

During the year, charitable donations amounting to £100,000 were made. Details relating to charitable and other donations are set out in the Operating and Financial Review on page 20. 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 Operating and Financial Review on page 30.

•• SUBSTANTIAL SHAREHOLDINGS

Details are set out in the Shareholder information section on page 96.

•• AUDITORS

PricewaterhouseCoopers LLP were appointed auditors until the conclusion of the sixteenth 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 2005 upon application to the Company Secretary at Peninsula House, Rydon Lane, Exeter EX2 7HR.

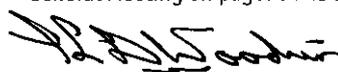
•• ANNUAL GENERAL MEETING

The sixteenth Annual General Meeting will be held at the Plymouth Pavilions, Millbay Road, Plymouth, Devon PL1 3LF on 28 July 2005 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
- re-elect Bob Baty, David Dupont and Kate Mortimer as Directors of the Company
- seek approval to amend the Articles of Association of the Company by way of separate resolutions to (a) amend the borrowing powers of the Company, and (b) update the Articles generally.

Details of the resolutions are set out in the Notice of Annual General Meeting on pages 90 to 95 of this Annual Report.



By Order of the Board

*KEN WOODIER, Group General Counsel & Company Secretary
23 June 2005*

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 Operating and Financial Review, the unaudited part of the Directors' remuneration report, the statements of compliance on corporate governance and internal control and the Report of the Directors.

We review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 Financial Reporting Council (FRC) Combined Code 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.

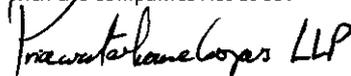
•• BASIS OF AUDIT OPINION

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 2005 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

23 June 2005

GROUP PROFIT AND LOSS ACCOUNT

for the year ended 31 March 2005

	Notes	Before exceptional items 2005 £m	Exceptional items 2005 £m	Total 2005 £m	Before exceptional item 2004 £m	Exceptional item 2004 £m	Total 2004 £m
Turnover							
Continuing operations		514.0	-	514.0	471.3	-	471.3
Acquisitions		40.2	-	40.2	-	-	-
Total turnover	2	554.2	-	554.2	471.3	-	471.3
Operating costs	3	(406.2)	(4.9)	(411.1)	(335.0)	(6.5)	(341.5)
Group operating profit							
Continuing operations		144.5	(4.9)	139.6	136.3	(6.5)	129.8
Acquisitions		3.5	-	3.5	-	-	-
Total Group operating profit	2	148.0	(4.9)	143.1	136.3	(6.5)	129.8
Share of operating profit/(loss) in joint venture		0.1	-	0.1	(0.3)	-	(0.3)
Total operating profit		148.1	(4.9)	143.2	136.0	(6.5)	129.5
Business disposal profit	5	-	5.0	5.0	-	-	-
Net interest payable	6	(60.7)	-	(60.7)	(57.2)	-	(57.2)
Profit on ordinary activities before taxation	2	87.4	0.1	87.5	78.8	(6.5)	72.3
Tax on profit on ordinary activities	7			(18.7)			(10.8)
Profit on ordinary activities after taxation				68.8			61.5
Dividends	9			(55.1)			(51.1)
Retained surplus transferred to reserves	27			13.7			10.4
Earnings per share							
	10						
Before exceptional items and deferred tax:							
Adjusted basic				63.1p			57.7p
Adjusted diluted				62.6p			57.3p
After exceptional items and deferred tax:							
Basic				54.6p			49.8p
Diluted				54.2p			49.5p
Dividend per share				43.0p			41.0p

All operating activities are continuing operations, except the business disposal profit which relates to a discontinued operation.

There were no recognised gains or losses, other than the profit for the year, in 2005 and 2004.

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

The notes on pages 54 to 85 form part of these financial statements.

BALANCE SHEETS

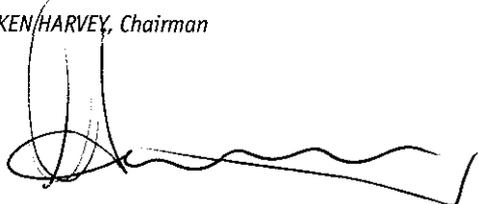
at 31 March 2005

	Notes	Group		Company	
		2005 £m	2004 Restated (note 13) £m	2005 £m	2004 Restated (note 13) £m
Fixed assets					
Intangible assets	14	63.2	47.6	-	-
Tangible assets	15	2,248.1	2,141.1	0.2	0.2
Investments	16	2.6	2.6	931.8	931.8
		2,313.9	2,191.3	932.0	932.0
Current assets					
Stocks	17	4.7	4.5	-	-
Debtors: amounts falling due after more than one year	18	1.3	5.0	239.6	230.8
Debtors: amounts falling due within one year	19	99.6	92.3	32.9	25.8
Investments	20	298.4	253.7	57.5	-
Cash at bank and in hand		4.4	14.0	-	-
		408.4	369.5	330.0	256.6
Current liabilities					
Creditors: amounts falling due within one year	21	(270.9)	(293.6)	(358.1)	(476.1)
Net current assets/(liabilities)		137.5	75.9	(28.1)	(219.5)
Total assets less current liabilities					
Creditors: amounts falling due after more than one year	22	(1,366.8)	(1,234.9)	(293.6)	(158.7)
Provisions for liabilities and charges	24	(108.7)	(94.0)	-	(0.1)
Deferred income	25	(37.8)	(38.7)	-	-
Net assets	2	938.1	899.6	610.3	553.7
Capital and reserves					
Called-up share capital	26	142.0	137.9	142.0	137.9
Share premium account	27	153.7	154.2	153.7	154.2
Profit and loss account	27	642.4	607.5	314.6	261.6
Shareholders' funds	28	938.1	899.6	610.3	553.7

The notes on pages 54 to 85 form part of these financial statements.

Approved by the Board on 23 June 2005 and signed on its behalf by:

KEN HARVEY, Chairman



GROUP CASH FLOW STATEMENT

for the year ended 31 March 2005

	Notes	2005 £m	2004 Restated (note 13) £m
Net cash inflow from operating activities	35(a)	255.3	215.1
Returns on investments and servicing of finance	35(b)	(59.1)	(41.3)
Taxation		(0.4)	(0.1)
Capital expenditure and financial investment	35(b)	(174.7)	(178.6)
Acquisitions	35(b)	(28.6)	(20.0)
Equity dividends paid		(28.3)	(47.0)
<hr/>			
Net cash outflow before use of liquid resources and financing		(35.8)	(71.9)
Management of liquid resources	35(b)	(8.1)	(62.1)
Financing	35(b)	72.5	155.7
<hr/>			
Increase in cash in year	35(c)	28.6	21.7

NOTES TO THE FINANCIAL STATEMENTS

•• 1. ACCOUNTING POLICIES

The main policies are:

(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 2005, together with the attributable share of results and reserves of joint ventures 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 1988 goodwill arising on acquisitions 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, 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.

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.

•• 1. ACCOUNTING POLICIES continued

(f) Tangible fixed assets and depreciation continued

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:

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

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, it is calculated from an independently certified Asset Management Plan and not determinable finite lives. 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 15.

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

(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.

NOTES TO THE FINANCIAL STATEMENTS

•• 1. ACCOUNTING POLICIES continued

(j) Employee Share Ownership Plan

The cost of shares acquired under the Employee Share Ownership Plan is recognised in the profit and loss account on a straight-line basis over the period to which the performance criteria relate and is based on an assessment of the expectations of the extent to which those performance criteria will be met. To meet the award, shares are held in a discretionary trust. Until such time as the shares vest unconditionally with the employees, the consideration paid for the shares is deducted in arriving at shareholders' funds.

The application of the Urgent Issues Task Force Abstract 17 (revised 2003) 'Employee Shares Schemes' and Urgent Issues Task Force Abstract 38 'Accounting for ESOP Trusts' has resulted in a change in the method of accounting for shares acquired under the Employee Share Ownership Plan. The effect of this change is disclosed in note 13.

(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 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 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 33, 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.

(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

	2005 £m	2004 £m
Turnover		
<i>Continuing operations</i>		
Water and sewerage	309.8	291.8
Waste management	248.3	183.1
Other	6.9	7.3
Less intra-group trading	(10.8)	(10.9)
Group total	554.2	471.3
Group operating profit		
<i>Continuing operations before exceptional items and goodwill amortisation</i>		
Water and sewerage	121.7	118.9
Waste management	29.8	22.7
Other	-	(2.8)
Total continuing operations before exceptional items and goodwill amortisation	151.5	138.8
Group operating profit		
<i>Continuing operations after exceptional items and goodwill amortisation</i>		
Water and sewerage	118.3	118.9
Waste management	26.3	20.2
Other	(1.5)	(9.3)
Group total	143.1	129.8
Profit on ordinary activities before taxation		
<i>Continuing operations after net exceptional items and goodwill amortisation</i>		
Water and sewerage	67.1	70.1
Waste management	18.0	14.7
Other	2.4	(12.5)
Group total	87.5	72.3

	Net assets/(liabilities)		Employees (average number)	
	2005 £m	2004 Restated (note 13) £m	2005	2004
<i>Continuing operations</i>				
Water and sewerage	871.4	896.0	1,336	1,341
Waste management	99.1	97.9	1,169	895
Other, including intra-group trading	(32.4)	(94.3)	39	39
Group totals	938.1	899.6	2,544	2,275

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

NOTES TO THE FINANCIAL STATEMENTS

•• 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 (2004 none).

•• 3. OPERATING COSTS

	Continuing operations £m	Acquisitions £m	Total 2005 £m	Total 2004 £m
Manpower costs (note 11)	69.4	6.7	76.1	57.9
Raw materials and consumables	28.5	4.3	32.8	35.8
Rentals under operating leases:				
Hire of plant and machinery	3.2	1.6	4.8	3.5
Other operating leases	3.7	0.1	3.8	3.2
Research and development expenditure	0.1	–	0.1	0.1
Other external charges	87.5	12.7	100.2	70.4
Amortisation of intangible fixed assets	2.6	0.9	3.5	2.5
Depreciation:				
On owned assets	69.8	3.9	73.7	66.8
On assets held under finance leases	21.3	0.1	21.4	19.3
Profit on disposal of tangible fixed assets	(1.4)	–	(1.4)	(1.7)
Deferred income released to profits	(1.3)	–	(1.3)	(1.2)
Other operating charges	91.0	6.4	97.4	84.9
	374.4	36.7	411.1	341.5

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

Fees payable to the Group's auditors

	2005 £000	2004 £000
Audit services		
Statutory audit	308	250
Regulatory audit and reporting	29	116
Other assurance services	220	740
Tax services		
Compliance services	24	35
Advisory services	105	219
Other services	66	385

Included within the statutory audit fee above is an amount of £46,000 (2004 £46,000) for the Company's audit.

Regulatory audit and reporting is lower in 2005 than in 2004 as during 2004 the auditors were engaged in the audit of South West Water Limited's Periodic Review submission to Ofwat.

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

•• 3. OPERATING COSTS continued

Other services in 2004 represent fees for consulting services in relation to Viridor Waste Limited's successful bid for a Private Finance Initiative (PFI) contract with West Sussex County Council.

•• 4. EXCEPTIONAL ITEMS

	2005 £m	2004 £m
The exceptional items are:		
Abortive acquisition costs		
Other external charges	1.5	6.5
Water and sewerage business restructuring		
Manpower costs	3.0	–
Other external charges	0.4	–
	4.9	6.5

The abortive acquisition costs arise from negotiations to acquire the UK landfill and landfill gas operations of Shanks Group Plc where discussions were terminated on 25 May 2004.

