

COMPANY NO: 2366640

**PENNON GROUP PLC**

**ANNUAL REPORT & ACCOUNTS**

**FOR THE YEAR ENDED 31 MARCH 2007**



## ■ HIGHLIGHTS OF THE YEAR

REVENUE UP 15.9% TO £748.3 MILLION  
OPERATING PROFIT UP 14.2%<sup>(1)</sup> TO £200.0 MILLION  
PROFIT BEFORE TAX UP 18.2%<sup>(2)</sup> TO £131.1 MILLION  
EARNINGS PER SHARE<sup>(3)</sup> UP 20.2% TO 30.3p<sup>(4)</sup>  
DIVIDEND PER SHARE UP 7.8% TO 18.55p

(1) Before exceptional items in 2005/06 of £14.5 million. Statutory result £200.0 million (2005/06 £160.6 million)

(2) Before exceptional items in 2005/06 of £56.8 million. Statutory result £131.1 million (2005/06 £54.1 million)

(3) Before deferred tax, and exceptional items in 2005/06

(4) Basic earnings per share are 26.5p (2005/06 9.9p)

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## CHAIRMAN'S STATEMENT

I AM ONCE AGAIN PLEASED TO REPORT EXCELLENT PROGRESS BY THE GROUP DURING THE YEAR, RE-AFFIRMING THE SUCCESS OF OUR STRATEGY TO FOCUS ON OUR TWO KEY BUSINESSES OF SOUTH WEST WATER AND VIRIDOR

### ■ FINANCIAL OVERVIEW

Group revenue increased by 15.9% to £748.3 million. Operating profit increased by 14.2% to £200.0 million, profit before tax increased by 18.2% to £131.1 million and earnings per share (before deferred tax) for the year were 30.3p, an increase of 20.2% (all before exceptional items in 2005/06).

The Board is recommending a final dividend of 12.7p, an 8.5% increase which, together with the interim dividend of 5.85p, will result in a total dividend for the year of 18.55p, an increase of 7.8% on the total dividend for the previous year. This is in accordance with the Board's stated policy of growing the Group dividend by 3% above inflation per annum up to 2009/10. Once again, shareholders will also be given the opportunity to participate in the Company's Dividend Re-investment Plan.

In April 2006 the Company completed the redemption of the outstanding B Shares as part of the approved return of cash to shareholders. Circa £145 million has now been returned through the B Share issue.

### ■ SOUTH WEST WATER

South West Water's revenue increased by £33.0 million to £381.5 million and operating profit increased 10.8% (before exceptional costs in 2005/06) to £156.8 million. Operating costs, excluding depreciation, increased by £11.9 million to £147.0 million after £3.0 million of efficiency savings.

The company is implementing detailed plans to ensure it is well on track to achieve the operating cost efficiency target set by the Director General of Water Services for the K4 period up to 2010.

The company has put in place a comprehensive strategy to help ensure a continued secure supply of water for the region. Three of the company's key reservoirs were again replenished during the winter by pumping water from downstream river flows to supplement the natural rainwater inflow. The pump infrastructure was installed several years ago to provide enhanced drought protection.

Once again, drinking water quality and river water quality have been sustained at an all time high and the region features the highest proportion of high quality rivers in England.

In 2006, for the first time, 100% of the designated bathing waters in the South West Water region achieved the EU mandatory standard and 92% achieved the even more stringent guideline standard. All major projects in the company's 15 year original 'Clean Sweep' coastal sewage treatment programme have now been completed. This is a significant contributor to the record bathing water quality compliance.

The company continues to deliver improving levels of product and customer service and has embarked upon a number of initiatives to enhance service and efficiency further. These include the company's new 'Service+' centre, which utilises the latest mobile computing technology, and 'WaterCare', a ground-breaking new customer care programme targeted at helping those most in need to pay their water bills.

Regulatory capital value (RCV) is expected to grow by 34% to £2.6 billion over the current regulatory period to March 2010. This is the highest forecast percentage increase of any quoted UK water company.

In preparing for the forthcoming Periodic Review of prices in 2009 (PR09), a number of projects are under way to ensure that South West Water is prepared for the new challenges that lie ahead. Further details of these are provided in Chris Loughlin's Overview of the company's performance and activities.