•• 5. BUSINESS DISPOSAL PROFIT

	2005 £m	2004 £m
Societa Italo Britannica dell'Acqua Srl	5.0	–

The business disposal profit relates to the balance of proceeds due from the 1998 arrangement to dispose of the Group's interest in Societa Italo Britannica dell'Acqua Srl.

The tax charge was not affected by the business disposal profit.

•• 6. NET INTEREST PAYABLE

	2005 £m	2004 £m
Interest payable:		
Bank loans and overdrafts	(23.5)	(18.8)
Other loans	(16.2)	(16.7)
Interest element of finance lease rentals	(32.7)	(29.6)
Other finance costs	(0.6)	(0.5)
	(73.0)	(65.6)
Interest receivable:		
Listed redeemable securities	0.3	0.2
Other investments (as defined in note 20)	13.0	9.2
	13.3	9.4
Unwinding of discount in provisions	(1.0)	(1.0)
Net interest payable	(60.7)	(57.2)

NOTES TO THE FINANCIAL STATEMENTS

•• 7. TAX ON PROFIT ON ORDINARY ACTIVITIES

(a) Analysis of charge for the year

	2005 £m	2004 £m
<i>Current tax:</i>		
UK corporation tax at 30%:		
Current year	13.1	12.8
Prior year	(5.2)	(5.3)
Total current tax (note 7(b))	7.9	7.5
<i>Deferred tax:</i>		
Origination and reversal of timing differences	18.4	16.2
Increase in discount	(7.6)	(12.9)
Total deferred tax (note 24)	10.8	3.3
Tax on profit on ordinary activities	18.7	10.8

(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:

	2005 £m	2004 £m
Profit on ordinary activities before tax	87.5	72.3
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK (30%)	26.3	21.7
<i>Effects of:</i>		
Income not taxable/expenses not deductible for tax purposes	1.3	5.9
Capital allowances for year in excess of depreciation	(14.8)	(15.3)
Other timing differences	0.3	0.5
Adjustments to tax charge in respect of prior year	(5.2)	(5.3)
Current tax charge for year (note 7(a))	7.9	7.5

•• 8. PROFIT OF PARENT COMPANY

	2005 £m	2004 £m
Profit on ordinary activities after taxation dealt with in the accounts of the parent company	85.7	74.6

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

•• 9. DIVIDENDS

	2005 £m	2004 £m
Interim dividend of 13.8p (2004 13.2p) per share paid 7 April 2005	17.7	16.4
Proposed final dividend of 29.2p (2004 27.8p) per share payable 5 October 2005	37.4	34.7
	55.1	51.1

•• 10. EARNINGS PER SHARE

	2005			2004		
	Profit after tax £m	Earnings per share		Profit after tax £m	Earnings per share	
		Basic p	Diluted p		Basic p	Diluted p
Adjusted earnings:						
Profit on ordinary activities after taxation	68.8	54.6	54.2	61.5	49.8	49.5
Net exceptional items	(0.1)	(0.1)	(0.1)	6.5	5.3	5.2
Deferred tax	10.8	8.6	8.5	3.3	2.6	2.6
Adjusted earnings before exceptional items and deferred tax	79.5	63.1	62.6	71.3	57.7	57.3

Adjusted earnings per share have been calculated to exclude the impact of net exceptional items 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 126.0 million (2004 123.5 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 126.9 million (2004 124.3 million).

•• 11. EMPLOYEES AND EMPLOYMENT COSTS

The average number of persons (including Directors) employed by the Group was 2,544 (2004 2,275).

	Continuing operations £m	Acquisitions £m	Total 2005 £m	Total 2004 £m
<i>Employment costs comprise:</i>				
Wages and salaries	59.3	6.1	65.4	55.2
Social security costs	5.1	0.5	5.6	4.4
Pension costs	14.8	0.1	14.9	7.1
Total employment costs	79.2	6.7	85.9	66.7
<i>Charged as follows:</i>				
Manpower costs (note 3):				
Before exceptional costs	66.4	6.7	73.1	57.9
Exceptional costs (note 4)	3.0	–	3.0	–
	69.4	6.7	76.1	57.9
Capital schemes	9.8	–	9.8	8.5
Restructuring provision	–	–	–	0.3
	79.2	6.7	85.9	66.7

NOTES TO THE FINANCIAL STATEMENTS

•• 12. DIRECTORS' EMOLUMENTS

	2005 £000	2004 £000
Executive Directors:		
Salary	590	490
Performance related bonus payable	209	153
Vesting of Restricted Share Plan awards	607	–
Other emoluments	54	51
Payments in respect of tax liability from supplementary pension arrangements	108	86
Non-executive Directors	289	262
Total emoluments	1,857	1,042

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 41 to 44.

Conditional awards made to Directors in 2000 and 2001 vested during the year, as described in the Directors' remuneration report on page 43.

The emoluments of the highest paid Director were £600,000, which includes £250,000 from the vesting of two awards (one deferred from the previous year) under the Company's Restricted Share Plan (2004 £300,000).

Total gains made by Directors on the exercise of share options were £3,000 (2004 £4,000).

Total emoluments above include £911,000 (2004 £427,000) payable to Directors in respect of services performed as directors of subsidiary undertakings. This sum also includes a total of £400,000 in respect of the vesting of the Restricted Share Plan awards described above.

At 31 March 2005 and 31 March 2004, retirement benefits were accruing to three Directors under defined benefit pension schemes. The accrued pension entitlement at 31 March 2005 under defined benefit schemes of the highest paid Director was £73,000 (2004 £57,000). No pension contributions were payable to defined contribution schemes in 2005 or 2004.

More detailed information concerning Directors' emoluments, shareholdings and share options is shown in the Directors' remuneration report on pages 38 to 44.

•• 13. PRIOR YEAR ADJUSTMENTS

The Group's accounting policy on the treatment of shares acquired under the Employee Share Ownership Plan has been changed following adoption of Urgent Issues Task Force Abstract 17 (revised 2003) 'Employee Share Schemes' (UITF17 revised 2003) and Urgent Issues Task Force Abstract 38 'Accounting for Employee Share Option Plan (ESOP) Trusts' (UITF38).

The policy adopted by the Group for the treatment of shares acquired under the Employee Share Ownership Plan recognises in the profit and loss account the cost of an award on a straight-line basis over the period to which the performance criteria relate and is based on an assessment of the expectations of the extent to which those performance criteria will be met. To meet the award, shares are held in a discretionary trust. Until such time as the shares vest unconditionally with the employees, the consideration paid for the shares is deducted in arriving at shareholders' funds. Previously, the shares acquired by the trust were recognised on the balance sheet at cost of acquisition less impairment, being the charge to profits over the period to which the employees' performance related. Any gain or loss on transactions in own shares will be reported through the statement of movements in shareholders' funds.

•• 13. PRIOR YEAR ADJUSTMENTS continued

As a result of these changes in accounting policy, the comparative year has been restated as follows:

Group and Company balance sheets

	Group		Company	
	Fixed asset investments	Profit and loss reserve	Fixed asset investments	Profit and loss reserve
	2004 £m	2004 £m	2004 £m	2004 £m
Previously reported	3.6	608.5	932.0	261.8
Application of UITF17 (revised 2003)	3.7	3.7	1.3	1.3
Application of UITF38	(4.7)	(4.7)	(1.5)	(1.5)
Restated now reported	2.6	607.5	931.8	261.6

The restatement of the Group's profit and loss reserve at 31 March 2004 includes a prior period adjustment of £1.3 million at 31 March 2003. There has been no change to the amount recognised as the cost of the awards in the profit and loss account for the year.

Group cash flow statement

	Capital expenditure and financial investment	Financing
	2004 £m	2004 £m
Previously reported	(179.2)	156.3
Application of UITF38	0.6	(0.6)
Restated now reported	(178.6)	155.7

•• 14. INTANGIBLE FIXED ASSETS

	Goodwill £m	Patents £m	Total 2005 £m
Cost:			
At 1 April 2004	51.7	—	51.7
Additions	18.9	0.2	19.1
At 31 March 2005	70.6	0.2	70.8
Amortisation:			
At 1 April 2004	4.1	—	4.1
Charge for year	3.5	—	3.5
At 31 March 2005	7.6	—	7.6
Net book value:			
At 31 March 2005	63.0	0.2	63.2
At 31 March 2004	47.6	—	47.6

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

NOTES TO THE FINANCIAL STATEMENTS

•• 15. 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 2005 £m	Company Total 2005 £m
Cost:							
At 1 April 2004	206.0	1,103.5	557.7	857.0	76.5	2,800.7	0.3
Arising on acquisitions	9.0	–	–	9.8	–	18.8	–
Additions	23.9	46.6	0.6	54.1	63.2	188.4	0.1
Grants and contributions	–	(2.8)	–	–	–	(2.8)	–
Disposals	(2.1)	(0.7)	(0.9)	(12.2)	(0.1)	(16.0)	(0.1)
Transfers/reclassifications	(3.8)	16.5	2.6	52.4	(67.7)	–	–
At 31 March 2005	233.0	1,163.1	560.0	961.1	71.9	2,989.1	0.3
Depreciation:							
At 1 April 2004	80.4	127.2	111.6	340.4	–	659.6	0.1
Charge for year	15.1	14.9	9.9	56.6	–	96.5	0.1
Disposals	(2.1)	(0.7)	(0.9)	(11.4)	–	(15.1)	(0.1)
Transfers/reclassifications	(0.2)	–	(0.5)	0.7	–	–	–
At 31 March 2005	93.2	141.4	120.1	386.3	–	741.0	0.1
Net book value:							
At 31 March 2005	139.8	1,021.7	439.9	574.8	71.9	2,248.1	0.2
At 31 March 2004	125.6	976.3	446.1	516.6	76.5	2,141.1	0.2
Assets held under finance leases included above:							
Cost: At 31 March 2005	–	155.8	315.0	246.0	59.0	775.8	–
Depreciation: Charge for year	–	2.0	5.5	13.9	–	21.4	–
Depreciation: At 31 March 2005	–	10.7	49.0	111.7	–	171.4	–

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 £5.1 million (2004 restated £4.7 million) and £9.3 million (2004 £9.3 million) respectively.

The net book value of land and buildings comprises:

	2005 £m	2004 £m
Freehold	83.4	78.1
Long leasehold	35.0	34.1
Short leasehold	21.4	13.4
	139.8	125.6

Long leasehold land and buildings have an unexpired term of not less than 50 years.

•• 15. TANGIBLE FIXED ASSETS continued

The net book value of infrastructure assets is stated after deducting £49.8 million (2004 £47.0 million) grants and contributions.

The net book value of infrastructure assets includes £13.8 million (2004 £13.8 million) for the accumulated difference between expenditure on maintaining operating capacity and depreciation charges. Expenditure in the year was £14.9 million (2004 £16.4 million).

Out of the total depreciation charge for the Group of £96.5 million (2004 £87.7 million), £1.4 million (2004 £1.6 million) has been charged to capital projects and £95.1 million (2004 £86.1 million) against profits.

•• 16. FIXED ASSET INVESTMENTS

	Subsidiary undertakings £m	Own shares £m	Other investments £m	Total investments 2005 £m
<i>Group</i>				
At 1 April 2004	–	1.0	2.6	3.6
Prior year adjustment (note 13)	–	(1.0)	–	(1.0)
At 1 April 2004 (restated)	–	–	2.6	2.6
At 31 March 2005	–	–	2.6	2.6
<i>Company</i>				
At 1 April 2004	931.8	0.2	–	932.0
Prior year adjustment (note 13)	–	(0.2)	–	(0.2)
At 1 April 2004 (restated)	931.8	–	–	931.8
At 31 March 2005	931.8	–	–	931.8

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

Details of principal subsidiary, joint venture and associated undertakings of the Group are set out in note 32.