### ■ VIRIDOR

Building further on the growth achieved over the past six years, Viridor traded particularly strongly in 2006/07. Revenue was up £68.8 million (23.0%) to £367.7 million. Operating profit before intangibles amortisation (PBITA) for the year increased by 30.4% to £46.8 million. This increase included a full year's contribution from last year's Brett Waste Management acquisition, the positive effect of Wyvern Waste and Skipaway, which were acquired during the year and 12.6% growth in the underlying business.

Total landfill disposal volumes increased by 9% to 4.7 million tonnes due to acquisitions. Average gate fees rose by 7% to £19 per tonne with margins increasing by 50p to over £6 per tonne. In addition, power generation output increased by a further 15% in the year to 423 GWh with average prices increasing 4.3% to £62 per MWh reflecting strong brown energy prices.

A significant part of Vindor's strategy is exploring private finance initiative and public/private partnership opportunities. In January 2007 Greater Manchester Waste Disposal Authority announced that the Vindor Waste Management Limited/John Laing Infrastructure Limited consortium had been selected as preferred bidder for its waste management services contract. With an investment value of around £300 million, this will be the largest such scheme in the UK and will involve the handling of around 1.4 million tonnes of waste per annum. Final negotiations are under way and the contract is due to commence in the current financial year.

There were other significant developments in the year. These included new and extended recycling contracts, achieving preferred bidder status for medium-term council waste disposal contracts, the submission of a planning application for a 60,000 tonne energy from waste facility in Exeter, and progress as planned with the Lakeside energy from waste plant at Colnbrook, near Heathrow, as part of the 50/50 joint venture with Grondon Waste Management Limited.

Colin Drummond's Overview of performance and activities contains more detail on the achievements of the company during the year.

## ■ STRATEGY & PROSPECTS

The Board's priority continues to be the creation of shareholder value through its strategic focus on water, sewerage and waste management. The excellent performance highlighted above is testament to the Board's strategy of focusing on these key business areas.

The Board remains confident that South West Water will successfully deliver the K4 regulatory contract and significantly grow its regulatory capital value up to 2010. Furthermore, Vindor'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. In addition, the Group has put in place a long-term funding structure to enable it to continue to finance its activities efficiently.

## ■ BOARD MATTERS

Chris Loughlin joined the Board as an Executive Director and became Chief Executive of South West Water on 1 August 2006 following Bob Baty's retirement from that role on 31 July. The Board expresses its gratitude to Bob for his significant contribution to South West Water since privatisation in 1989 and wishes him a long and enjoyable retirement.

To recognise the growing importance of sustainability and the need for the continuing development of the Group's environmental, social and governance policies, the Board established the Corporate Responsibility Committee in November 2006 under the chairmanship of Dinah Nichols. This Committee supersedes the Environment Committee and further details are set out in the Corporate Governance and Internal Control Report on page 41.

## ■ EMPLOYEES

During the time I have been Chairman of the Group many structural and organisational changes have taken place, throughout which employees have continued to demonstrate a high level of loyalty, commitment and professionalism. I thank them most sincerely for their continuing support.

My personal thanks also go to the Non-executive Directors and Executive Directors for their significant contributions during what has been another busy and demanding year.

*Ken Harvey, Chairman  
Pennon Group Plc  
22 June 2007*

## SOUTH WEST WATER

### SOUTH WEST WATER CONTINUED TO MAKE EXCELLENT PROGRESS IN DELIVERING IMPROVEMENTS TO CUSTOMER SERVICE AND ACHIEVING REGULATORY PERFORMANCE TARGETS

#### ■ OVERVIEW

The company's revenue increased by £33.0 million to £381.5 million. Ofwat approved tariff increases and 7,100 new customer connections, offset by customers switching to metered tariffs and a 2.9% decrease in measured demand, were the main drivers of this change. Over 57% of our domestic customers now receive a metered supply.

South West Water's operating profit rose by 10.8% (before exceptional costs in 2005/06) to £156.8 million. Operating costs, excluding depreciation, increased by £11.9 million to £147.0 million. The increase was driven by additional costs from new capital schemes of £2.7 million, inflation of £10.2 million (including additional power costs of £5.5 million) and other cost increases of £2.0 million (including infrastructure expenditure charged to operating costs). The cost of bad debts (part of which is charged against revenue) is rising more slowly than the tariff increase. These inflationary pressures were partially offset by continued good progress on operational efficiencies with some £3.0 million achieved in the year and £7.0 million so far in K4. The company remains on track to deliver the demanding efficiency targets, set by Ofwat at the last price Determination, over the 2005-2010 period. Capital expenditure was £184.0 million with over £70.0 million being spent on quality schemes, principally water mains rehabilitation.

This is my first contribution to the Pennon Group Annual Report since succeeding Bob Baty as Chief Executive last August. The achievements delivered during my predecessor's time have been outstanding. In particular, the hugely successful 'Clean Sweep' waste water programme has transformed the quality of the very special coastal and estuarine environment of the South West.

'Clean Sweep' was a massive capital investment programme which dominated the company's activities for the best part of two decades. As this nears completion, it is appropriate to look towards the future direction of the company and the many challenges it faces. This is particularly important as we begin planning for the next Periodic Review for the period 2010-15. We want to strike the right balance for the future between investment to improve our services, financeability and, importantly, customer affordability. This is a particular challenge we are determined to meet. We must also meet the ongoing governmental and regulatory requirements whilst preparing for potential climate change impacts. The coming years should nevertheless see a shift away from capital delivery to achieve new standards driven by legislation, towards a more customer-focused agenda.

As we embark on new challenges, we must build on what has been an outstanding year across the company.

This has been our tenth consecutive year without water restrictions. The company has put in place a comprehensive strategy to help ensure a continued secure supply of water for the region. Three of the company's key reservoirs were again replenished during the winter by pumping water from downstream river flows to supplement the natural rainwater inflow. The pump infrastructure was installed several years ago to provide enhanced drought protection. To improve water resource flexibility, significant additional water resources in Cornwall were secured through the purchase of a former china clay pit to be named Park Lake. It will become the region's fourth-largest reservoir.

We achieved our best ever leakage performance. We have achieved or beaten our leakage target in every year since targets were introduced by Ofwat in 1999/2000.

A further 638km of water mains were replaced or relined during the year as part of the company's 'Putting the Sparkle Back into Your Water' programme, agreed with the Drinking Water Inspectorate (DWI) for completion by 2010. Drinking water quality compliance for calendar year 2006, as monitored by the DWI, equalled the highest ever 99.96% level achieved in 2005.

The success of 'Clean Sweep' is evident from our achieving 100% compliance with mandatory bathing water standards for the first time (99% in 2005) at the 144 bathing waters in our area. Compliance with the even higher guideline standards has also improved to 92% from 89% the year before. The extent of this achievement can be measured against only 51% compliance with the guideline standard ten years ago. The 'percentage population equivalent' (see Glossary, page 29, for description) connected to sanitary compliant waste water treatment works was the highest ever at 99.6%.

'Service+', a major project to improve the service to customers in relation to the company's day to day operational activities and to reduce costs, was launched in October 2006. The new Service Centre in Exeter utilises the latest mobile computing technology to give quicker, more accurate information to customers on service issues as well as better prioritising the work of field operations staff. The benefits of the new system are already being seen, with a significant reduction in the number of repeat contacts from customers.

'Watercare', a ground-breaking new customer care programme, was launched early in 2007 targeted at helping those most in need to pay their bills by advising them on how to manage better both their water use and household budget. Trained advisors are meeting with around 2,500 qualifying customers a year in their homes and offering a range of free services including home water audits, advice on potential savings from fitting a meter and advice on receiving financial benefits to which they are entitled. The identification of customers who would benefit from moving on to special payment plan enables them to make regular affordable payments, thereby reducing the company's outstanding debt.

Ofwat's 2005/06 'Levels of Service Report' confirms that South West Water has maintained last year's step change improvement in its Overall Performance Assessment (OPA) ranking, maintaining its 6th position out of the 10 water and sewerage companies. We expect this position to be consolidated when 2006/07 scores are published later this year.

In preparing for the forthcoming periodic review of prices in 2009, a number of initiatives are under way to ensure that South West Water is prepared for the new challenges that lie ahead. The customer contact/billing contract will be re-tendered during 2007 and the company will build on the success of 'Service+'. The role of tariff structures in addressing the agenda of affordability and sustainability is also being reviewed.

To meet the twin objectives of service excellence and operational efficiency, South West Water has launched a long-term project, 'Puros', to move the organisation towards a more centralised operational structure employing increased levels of automation and remote working. In the shorter term, a new 'rightsourcing' review is under way to determine the optimal combination of internal and external resource provision. It is expected that the cost of £3 million to £4 million of ongoing organisational restructuring will be provided for in 2007/08.