The Group's share of the turnover of £4.5 million (2004 £4.2 million) and net liabilities of £0.3 million (2004 £0.4 million) of the joint venture is not considered material for disclosure on the face of the Group Profit and Loss Account and Balance Sheet.

•• 17. STOCKS

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Raw materials and consumables	4.6	4.1	–	–
Work in progress	0.1	0.4	–	–
	4.7	4.5	–	–

NOTES TO THE FINANCIAL STATEMENTS

•• 18. DEBTORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Amounts owed by subsidiary undertakings	-	-	238.4	229.4
Amounts owed by joint venture	0.2	-	-	-
Other debtors	1.1	1.1	1.1	1.0
Prepayments for pension costs	-	3.9	-	0.2
Deferred tax (note 24)	-	-	0.1	0.2
	1.3	5.0	239.6	230.8

•• 19. DEBTORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Trade debtors	63.9	61.5	-	-
Amounts owed by subsidiary undertakings	-	-	32.6	24.5
Amounts owed by joint venture	1.1	1.4	-	-
Other debtors	10.1	5.6	0.1	1.0
Prepayments for pension costs	-	0.7	0.2	0.3
Other prepayments and accrued income	24.5	23.1	-	-
	99.6	92.3	32.9	25.8

•• 20. CURRENT ASSET INVESTMENTS

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Listed investments	-	4.2	-	-
Other investments:				
Overnight deposits	49.8	13.5	29.4	-
Other	248.6	236.0	28.1	-
	298.4	249.5	57.5	-
	298.4	253.7	57.5	-

At 31 March 2005 the market value of listed investments was nil (2004 £4.2 million).

Other investments include deposits of £177.1 million (2004 £173.6 million) made to counter-indemnify letters of credit by financial institutions to lessors in order to secure rental obligations (note 29). The Group's access to these funds is restricted during the period of the counter-indemnity.

NOTES TO THE FINANCIAL STATEMENTS

•• 21. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Loans:				
Bank loans and overdrafts	5.1	7.0	1.6	7.3
Short-term loans	0.1	53.0	–	53.0
European Investment Bank loans	14.7	14.5	–	–
Unsecured loan stock notes	5.6	12.2	5.6	12.2
	25.5	86.7	7.2	72.5
Obligations under finance leases	29.3	20.3	–	–
Trade creditors	61.2	53.4	0.1	0.8
Amounts owed to subsidiary undertakings	–	–	288.7	342.9
Amounts owed to joint venture	0.4	0.5	–	–
Other creditors	15.9	21.1	6.4	5.2
Corporation tax	23.6	15.7	–	–
Other taxation and social security	19.2	17.0	0.2	0.3
Accruals and deferred income	40.7	27.8	0.4	3.3
Interim dividend	17.7	16.4	17.7	16.4
Proposed final dividend	37.4	34.7	37.4	34.7
	270.9	293.6	358.1	476.1

•• 22. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Loans:				
Sterling bond (repayable February 2012)	150.0	150.0	150.0	150.0
European Investment Bank loans	166.4	181.1	–	–
Other bank loans	255.3	160.4	134.9	–
	571.7	491.5	284.9	150.0
Obligations under finance leases	795.1	743.3	–	–
Amounts owed to subsidiary undertakings	–	–	8.7	8.7
Other creditors	–	0.1	–	–
	1,366.8	1,234.9	293.6	158.7

•• 23. 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 £8.0 million (2004 £7.8 million) and sold services to Echo South West Limited at a value of £2.5 million (2004 £2.5 million). Amounts owed by and to joint venture undertakings are disclosed in notes 18, 19 and 21. These amounts relate to trading balances except for loans of £0.2 million included in debtors falling due after more than one year, note 18 (2004 £0.1 million included in debtors falling due within one year, note 19).

NOTES TO THE FINANCIAL STATEMENTS

•• 24. PROVISIONS FOR LIABILITIES AND CHARGES

	Deferred tax £m	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Group Total 2005 £m	Company Restructuring 2005 £m
At 1 April 2004	63.3	28.0	0.4	2.3	94.0	0.1
Arising on acquisitions	(1.7)	7.0	–	–	5.3	–
Charged against/(released) to profits	10.8	2.4	3.7	(1.0)	15.9	(0.1)
Utilised during year	–	(3.9)	(1.5)	(1.1)	(6.5)	–
At 31 March 2005	72.4	33.5	2.6	0.2	108.7	–

Environmental and landfill restoration provisions will be utilised over the period from 2006 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 provision principally relates to severance costs which are expected to be incurred by September 2006.

Deferred taxation

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Accelerated capital allowances	293.4	275.4	–	–
Other timing differences	(7.5)	(6.2)	(0.1)	(0.2)
Undiscounted provision/(asset) for deferred tax	285.9	269.2	(0.1)	(0.2)
Discount	(213.5)	(205.9)	–	–
Discounted provision/(asset) for deferred tax	72.4	63.3	(0.1)	(0.2)
Provision at 1 April 2004	63.3		(0.2)	
Arising on acquisitions	(1.7)		–	
Deferred tax charge in profit and loss account for year	10.8		0.1	
Provision/(asset) at 31 March 2005	72.4		(0.1)	

The Company deferred tax asset is included within debtors falling due after more than one year (note 18).

NOTES TO THE FINANCIAL STATEMENTS

•• 25. DEFERRED INCOME

	Forward interest rate swaps (note 30) £m	Grants and contributions £m	Group Total 2005 £m	Forward interest rate swaps (note 30) £m	Grants and contributions £m	Group Total 2004 £m
At 1 April 2004:						
Amount to be released:						
After more than one year	18.2	20.5	38.7	18.2	21.2	39.4
Within one year	–	1.3	1.3	–	1.3	1.3
	18.2	21.8	40.0	18.2	22.5	40.7
(Settlements)/additions	(3.4)	4.1	0.7	–	0.5	0.5
Released to profits	–	(1.3)	(1.3)	–	(1.2)	(1.2)
At 31 March 2005:	14.8	24.6	39.4	18.2	21.8	40.0
Amount to be released:						
Within one year	–	(1.6)	(1.6)	–	(1.3)	(1.3)
After more than one year	14.8	23.0	37.8	18.2	20.5	38.7

•• 26. CALLED-UP SHARE CAPITAL

	2005 £m	2004 £m
Authorised		
157,657,600 Ordinary shares of £1.11 each	175.0	175.0
Allotted, called-up and fully paid		
127,944,340 Ordinary shares of £1.11 each (2004 124,284,779)	142.0	137.9
	2005 number	2004 number
Ordinary shares allotted during the year		
In lieu of £22.8 million cash (2004 £1.3 million) under scrip dividend alternative	3,151,305	202,015
For consideration of £0.8 million under the Company's Sharesave Scheme (2004 £2.1 million)	163,276	453,391
Own shares issued in respect of share options granted	344,980	–
	3,659,561	655,406

NOTES TO THE FINANCIAL STATEMENTS

•• 26. 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	
			2005	2004
Sharesave	8 July 1997 556p	2000 – 2004	–	52
	7 July 1998 775p	2001 – 2005	8	9
	6 July 1999 825p	2002 – 2006	6	22
	5 July 2000 461p	2003 – 2007	258	262
	4 July 2001 489p	2004 – 2008	63	172
	9 July 2002 566p	2005 – 2009	198	215
	8 July 2003 530p	2006 – 2010	441	476
6 July 2004 601p	2007 – 2011	308	–	
Executive	6 Jan 1995 503p	1998 – 2005	–	6
			1,282	1,214

At 31 March 2005 there were 1,133 participants in the Sharesave Scheme (2004 1,084) and none in the Executive Scheme (2004 one).

Options granted to Directors, included above, are shown in the Directors' remuneration report on pages 38 to 44.

•• 27. RESERVES

	Group and Company share premium account £m	Profit and loss account	
		Group Restated (note 13) £m	Company Restated (note 13) £m
At 1 April 2004	154.2	608.5	261.8
Prior year adjustment (note 13)	–	(1.0)	(0.2)
At 1 April 2004 (restated)	154.2	607.5	261.6
Retained surplus for year	–	13.7	30.6
Adjustment for shares issued under the scrip dividend alternative	(3.5)	22.8	22.8
Purchase of own shares	–	–	–
Own shares issued to the Pennon Employee Share Trust in respect of share options granted	–	(2.8)	(0.8)
Adjustment for shares issued in respect of the Incentive Bonus Plan – deferred shares	–	0.5	0.2
Adjustment in respect of employee share schemes	–	0.9	0.2
Premium on shares issued under the Sharesave Scheme	3.0	–	–
Goodwill arising on previously acquired business (note 31)	–	(0.2)	–
At 31 March 2005	153.7	642.4	314.6

The cumulative value of goodwill at 31 March 2005 resulting from acquisitions, which has been written-off to reserves, is £126.8 million (2004 £126.6 million).

•• 27. RESERVES continued

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, are dependent upon performance conditions being met. Shares are also held as part of an 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. Shares held by the discretionary trust, which is controlled by the Company, are deducted at cost in arriving at shareholders' funds. The cost of an award is recognised in the profit and loss account as employment costs on a straight-line basis over the period to which the performance criteria relate and is based on an assessment of the expectation of the extent that those performance criteria will be met. This is a change of accounting policy and the prior year adjustment is set out in note 13. More information on the operation of the incentive plans is included in the Directors' remuneration report on pages 38 to 44.

During the year, 345,000 of the Company's ordinary shares were issued to the trustees of the Employee Share Ownership Plan, financed through non-interest bearing advances made by sponsoring Group companies (2004 nil). During 2004, 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.

The market value of the 690,000 ordinary shares (2004 531,000) held by the trust at 31 March 2005 was £6.7 million (2004 £3.7 million). 200,000 of those shares (2004 153,000) held for the Company had a market value of £1.9 million at 31 March 2005 (2004 £1.1 million).

The Group and the Company have taken advantage of the exemption provided in Urgent Issues Task Force Abstract 17 (revised 2003) 'Employee Share Schemes' not to recognise a cost arising from the award of discounted Company shares to employees under the Sharesave Scheme.

•• 28. STATEMENT OF MOVEMENTS IN SHAREHOLDERS' FUNDS

	Group		Company	
	2005 £m	2004 Restated (note 13) £m	2005 £m	2004 Restated (note 13) £m
Profit on ordinary activities after taxation	68.8	61.5	85.7	74.6
Dividends	(55.1)	(51.1)	(55.1)	(51.1)
	13.7	10.4	30.6	23.5
Adjustment for shares issued under the scrip dividend alternative	22.8	1.3	22.8	1.3
Shares issued for cash consideration	0.8	2.1	2.8	2.1
Purchase of own shares	-	(0.6)	-	(0.2)
Disposal of own shares	-	-	-	0.1
Adjustment for shares issued in respect of the Incentive Bonus Plan – deferred shares	0.5	-	0.2	-
Adjustment in respect of employee share schemes	0.9	0.9	0.2	0.5
Goodwill arising on previously acquired business (note 31)	(0.2)	(3.3)	-	-
Shareholders' funds (equity interest):				
Addition for year	38.5	10.8	56.6	27.3
At 1 April				
As previously reported	900.6	890.1	553.9	527.0
Prior year adjustment (note 13)	(1.0)	(1.3)	(0.2)	(0.6)
At 1 April (restated)	899.6	888.8	553.7	526.4
At 31 March	938.1	899.6	610.3	553.7

The restatement of Group shareholders' funds at 1 April 2003 is £1.3 million (Company £0.6 million). No restatement of the profit for the year 2003 was required (Company nil).