Looking forward, we are determined to improve further our customer service and deliver new operational efficiencies. I am confident that with the quality and commitment of the people we have in place and the improvement programmes that they are focused on, we will build on our achievements to date.

## ■ BUSINESS AND STRATEGY

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 1.65 million residents and around eight million annual visitors. It distributes over 440 million litres of treated water per day and disposes of around 250 million litres of waste water each day through an asset base comprising

- 15,000 kms – Distribution mains
- 9,100 kms – Sewers
- 16 – Impounding reservoirs
- 39 – Water treatment works
- 623 – Waste water treatment works
  - including 52 works with ultra violet treatment and two with membrane filtration
- 1,030 – Combined sewer overflows

Since privatisation, 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 144 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 (now the Water Services Regulatory Authority). The contract scope 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 (April 2005 to March 2010), Ofwat assumed that the equity cost of capital for all companies would be 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. As a result, the company's Regulatory Capital Value is expected to increase from around £1.95 billion in March 2005 to circa £2.6 billion in March 2010. This will enlarge 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 and/or financing the investment programme and operation at lower cost.

## ■ REGULATORY & COMPETITIVE ENVIRONMENT

### ■ APPOINTMENTS

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 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 the Consumer Council for Water, a separate statutory body.

### ■ 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 Retail Price Index (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 instituted a system of 'comparative competition' which compares South West Water's performance on a wide range of parameters, including efficiency, customer service, and environmental performance. Operating and capital cost comparisons are used by Ofwat to determine the level of efficiency improvement which might be achieved at each Periodic Review.

Companies are incentivised to be efficient both in terms of their operating costs and in the implementation of their capital expenditure programmes. 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 that 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. These may, in certain circumstances agreed by Ofwat, be logged up or down, with prices adjusted at the next Periodic Review to compensate for the unexpected change. 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. This is 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 in December 2004 and are shown 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 reliable water supply and sewerage services
- install 113,000 optional domestic customer water meters
- deliver required drinking water and environmental quality improvements including
  - renovation of more than 3,200kms of water distribution mains
  - improvements at 14 water treatment works to improve drinking 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 internal flooding
- 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. This places 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 into UK law in 2003 and rationalises EU water legislation. This provides 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.

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, amongst 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 DWI which sets and enforces drinking water quality standards

**COMPETITION**

As the licensed undertaker in Devon, Cornwall and small parts of Dorset and Somerset, South West Water has no direct competition for the provision of water and sewerage services to the vast majority of its customers. The Government has introduced a new regime whereby customers using more than 50ML per year can contract with alternative suppliers for water supply. South West Water has only 37 customers in this category, whose aggregate water charges account for less than 2% of its total revenue. No single customer accounts for more than 1.0% of revenue.

**KEY PERFORMANCE INDICATORS**

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

**GROWTH IN REGULATORY CAPITAL VALUE**

Regulatory Capital Value (RCV) is the financial base upon which Ofwat allows a rate of return and sets prices at the Periodic Review. The opening RCV is adjusted for projected capital and infrastructure renewals expenditure, grants and contributions, infrastructure renewals charge and current cost depreciation, together with the efficiency outperformance from the previous regulatory period.

Ofwat then projects each component for every year of the Review period. The RCV is adjusted annually for Retail Price Index movements. At the following price review, the RCV 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](http://www.ofwat.gov.uk)

The RCV at 31 March 2007 amounted to £2.265 billion.

Graph here

Projected RCVs up to 2009/10 are based upon Ofwat's projections. These were set out in 'Future Water and Sewerage Charges 2005-10' published in December 2004 and have been adjusted by South West Water's estimates of RPI indexation.

The growth in RCV adds directly to shareholder value as the allowed return is attributed to South West Water's asset base by the water regulator.

**OPERATING PROFIT**

South West Water achieved an operating profit of £156.8 million in 2006/07, up £15.3 million on 2005/06 (before exceptional costs in 2005/06).

For the five year period 2003 to 2007, operating profit (before exceptional items) was:

Year ended 31 March	2003*	2004	2005	2006	2007
	£m	£m	£m	£m	£m
	111.5	118.9	122.2	141.5	156.8

\* UK GAAP

**OVERALL PERFORMANCE ASSESSMENT**

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

Data is collated for 12 month periods, part calendar year and part financial year. 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.

In 2005/06, South West Water maintained its 6th position out of the 10 water and sewerage companies in Ofwat's OPA index.

Graph here

■ **DRINKING WATER COMPLIANCE**

During 2006, South West Water maintained its overall high level of compliance with the drinking water quality regulations with 99.96% of its regulatory tests meeting the required standards

Graph here

manage performance and to identify and deliver 'continuous improvement' opportunities for further reducing cost while improving performance and service levels

■ **CORPORATE RESPONSIBILITY/RELATIONSHIPS**

■ **RELATIONSHIPS WITH REGULATORS AND CUSTOMERS**

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

The company maintains a continuing dialogue with Ofwat, the EA and DWI and contributes to national dialogue on developing issues through its membership of Water UK, the industry trade body

It works with 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

Customers are informed through a customer newspaper entitled 'Waterlevel' and by regular press releases and media briefings

Customer service improvement is a key focus for the company, as evidenced by the 'Service+' project and the recent introduction of a new contact centre platform

The company is also investing in a new debt recovery system to provide improved management and structure of payment arrangements for customers who, for whatever reason, do not or are unable to pay their bills

■ **CUSTOMER/SUPPLIER RELATIONSHIPS**

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

South West Water's procurement strategy is focused on the management of around 50 key and strategic suppliers who account for the large majority of expenditure. Regular meetings are held to

■ **EMPLOYEES**

South West Water continues to take advantage of the introduction of new technology, such as mobile computing to improve the efficient operation of the workforce in the field. In addition the company has been pressing ahead with upskilling programmes for its operational employees and, following a series of meetings with employee representatives, new working arrangements have been introduced to a number of areas of the business. During 2006 the new Service Centre was opened at the company's headquarters in Exeter, designed to improve the planning of field staff activity as well as provide a much more effective interface with customers

All these measures will help to enhance the service to customers and contribute to meeting the company's demanding efficiency targets for the K4 period. It is anticipated that as a result of these and other efficiency improvements, a number of employees will be released on early retirement or voluntary severance terms and this will enable the company to meet its target of a directly employed workforce of below 1300 by 2010

South West Water has a highly skilled management team focused on financial and operational targets. It has invested significant sums to ensure that its staff have the experience and competencies to undertake their roles. For example, NVQ training is provided to operators and craftsmen to ensure that basic skills are in place and health and safety requirements met. A range of training opportunities including assistance to obtain professional qualifications is offered to office-based staff, and managers are encouraged to widen 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' (IIP) standard and is closely aligned with business requirements

Staff turnover is below the national average. Job satisfaction is supported by encouraging role changes wherever possible around the company to help employees gain a broad experience of business activities. The company has introduced a number of 'Family Friendly' policies to ensure that a proper balance is maintained between work and home life. Regular benchmarking of salary levels is carried out to maintain the company's competitive position in the job market. The latest of an ongoing series of employee surveys was carried out during 2006 and IIP re-accreditation was also confirmed.

A similar business-focused approach is now under way to reduce work-related ill health. Although the company acknowledges that much still needs to be done to improve health at work, at a major health conference hosted by the TUC during the year, South West Water was the only private sector organisation to be cited by the Minister with responsibility for Health and Safety as effectively integrating ethical, commercial and statutory objectives.

Occupational health and safety are key elements of South West Water's risk management and internal control processes. Following privatisation, the company set out to build an occupational health and safety culture throughout its supply chain in partnership with stakeholders including trade unions, regulators, other water companies and construction partners. South West Water's reportable accident rate is an important KPI and is set out below for the five year period 2002 to 2006. It was 11 accidents per 1,000 employees in 2006 compared with 12.56 per 1,000 employees in 2005. Whilst the significant reduction achieved in recent years has largely been maintained, the company continues to pursue initiatives to improve the health and safety of its employees.

Graph here

South West Water continues to play a major role in 'Clear Water 2010', a 10 year occupational health programme for the water industry. Independently verified data gathered across the industry has identified the industry's greatest work-related challenges as stress and musculo-skeletal disorders.

An essential aspect of South West Water's activities with regard to the safety, health, welfare and well-being of its own workers is the extensive provision of training in skills acquisition and health and safety, thus ensuring that employees have the knowledge and expertise to undertake their jobs in a well-motivated, contented and productive manner.