NOTES TO THE FINANCIAL STATEMENTS

•• 29. LOANS AND OTHER BORROWINGS

Loans

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Repayable:				
Over five years	267.7	281.9	150.0	150.0
Over two and up to five years	239.7	194.8	114.9	–
Over one and up to two years	64.3	14.8	20.0	–
Falling due after more than one year (note 22)	571.7	491.5	284.9	150.0
Falling due within one year (note 21)	25.5	86.7	7.2	72.5
	597.2	578.2	292.1	222.5

£1.1 million floating rate unsecured loan stock notes were issued in the year. £0.9 million, repayable at par in 2006 or on notice being given by the noteholder, was to satisfy consideration payable in connection with the November 2004 acquisition of Mac-Glass Recycling Limited (note 31) and £0.2 million, repayable at par in 2009 or on notice being given by the noteholders, was to satisfy contingent consideration payable in connection with the December 1997 acquisition of Terry Adams Limited (note 31).

Obligations under finance leases

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Repayable:				
Over five years	709.2	663.5	–	–
Over two and up to five years	58.2	55.6	–	–
Over one and up to two years	27.7	24.2	–	–
Falling due after more than one year (note 22)	795.1	743.3	–	–
Falling due within one year (note 21)	29.3	20.3	–	–
	824.4	763.6	–	–

Included above are accrued finance charges arising on obligations under finance leases totalling £104.6 million (2004 £96.0 million), of which £22.7 million (2004 £15.6 million) is repayable within one year.

•• 29. LOANS AND OTHER BORROWINGS continued

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	
	2005 £m	2004 £m	2005 £m	2004 £m
Loans	310.0	310.0	150.0	150.0
Obligations under finance leases	824.4	763.6	–	–
	1,134.4	1,073.6	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 3.7% and 10.6% (2004 3.4% and 10.6%) and are repayable over the period 2006 to 2035.

Within obligations under finance leases South West Water Limited has:

- (a) utilised finance lease facilities of £180.0 million at 31 March 2005 (2004 £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 2005 (2004 £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.

Borrowing facilities

Undrawn committed borrowing facilities of £240.0 million were available to the Group at 31 March 2005 which expire as follows:

	2005 £m	2004 £m
Between one and two years	20.0	–
Over two years	220.0	80.0
	240.0	80.0

In addition, the Group has short-term uncommitted bank facilities of £115.0 million.

NOTES TO THE FINANCIAL STATEMENTS

•• 30. FINANCIAL INSTRUMENTS

Disclosures on financial and treasury policies are also included in the Corporate governance and internal control section on pages 45 to 47.

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	
	2005 £m	2004 £m	2005 £m	2004 £m
Floating rate	302.1	262.6	(650.6)	(668.5)
Fixed rate	2.1	6.1	(771.0)	(673.3)
On which no interest is paid	2.5	2.7	(0.2)	(19.6)
	306.7	271.4	(1,421.8)	(1,361.4)
Which is included in:				
Net debt	302.8	267.7	(1,421.6)	(1,341.8)
Provisions for liabilities and charges	–	–	(0.2)	(1.3)
Deferred income	–	–	–	(18.2)
Other long-term monetary assets/(liabilities)	3.9	3.7	–	(0.1)
	306.7	271.4	(1,421.8)	(1,361.4)
Fixed rate financial assets and liabilities:				
Weighted average interest rate	6.8%	6.1%	6.4%	6.5%
Weighted average period for which rate is fixed	3.6 years	2.6 years	4.0 years	2.8 years
Range of interest rates	3.5% to 8.0%	4.2% to 8.0%	4.0% to 11.3%	4.3% to 11.3%
Financial assets and liabilities on which no interest is paid:				
Weighted average period until maturity	–	–	1.0 years	14.2 years

All financial assets and liabilities are denominated in sterling.

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 2005 was 3.7% to 5.7% (2004 3.4% to 5.0%).

The maturity profile of floating rate and fixed rate financial liabilities is shown in note 29. Other financial liabilities fall due for payment principally after five years.

•• 30. FINANCIAL INSTRUMENTS continued

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 2005 69% of net debt was at fixed rate (2004 62%);

at 31 March 2005 interest rate swaps to hedge financial liabilities with a notional principal value of £365.0 million existed, with a weighted average maturity of 2.4 years (2004 £490.0 million, with 1.3 years) to swap from floating to fixed rate.

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. A settlement of £18.2 million, which was received when these swaps were entered into during December 1999, was deferred (note 25). In May 2004 these interest rate swaps were terminated through the payment of £3.4 million. The net balance of £14.8 million received remains deferred and will be matched with interest charges on the underlying hedged debt over the period of the original 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.

The fair values of the Group's financial assets and liabilities are as follows:

	2005		2004	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Financial assets:				
Current asset investments	298.4	298.4	253.7	253.8
Cash at bank	4.4	4.4	14.0	14.0
Other	3.9	4.0	3.7	3.8
	306.7	306.8	271.4	271.6
Financial liabilities:				
Short-term debt	(54.8)	(54.4)	(107.0)	(107.4)
Long-term debt	(1,366.8)	(1,363.8)	(1,234.8)	(1,226.3)
Other	(0.2)	(0.2)	(1.4)	(1.4)
	(1,421.8)	(1,418.4)	(1,343.2)	(1,335.1)
Derivative financial instruments				
(used to manage interest rate profile):				
Interest rate swaps	-	(0.9)	(18.2)	(6.1)

NOTES TO THE FINANCIAL STATEMENTS

•• 30. FINANCIAL INSTRUMENTS continued

Market values, where available, have been used to determine fair values. The fair values of floating rate loans and obligations under finance leases have been estimated by discounting cash flows at prevailing interest rates. Other floating rate liabilities, floating rate current asset investments and cash at bank are assumed to have a fair value equal to book value.

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	2005 Total net gains £m	Gains £m	Losses £m	2004 Total net gains £m
Unrecognised gains and losses on hedges:						
At 1 April	13.7	(1.6)	12.1	12.4	(10.8)	1.6
Of which recognised in current year	1.0	(1.4)	(0.4)	0.4	(5.8)	(5.4)
	12.7	(0.2)	12.5	12.0	(5.0)	7.0
Arising in previous years on swaps terminated in current year	(12.3)	–	(12.3)	–	–	–
Arising and not recognised in current year	0.2	(1.3)	(1.1)	1.7	3.4	5.1
At 31 March	0.6	(1.5)	(0.9)	13.7	(1.6)	12.1
Expected to be recognised:						
In next year	0.6	(0.4)	0.2	1.0	(1.4)	(0.4)
Thereafter	–	(1.1)	(1.1)	12.7	(0.2)	12.5
	0.6	(1.5)	(0.9)	13.7	(1.6)	12.1

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

•• 31. ACQUISITIONS

On 5 April 2004, the entire issued share capital of Thames Waste Management Limited, (now renamed Viridor Waste (Thames) Limited), was purchased by Viridor Waste Management Limited for a cash consideration of £30.8 million, including costs of £0.3 million. The acquisition was accounted for using the acquisition method and goodwill arising on the acquisition, amounting to £18.0 million, has been capitalised and will be amortised evenly over the Directors' estimate of useful economic life, which is 20 years.

The profit after tax of Thames Waste Management Limited amounted to £0.4 million for the period from 1 January 2004 to 4 April 2004. Profit after tax for the year ended 31 December 2003 was £3.7 million.

The operating assets and liabilities of the acquisition were:

	Book value £m	Accounting policy harmonisation £m	Revaluation adjustment £m	Other adjustments £m	Fair value to the Group £m
Tangible fixed assets	16.7	(3.7)	5.4	–	18.4
Debtors: amounts falling due after more than one year	1.7	–	–	–	1.7
Debtors: amounts falling due within one year	6.4	–	–	–	6.4
Cash at bank	2.2	–	–	–	2.2
Creditors: amounts falling due within one year	(8.4)	–	–	(0.5)	(8.9)
Provisions for liabilities and charges	(8.2)	1.2	–	–	(7.0)
	10.4	(2.5)	5.4	(0.5)	12.8

Accounting policy harmonisation in respect of tangible fixed assets related to a change from the accounting policy of Thames Waste Management Limited which recognised the full cost of aftercare of landfill sites as an asset within tangible fixed assets matched by an equivalent liability. The policy of the Group is to recognise a provision for aftercare by taking account of the usage of void space. The other accounting policy harmonisation for provisions for liabilities and charges related to the recognition of environmental and licence obligations. The revaluation adjustment recognises the value to the Group of the landfill acquired, based on projected discounted cash flows. Other adjustments include additional creditors for taxation following a reassessment of the taxation affairs of the company for pre-acquisition periods.

On 19 November 2004, the entire issued share capital of Mac-Glass Recycling Limited was purchased by Viridor Waste Management Limited through the issue of loan notes by Pennon Group Plc of £0.9 million (note 29). The acquisition was accounted for using the acquisition method and provisional goodwill arising on the acquisition, amounting to £0.9 million, has been capitalised and will be amortised evenly over the Directors' estimate of useful economic life, which is 20 years.

The profit after tax of Mac-Glass Recycling Limited amounted to £0.1 million for the period from 1 December 2003 to 18 November 2004. The company incurred a loss of £0.1 million for the year ended 30 November 2003.

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 2004, £10.7 million remained as contingently payable. During the year, £0.2 million of that contingent consideration was settled through the issue of loan stock notes (note 29) and goodwill arising amounting to £0.2 million has been written-off to reserves. At 31 March 2005, £6.9 million remained as contingently payable.

During the year, £3.0 million fair value acquisition accruals and provisions were established (2004 £1.2 million), £1.5 million were utilised (2004 £0.7 million), £1.4 million were released (2004 £1.4 million) and at 31 March 2005 £12.9 million (2004 £12.8 million) were carried forward.

NOTES TO THE FINANCIAL STATEMENTS

•• 32. 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
Viridor Waste Exeter Limited	England
Dragon Waste Limited	England
Viridor Waste Hampshire Limited	England
Viridor Waste Management Limited	England
Mac-Glass Recycling Limited	Scotland
Viridor EnviroScot Limited	Scotland
Viridor Parkwood Holdings Limited	British Virgin Islands [†]
Parkwood Group Limited	England
Viridor Glass Recycling Limited	England
Viridor Waste (Bristol Holdings) Limited	England
Viridor Waste (Bristol) Limited	England
Viridor Waste (Thames) 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. [†] 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 Exeter 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.

•• 33. 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 1 April 2004. At that date, the market value of the scheme's assets was £196.4 million and this covered 77% 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, the rates of increase in earnings and pensions, current life expectancy of pensioners and future improvements in life expectancy. The valuation assumes that the investment return would be 6.7% per annum before retirement and 5.5% per annum after retirement, pensionable pay increases would average 3.7% per annum and that present and future pensions would both increase at a rate of 2.7% 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 (2004 11.5%). The pension charge for the year ended 31 March 2005 for the main scheme was £12.3 million (2004 £5.6 million) reflecting the recovery of the pension deficit identified in the 1 April 2004 actuarial valuation over the average remaining service lives of employees in the scheme.

Accrued pension costs included as creditors of the Group amount to £4.0 million (2004 prepayment £4.6 million), representing the accumulated difference between the Group pension charge 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 until 2005/06. Under transitional arrangements applying to FRS 17, certain additional disclosures are still required and these are given below.