## ■ THE ENVIRONMENT

In 2006/07, South West Water abstracted 177,000 Ml of raw water from its 81 licensed abstraction locations which have a total licensed volume of 384,000 Ml. The abstraction locations are either reservoirs, rivers or groundwater aquifers.

The 'percentage population equivalent' (see Glossary, page 29, for description) served by sanitary compliant waste water treatment works in 2006 improved to 99.6% (99.4% in 2005).

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 2006, all the region's 144 bathing waters achieved the EU mandatory standard (99% in 2005) and 92% achieved the even more stringent guideline standard (89% in 2005).

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

## ■ INCIDENTS AND PROSECUTIONS

The number of incidents classified by the EA as 'Category Two' (significant pollution incidents) in 2006/07 was five, but only four were deemed non-compliant. This compares with three in 2005/06.

During the year, the company was convicted on seven occasions for environmental offences and fined a total of £30,000 compared with two convictions and £6,000 in fines in 2005/06. The company is taking action to reduce incidents which lead to prosecution.

## ■ RISKS AND UNCERTAINTIES

### Price controls over the revenue of the company's regulated business could adversely affect profitability

The outcome of Ofwat's future Price Determinations 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 met Ofwat's efficiency expectations in the last two Periodic Review periods (K2 and K3) and is on track to meet them in K4.

### Failure to deliver the capital investment programme could adversely affect profitability

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

**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 debt financing. In setting price limits, the water regulator has a duty to ensure that a company can finance its functions. 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. However, 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 was 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.

**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 company'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. All these 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 with them at all times.

Environmental laws and regulations are complex and change frequently. These laws and their enforcement have tended to become more stringent over time. South West Water budgets for future capital and operating expenditures to achieve compliance with current and known future changes in law and regulations. However, 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.

In addition, the Group's ability to meet regulatory and environmental performance standards could be adversely affected. This could result in the potential for fines or other sanctions imposed by either the water regulator or the courts, including ultimately the loss of South West Water's licence. The company has a track record of delivering its capital programme in accordance with regulatory requirements.

**Contamination of water supplies could adversely affect profitability**

Water supplies may be subject to contamination, which may emanate from naturally occurring compounds and pollution resulting from man-made sources. If one or more of the company's water supplies becomes contaminated and the company is unable to substitute a supply or to treat adequately the contaminated water source, there may be an adverse effect on its reputation, operating results and financial position. Some or all of the remedial 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. Allowance is made by Ofwat in the Determination for its estimate of debt deemed to be irrecoverable but there can be no assurance that the amount allowed by the water regulator is adequate. In addition to existing strategies, South West Water is implementing new initiatives to improve and secure cash collection, including the use of property charging orders. Provision was made in the last Periodic Review for companies to make an application for an Interim Determination in the event of bad debts being significantly above the amount allowed by the water regulator.

**Energy cost pressures**

Energy costs are the second highest component of South West Water's operating costs. A proportion of recent increases was recognised and allowed for by Ofwat in the last price Determination. However, any additional costs will adversely affect the company's profitability.

South West Water mitigates rising energy costs through careful system operation, by maximising renewable energy generation and by purchasing all forms of energy in the most efficient way.

**Water resource adequacy**

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 has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures.

In particular, South West Water prepares a new Water Resources Plan every five years and reviews it annually for a range of climate change and demand scenarios. The Water Resource Plan indicates that no new reservoirs are required before the planning horizon of 2030. However, investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.

At the end of March 2007, reservoir storage levels were 92.0% compared with 82.7% in March 2006.

#### **Operational failures**

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 or DWI and/or be required to undertake costly upgrades.

#### **Meter option take-up**

Higher than national average water and sewerage charges exist within the South West Water area. This has 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 charged by the volume of water used. Most customers in properties built prior to 1989 can choose to opt for metered 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 metered charges is estimated at each Periodic Review.

The current rate of customers opting to change is currently higher than the estimates made at the last Periodic Review. This could have an adverse impact on the company's revenues going forward. An Interim Determination may be used to fully or partially recover revenue losses if they exceed the prescribed materiality threshold.