The full actuarial valuation at 1 April 2004 was updated at 31 March 2005 by the independent qualified actuary using the projected unit method, as required by FRS 17. The value of the schemes' assets has been updated to market value as at 31 March 2005. The demographic assumptions used in calculating the scheme liabilities under FRS 17 remain unchanged from those used in the 1 April 2004 actuarial valuation. The financial assumptions at each year end under FRS 17 were as follows:

	2005	2004	2003
	%	%	%
Rate of increase in pensionable pay	3.7	3.7	3.5
Rate of increase for present and future pensions	2.7	2.7	2.5
Rate used to discount scheme liabilities	5.5	5.5	5.5
Inflation	2.7	2.7	2.5

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

	2005		2004		2003	
	Return %	Value £m	Return %	Value £m	Return %	Value £m
Equities	7.8	172.3	7.7	154.6	7.0	119.0
Bonds	4.8	42.7	4.7	38.2	4.5	31.9
Other	4.8	9.1	4.3	8.4	3.5	8.4
Total market value of assets		224.1		201.2		159.3
Present value of schemes' liabilities		(303.6)		(278.4)		(244.2)
Deficit in schemes		(79.5)		(77.2)		(84.9)
Related deferred tax asset		23.8		23.2		25.5
Net pension liabilities		(55.7)		(54.0)		(59.4)

NOTES TO THE FINANCIAL STATEMENTS

•• 33. 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:

	2005 £m	2004 Restated (note 13) £m
Net assets including prepayments for pension costs and excluding net pension liabilities	938.1	899.6
Prepayments for pension costs	–	(4.6)
Creditor for pension costs	4.0	–
Net pension liabilities	(55.7)	(54.0)
Net assets including net pension liabilities	886.4	841.0
Profit and loss account reserve including prepayments for pension costs and excluding net pension liabilities	642.4	607.5
Prepayments for pension costs	–	(4.6)
Creditor for pension costs	4.0	–
Net pension liabilities	(55.7)	(54.0)
Profit and loss account including net pension liabilities	590.7	548.9

The following amounts would have been recognised in the financial statements for the year ended 31 March 2005:

	2005 £m	2004 £m
Operating profit		
Current service cost	8.3	6.3
Past service cost	0.6	0.2
Total operating charge	8.9	6.5
Other finance income		
Expected return on pension schemes' assets	14.0	10.0
Interest on pension schemes' liabilities	(15.3)	(13.4)
Net cost	(1.3)	(3.4)
Statement of total recognised gains and losses (STRGL)		
Actual return less expected return on pension schemes' assets	9.8	33.1
Experience (losses) and gains arising on schemes' liabilities	(7.9)	4.3
Changes in assumptions underlying the present value of schemes' liabilities	–	(25.1)
Actuarial gain to be recognised in STRGL	1.9	12.3

•• 33. PENSIONS continued

Movement in deficit in scheme during the year

	2005 £m	2004 £m
Deficit at 1 April	(77.2)	(84.9)
Movement in year:		
Current service cost	(8.3)	(6.3)
Contributions	6.0	5.3
Past service cost	(0.6)	(0.2)
Other finance income	(1.3)	(3.4)
Actuarial gain	1.9	12.3
Deficit at 31 March	(79.5)	(77.2)

History of experience gains and losses

	2005	2004	2003
Difference between the expected and actual return in schemes' assets:			
Amount (£m)	9.8	33.1	(61.0)
Percentage of schemes' assets	4.4%	16.5%	(38.3)%
Experience gains and losses on schemes' liabilities:			
Amount (£m)	(7.9)	4.3	(1.4)
Percentage of the present value of schemes' liabilities	(2.6)%	1.5%	(0.6)%
Total amount recognised in statement of total recognised gains and losses:			
Amount (£m)	1.9	12.3	(75.0)
Percentage of the present value of schemes' liabilities	0.6%	4.4%	(30.7)%

NOTES TO THE FINANCIAL STATEMENTS

•• 34. COMMITMENTS AND CONTINGENT LIABILITIES

	Group		Company	
	2005 £m	2004 £m	2005 £m	2004 £m
Capital commitments				
Contracted but not provided	46.1	56.3	-	-
Commitments under operating leases				
Rentals during the year following the balance sheet date:				
Land and buildings leases expiring:				
Within one year	0.2	0.1	-	-
Between one and five years	0.5	0.3	-	-
After five years	2.2	3.4	-	-
Other leases expiring:				
Within one year	0.2	0.1	-	-
Between one and five years	0.5	0.4	-	-
	3.6	4.3	-	-
Contingent liabilities				
Contractors' claims on capital schemes	-	0.3	-	-
Guarantees	60.2	41.5	623.8	594.4
Other	6.9	10.8	6.9	10.8
	67.1	52.6	630.7	605.2

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.

•• 35. NOTES TO THE GROUP CASH FLOW STATEMENT

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

	2005 £m	2004 Restated (note 13) £m
Group operating profit	143.1	129.8
Depreciation charge	95.1	86.1
Amortisation of intangible fixed assets	3.5	2.5
Deferred income released to profits	(1.3)	(1.2)
Decrease in provisions for liabilities and charges	(2.4)	(2.0)
Increase in stocks	(0.2)	(0.5)
Decrease/(increase) in debtors (amounts falling due within and over one year)	7.9	(4.2)
Increase in creditors (amounts falling due within and over one year)	10.1	5.4
Profit on disposal of tangible fixed assets	(1.4)	(1.7)
Other non-cash changes	0.9	0.9
Net cash inflow from operating activities	255.3	215.1

•• 35. 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	2005 £m	2004 £m
Interest received	12.8	9.4
Interest paid	(42.8)	(31.9)
Interest element of finance lease rentals	(25.7)	(18.8)
Forward interest rate swap settlements (note 30)	(3.4)	–
Net cash outflow for returns on investments and servicing of finance	(59.1)	(41.3)

ii Capital expenditure and financial investment	2005 £m	2004 Restated (note 13) £m
Purchase of intangible fixed assets	(0.2)	–
Purchase of tangible fixed assets	(183.0)	(181.9)
Grants and contributions:		
Infrastructure assets	2.8	1.4
Non-infrastructure assets	3.4	1.0
Receipts from disposal of tangible fixed assets	2.3	2.9
Other investment	–	(2.0)
Net cash outflow for capital expenditure and financial investment	(174.7)	(178.6)

iii Acquisitions	2005 £m	2004 £m
Purchase of businesses	(30.8)	(19.8)
Net cash/(overdrafts) acquired with businesses	2.2	(0.2)
Net cash outflow for acquisitions	(28.6)	(20.0)

iv Management of liquid resources	2005 £m	2004 £m
Purchase of current asset investments	(336.5)	(342.8)
Sale of current asset investments	328.4	280.7
Net cash outflow from management of liquid resources	(8.1)	(62.1)

NOTES TO THE FINANCIAL STATEMENTS

•• 35. NOTES TO THE GROUP CASH FLOW STATEMENT continued

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

Financing	2005 £m	2004 Restated (note 13) £m
Issue of ordinary share capital	0.8	2.1
Purchase of own shares	-	(0.6)
Reduction in debt due within one year (other than bank overdrafts)	(75.2)	(16.7)
Increase in debt due after more than one year	95.0	140.0
Finance lease drawdowns	57.3	36.4
Capital element of finance lease rental payments	(5.4)	(5.5)
	71.7	154.2
Net cash inflow from financing	72.5	155.7

(c) Analysis of net debt

	At 1 April 2004 £m	Cash flow £m	Acquisitions (excluding cash items) £m	Non-cash movements £m	At 31 March 2005 £m
Cash at bank and in hand	14.0	(9.6)	-	-	4.4
Current asset investments:					
Overnight deposits	13.5	36.3	-	-	49.8
Bank overdrafts	(7.0)	1.9	-	-	(5.1)
	20.5	28.6	-	-	49.1
Debt due within one year (other than bank overdrafts)	(79.7)	75.2	(1.1)	(14.8)	(20.4)
Debt due after more than one year	(491.5)	(95.0)	-	14.8	(571.7)
Finance lease obligations	(763.6)	(51.9)	(0.3)	(8.6)	(824.4)
	(1,334.8)	(71.7)	(1.4)	(8.6)	(1,416.5)
Current asset investments:					
Other than overnight deposits	240.2	8.1	-	0.3	248.6
	(1,074.1)	(35.0)	(1.4)	(8.3)	(1,118.8)

Non-cash movements include transfers between categories of debt for changing maturities, increased accrued finance charges within finance lease obligations and increased accrued interest on unlisted investments.

•• 35. NOTES TO THE GROUP CASH FLOW STATEMENT continued

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

	2005 £m	2004 £m
Increase in cash in year	28.6	21.7
Cash inflow from increase in debt and finance leasing	(71.7)	(154.2)
Cash outflow from increase in liquid resources	8.1	62.1
Increase in net debt arising from cash flows	(35.0)	(70.4)
Acquisition (excluding cash items):		
Loan stock notes issued as consideration for business acquired	(1.1)	(3.7)
Loans acquired with business purchase	-	(0.5)
Finance lease obligations acquired with business purchase	(0.3)	(2.8)
Non-cash movements:		
Loan stock notes issued in settlement of accrued consideration	-	(0.1)
Increase in accrued finance charges on finance lease obligations	(8.6)	(8.0)
Increase in accrued interest on unlisted investments	0.3	-
Increase in net debt in the year	(44.7)	(85.5)
Net debt at 1 April	(1,074.1)	(988.6)
Net debt at 31 March	(1,118.8)	(1,074.1)

(e) Purchase of businesses

	2005 £m	2004 £m
Net assets acquired:		
Tangible fixed assets	18.8	14.4
Debtors: amounts falling due after more than one year	1.7	-
Debtors: amounts falling due within one year	6.5	4.1
Cash at bank and in hand	2.2	-
Bank overdrafts	-	(0.2)
Creditors: amounts falling due within one year	(9.3)	(7.5)
Creditors: amounts falling due after more than one year	(0.1)	(2.0)
Provisions for liabilities and charges	(7.0)	(1.1)
Fair value of net assets acquired	12.8	7.7
Goodwill	19.1	15.8
	31.9	23.5
Satisfied by:		
Cash consideration	30.8	19.8
Loan stock notes	1.1	3.7
	31.9	23.5

The businesses acquired during the year contributed £10.1 million to the Group's net cash inflow from operating activities, utilised £0.3 million in respect of taxation and £8.9 million for capital expenditure.

In 2004, the businesses acquired in that 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 investment and servicing of finance and £1.3 million for capital expenditure.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

•• OVERVIEW

The Group is required to adopt International Financial Reporting Standards (IFRS) for its 2005/06 financial year, with comparative figures restated according to IFRS.

The first published results under IFRS will therefore be the interim results for the six months ending 30 September 2005. The Group intends to present fuller information on the restatement of the 2004/05 financial accounts on an IFRS basis no later than the publication of these interim results.

The implementation of IFRS within the Group is a major on-going project. The principal changes between UK Generally Accepted Accounting Principles (UK GAAP) and IFRS have been identified, together with an estimate of their impact upon shareholders' equity and reported profits for 2004/05.

The adjustments set out below are presented for illustrative purposes only and represent the current best estimates of the impact of IFRS on the specific areas identified in this document, under the assumption that all existing standards in issue from the International Accounting Standards Board (IASB) will be fully

endorsed by the European Union (EU). The failure of the EU to endorse all of these standards for financial reporting in 2005, the issue of any new or revised standards, or the publishing of further interpretational guidance, could result in changes to the financial information presented in this document. These illustrative adjustments are also subject to the completion of the on-going IFRS project. All figures are unaudited.

Certain exemptions are allowed under IFRS 1 to assist companies with the transition process. The Group intends to prepare its balance sheets at 31 March 2004 and 2005 using the elections relating to:

- the bringing forward of historic goodwill balances without restatement to IFRS principles
- the adoption of IAS 32 and IAS 39 (accounting for and disclosure of financial instruments) with effect from 1 April 2005
- the recognition of the full IAS 19 pension deficit in the Group's balance sheet
- the valuation of water and sewerage infrastructure assets at fair value.

•• KEY CHANGES

The key changes from IFRS impacting the Group's financial statements are:

	UK GAAP	IFRS
Taxation – deferred tax	FRS 19	IAS 12
Pensions	FRS 17	IAS 19
Acquisition accounting and goodwill	FRS 7	IFRS 3
Fixed assets – infrastructure accounting	FRS 15	IAS 16
Dividends	Cos. Act/FRS 21	IAS 10

Summary

The assessment of the above specific key changes from the standards identified is estimated to result in a restatement of total shareholders' equity at 31 March 2004 from £900 million under existing UK GAAP to circa £670 million on an IFRS basis, primarily from reductions through the non-discounting of the existing deferred tax provision and the recognition of the net pension deficit.

Reported profit before taxation for 2004/05 is estimated to be unchanged from the above key factors between UK GAAP and IFRS and adjusted earnings per share, before deferred tax, also remain as reported. The non-discounting of the 2004/05 deferred tax charge reduces basic earnings per share by circa 6p, to 49p.

The reduction in net worth reflecting these key changes does not affect compliance with debt covenants since these are subject to either 'frozen UK GAAP' or specific 'carve-out' clauses.

The identified reduction in net worth affects Group consolidated reserves only and consequently will not impact individual entities' existing distributable reserves or the current policy to cover dividend payments from net profit for the reporting period.

•• INCOME STATEMENT

The assessment of the above specific key changes is estimated to result in a restatement of reported profit performance for 2004/05, before exceptional items, as:

	UK GAAP basis £m	IFRS basis £m
Earnings before interest, taxation, depreciation and amortisation	244	243
Group operating profit	148	149
Profit before taxation	87	87
Adjusted earnings per share (before deferred tax)	63p	63p
Basic earnings per share	55p	49p

The illustrative impact of these specific adjustments to Group operating profit on the Group's 2004/05 reported segmental performance is:

	UK GAAP basis £m	IFRS basis £m
Water and sewerage	122	121
Waste management	26	28
Other	—	—
	148	149

•• SHAREHOLDERS' EQUITY

The assessment of the above specific key changes is estimated to result in a restatement of shareholders' equity of:

	31 March 2004 £m	31 March 2005 £m
Reported under UK GAAP	900	938
Indicative restated to IFRS	c.670	c.710

•• ADJUSTMENTS

The expected principal differences between accounting under UK GAAP and IFRS specifically identified above may be summarised as:

Taxation

Under UK GAAP, the Group creates a discounted provision for deferred taxation, as allowed under FRS 19, to reflect an assessment of the period over which timing differences are expected to reverse.

Under IFRS (IAS 12) a discounting methodology is not permitted. Consequently the deferred tax provision increases and commensurately reduces shareholders' equity as indicated below:

	31 March 2004 £m	31 March 2005 £m
Discounted provision – UK GAAP	63	72
Undiscounted provision – IFRS	269	286
Increase in provision	206	214

INTERNATIONAL FINANCIAL REPORTING STANDARDS

•• ADJUSTMENTS continued

Taxation continued

Other significant deferred tax effects are estimated to arise from the recognition under IFRS of deferred tax on property revalued at the time of acquisitions by Viridor Waste, circa £16 million and the recognition of the pension deficit, as outlined below.

The non-discounting of deferred tax increases the charge against 2004/05 profits from £11 million to £18 million.

The significant on-going level of capital expenditure projected for the Group's operations means that actual payment of tax is expected to continue to be deferred through the creation of further timing differences.

Pensions

Under UK GAAP (SSAP 24) the pensions charge is established by reference to the triennial valuation of the Group's pension schemes and is set at a level amount to recognise both the on-going service cost and the spreading of any actuarial surplus or deficit.

Under IFRS (IAS 19) only the on-going service cost is charged against operating profit. A net financing cost or credit to reflect expected changes in liabilities and investment return is included within interest payable or receivable. An annual update of the valuation of scheme assets and liabilities results in a movement in the total pension surplus or deficit which is recognised in the IFRS Statement Of Recognised Income and Expenditure (SORIE).

The gross pension deficit, circa £80 million at 31 March 2005, is shown as a balance sheet liability, with the related deferred tax asset, circa £24 million, within the net deferred tax balance.

The recognition of the pension deficit, net of deferred tax, reduces shareholders' equity by circa £59 million at 31 March 2004 and circa £51 million at 31 March 2005. Reported 2004/05 profit before tax increases by circa £4 million, principally due to the on-going service cost no longer containing an element of deficit recovery.

Acquisition accounting and goodwill

Under UK GAAP goodwill arising on acquisitions is amortised over its useful life, assessed by the Directors as being 20 years. No separately identifiable intangible assets are currently included in the fair values established for acquisitions.

Under IFRS (IFRS 3) a wider range of potential intangible assets arising on acquisition is required to be considered, identified and amortised according to the useful lives of the individual components. In addition, the amortisation of goodwill is not permitted but all goodwill balances are subject to an annual test for impairment by comparing the carrying values of assets to the discounted cash flows arising from the future use of those assets for identifiable cash generating units.

Shareholders' equity at 31 March 2004 is not affected since the Group is bringing-forward historic balances (as allowed under the exemption referred to above).

The 2004/05 reported operating profit is increased by net circa £2 million, comprising the elimination of goodwill amortisation, circa £3 million, partially offset by a charge for the amortisation of intangible assets acquired under the purchase of Thames Waste Management Limited, circa £1 million. No impairment charge is required in 2004/05 in relation to the goodwill balances recorded.

Fixed assets – infrastructure accounting

UK GAAP (FRS 15) permits 'renewals accounting' as a method for estimating depreciation on infrastructure assets which has been adopted by the UK water industry. The depreciation charge represents the level of annual expenditure required to maintain the operating capacity of the infrastructure network at a specified level of service potential by the continuing replacement and refurbishment of its components. South West Water uses an independently certified Asset Management Plan to determine the level of annual expenditure required.

IFRS does not permit the use of renewals accounting. Instead infrastructure assets are capitalised and depreciated over the estimated useful lives of major components.

Consequently, infrastructure assets in the opening balance sheet under IFRS have to be restated from their existing UK GAAP net book value. Under the first time adoption rules set out in IFRS 1, a fair value can be used as the deemed cost of the infrastructure assets where it is not possible to reconstruct a value for historic cost less depreciation on an IFRS compliant basis. This value is depreciated over the estimated remaining asset life.

Shareholders' equity at 31 March 2004 is not expected to be significantly affected since the opening fair value of infrastructure assets under IFRS in South West Water is currently estimated to be close to historic cost.

Reported operating profit for 2004/05 is estimated to be reduced by circa £4 million as a result of calculating specific depreciation compared to the previous normative long-term charge based upon the 1999 Periodic Review Asset Management Plan.

The revised estimated total infrastructure depreciation cost of circa £19 million for 2004/05 is circa £2 million below the level of the infrastructure renewals charge assumed by Ofwat in the Final Determination for 2005/06.

Dividends

Under UK GAAP (prior to the introduction of FRS 21 with effect from the 2005/06 financial year) dividends payable are recognised in the profit and loss account for the period to which they relate.

Under IFRS (IAS 10) if dividends are declared after the balance sheet date, the dividends are not recognised as a liability at the balance sheet date. In addition, given that interim dividends are approved only by resolution of the Board, and are thus revocable and discretionary, such interim dividends should only be recognised when paid. Dividends on equity instruments are therefore recognised as liabilities under IFRS as follows:

- Final dividends – when authorised in general meeting by shareholders.
- Interim dividends – when paid.

Shareholders' equity is consequently increased at the balance sheet date, by circa £51 million at 31 March 2004, and circa £55 million at 31 March 2005 as a result of adding-back, for each of the 2003/04 and 2004/05 financial years, the final dividend not authorised until after the year end and the interim dividend not paid until after the year end.

•• PROFIT AND LOSS ACCOUNT

	2005 £m	2004 £m	2003 £m	2002 £m	2001 £m
Turnover	554.2	471.3	417.2	423.9	435.1
Group operating profit	143.1	129.8	127.0	121.8	128.1
Share of operating profit/(loss) in joint venture and associate	0.1	(0.3)	(0.7)	(0.5)	(0.4)
Business disposal profit/(loss)	5.0	–	–	5.1	(2.1)
Net interest payable	(60.7)	(57.2)	(52.1)	(49.0)	(51.4)
Profit on ordinary activities before taxation	87.5	72.3	74.2	77.4	74.2
Tax on profit on ordinary activities	(18.7)	(10.8)	(17.1)	(3.3)	(17.6)
Profit on ordinary activities after taxation	68.8	61.5	57.1	74.1	56.6
Dividends	(55.1)	(51.1)	(144.3)	(51.4)	(49.4)
Retained surplus/(deficit) transferred to/(from) reserves	13.7	10.4	(87.2)	22.7	7.2
Earnings per share (basic):					
Before exceptional items and deferred tax	63.1p	57.7p	55.0p	53.0p	56.0p
Exceptional items	0.1p	(5.3)p	–	3.7p	(1.6)p
Deferred tax	(8.6)p	(2.6)p	(10.7)p	(2.4)p	(12.9)p
After exceptional items and deferred tax	54.6p	49.8p	44.3p	54.3p	41.5p
Dividend per share	43.0p	41.0p	109.1p	37.5p	36.0p

•• CAPITAL EXPENDITURE

	2005 £m	2004 £m	2003 £m	2002 £m	2001 £m
Acquisitions	30.8	19.8	41.8	12.1	0.9
Tangible fixed assets	188.4	170.0	204.6	186.4	166.5

•• BALANCE SHEET

	2005 £m	2004 £m	2003 £m	2002 £m	2001 £m
Fixed assets	2,313.9	2,191.3	2,084.6	1,920.5	1,824.3
Net current assets	137.5	75.9	17.5	100.8	101.5
Non-current liabilities	(1,513.3)	(1,367.6)	(1,213.3)	(1,047.3)	(1,018.7)
Net assets	938.1	899.6	888.8	974.0	907.1

•• NUMBER OF EMPLOYEES (average for year)

	2005	2004	2003	2002	2001
Water and sewerage business	1,336	1,341	1,343	1,485	1,537
Waste management	1,169	895	685	605	453
Instrumentation	–	–	–	421	495
Construction services	–	–	–	–	617
Other businesses	39	39	35	51	55
	2,544	2,275	2,063	2,562	3,157

The application of Urgent Issues Task Force Abstract 17 (revised 2003) 'Employee Share Schemes' and Abstract 38 'Accounting for ESOP Trusts' has resulted in a restatement of years 2001 to 2004.

NOTICE OF ANNUAL GENERAL MEETING

THE SIXTEENTH ANNUAL GENERAL MEETING OF PENNON GROUP PLC WILL BE HELD AT THE PLYMOUTH PAVILIONS, PLYMOUTH, DEVON ON THURSDAY 28 JULY 2005 AT 11.00am.

THESE PAGES ARE IMPORTANT AND REQUIRE YOUR IMMEDIATE ATTENTION.

If you are in any doubt about the action you should take, you should immediately consult your stockbroker, solicitor, accountant, bank manager or other independent financial adviser who is authorised under the Financial Services and Markets Act 2000.

If you have sold or otherwise transferred some or all of your ordinary shares, please send this Annual Report, together with the accompanying Form of Proxy, as soon as possible, to the purchaser or transferee or to the stockbroker, bank or other agent through whom the sale or transfer was effected, for delivery to the purchaser or transferee. The Form of Proxy, if used, should be lodged with the Company's Registrars, Lloyds TSB Registrars, not less than 48 hours before the time fixed for the meeting.

•• ANNUAL GENERAL MEETING

The sixteenth Annual General Meeting of Pennon Group Plc will be held at The Plymouth Pavilions, Millbay Road, Plymouth, Devon PL1 3LF on Thursday 28 July 2005 at 11.00 am for the transaction of the following business:

Resolution 1

To receive the Report of the Directors and the financial statements for the year ended 31 March 2005.

Resolution 2

To declare a final dividend, recommended by the Directors, for the year ended 31 March 2005.

Resolution 3

To propose the following as an ordinary resolution:

That the Directors' remuneration report for the financial year 2004/05, as contained in the Annual Report 2005, be approved.

Resolution 4

To re-elect Mr R J Baty as a Director.

Resolution 5

To re-elect Mr D J Dupont as a Director.

Resolution 6

To re-elect Ms K M H Mortimer as a Director.

Resolution 7

To propose the following as an ordinary resolution:

That PricewaterhouseCoopers LLP be reappointed auditors of the Company to hold office until the conclusion of the next Annual General Meeting at which accounts are laid before the Company.

Resolution 8

To propose the following as an ordinary resolution:

That the Directors be authorised to fix the remuneration of the auditors.

Resolution 9

To propose the following as an ordinary resolution:

That in accordance with Article 5 of the Company's Articles of Association, the Directors be authorised to allot relevant securities up to a maximum nominal amount of £32,802,000, that such authority shall expire on 27 October 2006 or, if earlier, at the conclusion of the next Annual General Meeting of the Company.

Resolution 10

To propose the following as a special resolution:

That in accordance with Article 6 of the Company's Articles of Association: (a) the Directors be given power to allot equity securities for cash; (b) that for the purpose of paragraph (A)(ii) of that Article, the nominal amount to which this power is limited is £7,109,000; and (c) this power shall expire on 27 October 2006 or, if earlier, at the conclusion of the next Annual General Meeting of the Company.

NOTICE OF ANNUAL GENERAL MEETING

Resolution 11

To propose the following as a special resolution:

That the Company is generally and unconditionally authorised to make market purchases (within the meaning of section 163 of the Companies Act 1985) of ordinary shares of £1.11 each in the capital of the Company ('ordinary shares') on such terms and in such manner as the Directors of the Company may from time to time determine provided that:

a the maximum number of ordinary shares that may be purchased under this authority is 12,810,000 (being no more than 10% of the issued share capital of the Company as at 15 June 2005);

b the maximum price which may be paid for an ordinary share purchased under this authority is an amount equal to 105% of the average of the middle market quotations for such ordinary shares (as appropriate), as derived from the London Stock Exchange Daily Official List for the five business days immediately preceding the day on which that share is purchased and the minimum price which may be paid is £1.11 per ordinary share (the nominal value of that share); and

c this authority will, unless previously varied, revoked or renewed, expire at the conclusion of the next Annual General Meeting of the Company but the Company may make a contract to purchase ordinary shares under this authority before its expiry which will or may be executed wholly or partly after the expiry of this authority and may make purchases of ordinary shares pursuant to such a contract.

Resolution 12

To propose the following as a special resolution:

That Article 102 of the Articles of Association of the Company be amended to deduct in determining the borrowings of the Company any sums held by the Company on deposit.

Resolution 13

To propose the following as a special resolution:

That the Articles of Association set out in the document produced to the meeting (which incorporate the amendment proposed in Resolution 12 relating to the borrowing powers of the Company and signed by the Chairman for purposes of identification) be adopted as the Articles of Association of the Company in substitution for, and to the exclusion of, all existing Articles of Association.

A brief description of the principal changes proposed are set out below. (The principal changes proposed are set out in more detail in the Explanatory Notes.)

a Treasury shares

To include a new definition of treasury shares in accordance with Section 162A of the Companies Act 1985.

b Share capital

To reflect the authorised share capital of the Company at the date of adoption of the new Articles of Association.

c Dis-application of pre-emption rights

To clarify that any dis-application of pre-emption rights will extend to the allotment of treasury shares for cash.

d Uncertificated shares

To facilitate the holding and transfer of shares in uncertificated form.

e Proceedings at general meetings

To ensure the orderly and secure running of shareholders' meetings.

f Number of Directors

The maximum number of Directors to be 12.

g Retirement of Directors

Any Director who has held office for three years or more to retire from office but be eligible for re-appointment.

h Removal of Directors

To add a provision to permit the removal of a Director by notice from his co-directors.

i Expenses

To permit a Director to have paid out of the funds of the Company all expenses incurred by him in obtaining professional advice in connection with the Company's affairs or his duties as a Director.

j Delegation to individual Directors

To give authority to the Board to delegate its powers to any Director.

k Directors' interests and voting

To provide updated provisions as to Directors' interests and voting and to give express ability to the Company to purchase Directors' and Officers' insurance.

l Issue of share certificates

To permit share certificates to be signed electronically.

m Power to differentiate

To permit the Board to differentiate between holders of shares.

n Calculation and currency of dividends

To permit dividends to be declared and paid in any currency.

o Indemnity

To provide that the Company may (rather than shall) indemnify a Director or other Officer (excluding an auditor) against liabilities incurred by him in connection with his duties, powers or office.

NOTICE OF ANNUAL GENERAL MEETING

Resolution 14

To propose the following as an ordinary resolution:

That in accordance with Section 347C of the Companies Act 1985 the Company and its subsidiaries be generally and unconditionally authorised to make donations to EU political organisations and to incur EU political expenditure in an aggregate amount not exceeding £100,000 during the period expiring 15 months after the date of the passing of this resolution, or if earlier at the conclusion of the next Annual General Meeting unless previously renewed, varied or revoked by the Company in general meeting. For the purposes of this resolution, the expressions 'donations', 'EU political organisations' and 'EU political expenditure' have the meanings set out in Part XA of the Companies Act 1985 (as amended by the Political Parties, Elections and Referendums Act 2000).

By Order of the Board

*K D WOODIER, Group General Counsel & Company Secretary
Peninsula House, Rydon Lane, Exeter EX2 7HR (Registered Office)
23 June 2005*

•• IMPORTANT NOTES

Pursuant to Regulation 41 of the Uncertificated Securities Regulations 2001, only those shareholders registered in the register of members as at 6.00 pm on 26 July 2005 will be entitled to attend or vote at the Annual General Meeting in respect of the number of shares registered in their name at that time. Changes to entries on the register after 6.00 pm on 26 July 2005 will be disregarded in determining the rights of any person to attend or vote at the meeting.

A person entitled to attend and vote at the meeting is entitled to appoint one or more proxies to attend and on a poll, vote instead of him or her. A proxy need not be a member of the Company.

To be valid, the Form of Proxy for use at the meeting and power of attorney or other authority, if any, under which it is signed or a notarially certified or office copy of such power or authority, must be deposited at the office of the Company's Registrars, Lloyds TSB Registrars, The Causeway, Worthing BN99 6UQ not less than 48 hours before the time fixed for the Annual General Meeting. Completion and return of the Form of Proxy will not prevent a shareholder from attending and voting at the Annual General Meeting instead of his or her proxy, if the shareholder so wishes.

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 Registrar, 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 communication facilities are available to all shareholders and those who use them will not be disadvantaged in any way.

Electronic proxy appointment through CREST

CREST members who wish to appoint a proxy or proxies through the CREST electronic proxy appointment service may do so for the Annual General Meeting and any adjournment(s) thereof by following the procedures described in the CREST Manual.

All messages relating to the appointment of a proxy or an instruction to a previously-appointed proxy, which are to be transmitted through CREST, must be received by Lloyds TSB Registrars (ID 7RA01) no later than 11.00am on 26 July 2005, or, if the Annual General Meeting is adjourned, close of business on the day two days prior to the day fixed for the adjourned Annual General Meeting.

Documents available for inspection

A copy of the proposed new Articles of Association and a copy of the existing Articles of Association of the Company will be available for inspection during normal business hours at the Registered Office of the Company and at Allen & Overy LLP, One New Change, London EC4M 9QQ up to and including 28 July 2005 and at the Annual General Meeting from 10.00 am on 28 July 2005 until the conclusion of the Annual General Meeting.

In addition, copies of the Executive Directors' service contracts, the Chairman's and the Non-executive Directors' contracts for service and the Register of Directors' Interests in the share capital of the Company, are available for inspection during normal business hours at the Registered Office of the Company and will remain so up to and including 27 July 2005. They will then be available for inspection at the Annual General Meeting from 10.00 am on 28 July 2005 until the conclusion of the meeting.

•• EXPLANATORY NOTES ON CERTAIN BUSINESS OF THE ANNUAL GENERAL MEETING

Remuneration policy

Resolution 3 proposes the approval of the Directors' remuneration report which is set out on pages 38 to 44 inclusive of the Annual Report. It is a requirement, pursuant to Schedule 7A of the Companies Act 1985, that the Directors' remuneration report be submitted to shareholders for approval, albeit that any voting on the report is advisory only. No changes have been made to the policy which was submitted to shareholders for approval at last year's Annual General Meeting.

Re-election of Directors

Resolutions 4, 5 and 6 propose the re-elections of Messrs Baty and Dupont and Ms Mortimer as Directors of the Company in accordance with the Company's Articles of Association which require that, at the date of the notice convening the Annual General Meeting, each Director who has held office for more than 30 months since appointment or re-appointment must retire. The Directors, being eligible, offer themselves up for re-election. Bob Baty was appointed a Director of the Company on 1 March 1996 and has extensive knowledge of the water business having joined South West Water as its engineering and scientific director. Prior to that he held engineering and operational appointments with North West Water Authority. David Dupont was appointed a Director of the Company on 2 March 2002 and has extensive finance, regulatory, strategic planning and business development experience having formerly been South West Water's regulatory and finance director. Prior to that he was Pennon Group's strategic planning manager. Kate Mortimer was appointed a Director of the Company on 1 May 2000. As demonstrated by her biographical details set out on page 37 of the Annual Report, Kate Mortimer has extensive financial and business experience and has been appointed as a member (and Chairman) of the Remuneration Committee of the Board and as a member of the Audit and Nomination Committees of the Board.

The Board supports the re-election of these Directors as it believes that their knowledge and experience assists in ensuring that the Board has an appropriate balance of skills and experience for the requirements of the business. The Chairman confirms that following the formal annual performance evaluation, Kate Mortimer, as a Non-executive Director, continues to be effective and continues to demonstrate commitment to the role, including commitment of time for Board and Committee meetings and other duties as they are likely to arise.

Reappointment of auditors

Resolution 7 proposes the reappointment of PricewaterhouseCoopers LLP as auditors. PricewaterhouseCoopers LLP have indicated their willingness to continue in office and their reappointment is supported by the Audit Committee of the Board.

Authority to allot shares

Resolution 9 requests shareholder approval by way of an ordinary resolution to renew (in compliance with recently published institutional guidelines) until 27 October 2006 or, if earlier, at the conclusion of the next Annual General Meeting of the Company, the Directors' existing general and unconditional authority to allot securities in accordance with the Companies Act 1985 and the Articles of Association of the Company. This authority would continue that granted in July 2004. The nominal share capital to which this authority relates of £32,802,000 (being the unissued share capital of the Company) represents approximately 23% of the issued share capital as at 15 June 2005.

Currently the Company does not hold any shares in the Company in treasury (see the note to Resolution 11). This authority will expire on 27 October 2006 or, if earlier, at the next Annual General Meeting of the Company, although it is the Directors' intention to renew the authority annually.

Resolution 10 requests shareholder approval by way of a special resolution to renew until 27 October 2006 or, if earlier, at the conclusion of the next Annual General Meeting of the Company, the Directors' authority to allot equity securities for cash without first being required to offer such securities to existing shareholders. The share capital to which this authority relates represents not more than 5% of the issued share capital as at 15 June 2005. The Directors would not intend to issue more than 7.5% of the Company's issued share capital in any rolling three year period without prior consultation with the Investment Committees of the Association of British Insurers and the National Association of Pension Funds.

The Directors consider that they should have the above authorities in order to be able to take advantage of opportunities as they arise and to retain flexibility although they have no current plans to issue shares, except pursuant to the Company's scrip dividend alternative, the exercise of options arising from the Company's all-employee sharesave scheme and new Share Incentive Plan, the operation of the Company's Restricted Share Plan and/or the operation of the deferred bonus share element of the Company's Annual Incentive Bonus Plan.

Authority to purchase ordinary shares of the Company

Resolution 11 requests shareholder approval by way of a special resolution to renew the Company's authority to purchase up to 10% of its ordinary shares at or between the minimum and maximum prices specified in the resolution. This authority is requested in order to increase the Company's flexibility to optimise the long-term financial and tax efficiency of its capital structure. The Directors have no specific plans to exercise such powers in the immediate future but will keep the matter under review and will only make such purchases if they would result in an increase in the Company's earnings per share and are in the best interests of the Company's shareholders generally.

Any shares purchased in this way will, unless the Directors determine that they are to be held as treasury shares (see below), be cancelled and the number of shares in issue will be reduced accordingly. Shares held in treasury will not automatically be cancelled and will not be taken into account in future calculations of earnings per share (unless they are subsequently resold or transferred out of treasury).

The Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 allows companies to hold shares acquired by way of market purchase in treasury, rather than having to cancel them. The Company may therefore consider holding any of its own shares that it may purchase pursuant to the authority conferred

NOTICE OF ANNUAL GENERAL MEETING

by this resolution as treasury shares as an alternative to cancelling them. This would give the Company the ability to re-issue such treasury shares quickly and cost effectively. No dividends may be paid on shares held in treasury and no voting rights may be exercisable in respect of treasury shares.

Authority to redefine the power of the Company to borrow money

Resolution 12 requests shareholder approval by way of a special resolution to amend Article 102 of the Company's Articles of Association to deduct in determining the borrowings of the Company, any sums held by the Company on deposit.

This updating of the Article is made to reflect the fact that it is the policy of the Company to forward borrow to fund the Group's capital programme for at least the forthcoming twelve months.

Adoption of proposed new Articles of Association of the Company

Resolution 13 requests shareholder approval by way of a special resolution that the new Articles of Association of the Company (which incorporates the amendment proposed in Resolution 12) be adopted. The current Articles of Association were adopted in 1989. Although subsequent amendments have been made, the Directors propose that new Articles of Association be adopted which will comply with current regulations, and best practice and which will generally update, clarify, simplify and re-order the Articles of Association of the Company. The changes will also remove the references to the special rights redeemable preference share which was redeemed on 31 December 1994.

A summary of the principal differences between the existing Articles of Association and the proposed new Articles of Association

The following is a summary of the principal changes proposed to be contained in the new Articles of Association. Other changes have been made to bring the Articles of Association into line with current regulation and best practice, generally to update, clarify and simplify the Articles of Association of the Company and to re-order the Articles of Association so as to make them easier to read. These changes require no further explanation.

Article 2: Interpretation

This article will include a new definition of treasury shares in accordance with Section 162A of the Companies Act 1985. The new article will clarify that when shares are held in treasury, all rights relating to those shares are suspended, including the right to attend and vote in general meetings, the right to receive a dividend and the right to receive any other distribution from the Company.

Article 3: Share Capital

This article will reflect the authorised share capital at the date of adoption of the new Articles of Association. There are no references in this article to the special rights redeemable preference share of £1 as this was redeemed on 31 December 1994 and by a special resolution of the Company passed on 25 July 1995, the rights attaching to that class of share were deleted from the Articles of Association of the Company.

Article 7: Dis-application of pre-emption rights

This article will include a clarification that any dis-application of pre-emption rights will extend to the allotment of treasury shares for cash.

Articles 14 and 17: Uncertificated shares

Article 14 will contain specific provisions facilitating the holding and transfer of shares in uncertificated form.

Article 17 will provide that the Company will maintain a record of uncertificated shares. Further changes will be made to other articles to facilitate the holding and transfer of uncertificated shares.

Articles 32, 34, 35, 37 and 38: Proceedings at general meetings

In common with other listed public companies, these articles will contain amendments to the previous provisions to ensure the orderly and secure running of shareholders' meetings for the benefit of the meeting as a whole.

Article 51: Number of Directors

This article will provide that the maximum number of Directors will be 12.

Article 57: Retirement of Directors

This article will simplify and clarify the existing article by providing that, at each Annual General Meeting, any Director who has held office for three years or more shall retire from office but be eligible for re-appointment.

Article 58: Removal of Directors

In addition to the power of the Company in general meeting to remove a Director, this article permits the removal of a Director by notice from his co-directors provided such notice is signed by or on behalf of all the other Directors (or their alternates) being not less than three in number.

NOTICE OF ANNUAL GENERAL MEETING

Article 65: Expenses

This article will permit a Director to have paid out of the funds of the Company all expenses incurred by him in obtaining professional advice in connection with the affairs of the Company or the discharge of his duties as a Director subject to any guidelines and procedures established from time to time by the Board.

Article 70: Power to borrow money

This article will be updated as set out in Resolution 12 to deduct any sums held by the Company on deposit when determining the borrowings of the Company.

Article 71: Delegation to individual Directors

This article will give the Board the power to delegate any of its powers to any Director on such terms and conditions as it thinks fit.

Article 75: Directors' interests and voting

This article will contain updated provisions as to Directors' interests and voting including the express ability of the Company to purchase Directors' and Officers' insurance for the benefit of any person who holds a relevant office with the Company.

Article 87: Issue of share certificates

This article will permit share certificates to be signed electronically.

Article 94: Power to differentiate

This article will provide that, on an issue of shares, the Board may differentiate between holders of shares in relation to the time and amount of payment of calls on those shares.

Article 104: Calculation and currency of dividends

This article will allow for dividends to be declared or to be paid in any currency. It will also allow the Board to agree with a member to pay a dividend in a currency different from the one in which it was declared and provides a mechanism for conversion of a dividend into that other currency.

Article 128: Indemnity

This article will provide that the Company may (rather than shall) indemnify a Director or other Officer (excluding an auditor) against liabilities incurred by him in connection with his duties, powers or office. The change is for the purposes of clarification and reflects a recent determination by the courts that a company's articles of association are not automatically binding as between a company and its officers and that indemnities will not be available to directors or officers unless they are also incorporated in a separate contract between the company and the relevant director or officer. The new article will also reflect recent changes in company law relating to such indemnities.

•• POLITICAL DONATIONS

Whilst Resolution 14 requests shareholder approval by way of an ordinary resolution to approve donations to political parties, please note that the Company has a policy that it does not make donations to, or incur expenditure on behalf of, political parties. However, the Political Parties, Elections and Referendums Act 2000 (the 'Act') amended the Companies Act 1985 and contains restrictions on companies making donations or incurring EU political expenditure and it defines these terms very widely and confirms that activities which form part of the normal relationship between the Company and bodies concerned with policy review, law reform and other business matters affecting the Company may be included. Such activities, which are in the shareholders' interests for the Company to conduct, are not designed to support, or implement support for, a particular political party.

The Company believes that the authority proposed under this Resolution (which is similar to that agreed by shareholders at the Annual General Meeting last year) is necessary to ensure that it does not commit any technical breach that could arise from the uncertainty generated by the wide definitions contained within the Act when carrying out activities in the furtherance of its legitimate business interests.

•• RECOMMENDATION

Your Directors consider that all the proposals to be considered at the Annual General Meeting are in the best interests of the Company and its shareholders as a whole and recommend shareholders to vote in favour of the Resolutions.

SHAREHOLDER INFORMATION

•• FINANCIAL CALENDAR

Financial year end	31 March
Sixteenth Annual General Meeting	28 July 2005
2005 Final dividend payable	5 October 2005
2005 Interim results announcement	December 2005
2006 Interim dividend payable	April 2006
2006 Preliminary results announcement	May 2006
Seventeenth Annual General Meeting	July 2006
2006 Final dividend payable	October 2006

•• SHAREHOLDER ANALYSIS AT 31 MARCH 2005

Shares held	Number of shareholders	Percentage of total shareholders	Percentage of ordinary shares
1 – 100	4,921	20.1	0.2
101 – 1,000	15,524	63.4	5.3
1,001 – 5,000	3,438	14.0	4.7
5,001 – 50,000	414	1.7	5.3
50,001 – 100,000	68	0.3	3.8
Over 100,000	132	0.5	80.7
	24,497	100.0	100.0
Category of shareholder			
Individuals	22,341	91.2	9.4
Companies	190	0.8	1.2
Trust companies (pension funds etc)	3	–	–
Banks and nominees	1,959	8.0	89.1
Insurance companies	4	–	0.3
	24,497	100.0	100.0

•• SUBSTANTIAL SHAREHOLDINGS

At 15 June 2005, interests in the issued share capital had been notified by:

AXA Investment Managers	5.51%
Lansdowne Partners Limited Partnership	5.05%
FMR Corp. and Fidelity International	3.82%
Zurich Financial Services	3.79%
Standard Life Group	3.77%
Legal & General Investment Management	3.64%

Further shareholder information may be found at:

www.pennon-group.co.uk

•• SHAREHOLDER SERVICES

Share dealing service

The low-cost share dealing service offered by Stocktrade enables shareholders to buy and sell shares in the Company on a low-cost basis and to make regular investments in the Company. Telephone Stocktrade on **0845 601 0995** and quote: LOW C0107. Commission is 0.5% (Subject to a minimum charge of £15, to £10,000, then 0.2% thereafter).

Share gift service

Through Sharegift, an independent charity share donation scheme, shareholders who only have a small number of shares with a value that makes it uneconomical to sell them, can donate such shares to charity. Donations can be made by completion of a simple share transfer form which is available from Lloyds TSB Registrars.

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 their dividends may be received in the form of shares instead of cash.

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

Electronic communications

Shareholders can elect to receive shareholder communications electronically by signing up through www.shareview.co.uk

•• ANNUAL GENERAL MEETING

The 2005 Annual General Meeting will be held on Thursday 28 July 2005. Further details are set out in the Notice of Annual General Meeting on pages 90 to 95.

Appointing a proxy

A proxy form is being sent out to shareholders with this Annual Report and instructions for its use are shown on the form.

Electronic proxy voting

Shareholders may register the appointment of a proxy for the Annual General Meeting and any adjournment(s) thereof via www.sharevote.co.uk – a website operated by Lloyds TSB Registrars.

Electronic proxy appointment through CREST

CREST members who wish to appoint a proxy or proxies through the CREST electronic proxy appointment service may do so for the Annual General Meeting and any adjournment(s) thereof by following the procedures described in the CREST manual.

•• THE PENNON GROUP WEBSITE

The Pennon Group 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