# VIRIDOR

Colin Drummond  
Chief Executive  
Viridor Limited

## VIRIDOR CONTINUES TO DELIVER STRONG GROWTH

### ■ OVERVIEW

The continuing improvements in the UK's overall waste management policies, driven by climate change and environmental awareness, create major opportunities for Viridor. In 2006/07 Viridor delivered another year of strong profit growth. At the same time it progressed various initiatives which are expected further to enhance its business in future years. This reflects its focused strategy set out opposite.

Financial performance in 2006/07 was particularly strong. Revenue at £367.7 million increased by 23% over the previous year. Operating profit (before amortisation of intangibles) at £46.8 million increased by 30% over the previous year. This was driven by good performance from the underlying business combined with the positive effect of this year's acquisitions (Wyvern and Skipaway) and the full year effect of last year's acquisition (Brett). In the six years since 2000/01, operating profit before amortisation of intangibles has grown by a compound average of 24% per annum. This year, around 12% has been organic with the remainder being from acquisitions. Profit before tax (PBT) at £27.6 million was 26% up on the previous year. This consistent strong financial performance reflects the success of Viridor's focused strategy.

The pie chart below provides a breakdown of Viridor's profit contribution by segment (before amortisation of intangibles and central overhead costs). Landfill and power generation, the first two legs of the strategy outlined above, currently account for 76% of the profit contribution.

In May 2006, as noted in last year's Annual Report, Viridor completed the acquisition of Wyvern Waste Services Limited from Somerset County Council for £25 million as part of a 25 year Public Private Partnership (PPP) contract with the County. This acquisition is now fully integrated and was earnings enhancing at PBT level (after amortisation of intangibles) in its first 10 months – a particularly strong result.

Construction of the Lakeside energy from waste (EFW) plant (in joint venture with Grundon Waste Management Limited), also reported last year, continues on schedule with the plant due to open in the second half of calendar 2008

In February 2007, Vindor acquired Skipaway Holdings Limited for £14.7 million. This acquisition comprises three transfer stations with associated waste collection and recycling in Kent. It fits well with the activities of Brett which Vindor acquired last year.

Landfill inputs excluding cover were 9% higher in 2006/07 compared with the previous year, at 4.7 million tonnes. Excluding the effect of acquisitions, underlying landfill volumes were unchanged. Average revenues per tonne increased by 7% and margins continued to improve (to over £6 per tonne). Consented landfill void grew from 87 million cubic metres last year end to 90 million cubic metres at 31 March 2007. This reflected acquisitions (5 million cubic metres) and planning gain at four sites (4 million cubic metres), less usage in the year (6 million cubic metres).

Vindor's landfill gas power generation output increased by 15% to 423 Gigawatt hours (GWh). Reflecting the general increase in underlying energy prices and the renewable premium in the UK, Vindor's average revenues per Megawatt hour increased by 4% to £62 (though current prices in 2007/08 are lower). At 31 March 2007, Vindor's landfill gas power generation capacity was 75MW compared with 61MW at the previous year end (both figures exclude a small amount of sub-contract capacity).

Vindor continues to explore suitable Private Finance Initiative (PFI)/Public Private Partnership (PPP) opportunities as part of its overall strategy. In January 2007, Greater Manchester Waste Disposal Authority announced that the Vindor Waste Management Limited/John Laing Infrastructure Limited consortium had been selected as preferred bidder for its 1.4 million tonnes per annum 25 year waste management services contract. Final negotiations are under way with the contract due to commence in the current financial year. At the same time Vindor is one of Greater Manchester's nominated landfill contractors for five years from 2008.

The Government's target of diverting municipal waste from landfill up to 2020 may be expected over time to lead to a decline in the landfill market. However, with only around six years' consented capacity in the UK as a whole (Environment Agency estimate) and new consents difficult to achieve, Vindor's 90 million cubic metres is likely to become an increasingly valuable resource. Whilst open-market renewable energy prices in 2007/08 are below 2006/07 peaks, as the UK increasingly relies on imports of energy and seeks to grow its output of renewables, Vindor's gas business is also expected to remain a valuable asset. Meanwhile, the need for councils to achieve their diversion targets creates attractive opportunities for PFI/PPP contracts such as Vindor's with West Sussex and Somerset and, subject to contract, with Greater Manchester, and for facilities such as the Lakeside EFW plant.

## ■ BUSINESS AND STRATEGY

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

Vindor'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 (including PFI/PPP contracts and integrated waste management contracts)

Map here

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

The amount of biodegradable municipal waste in the UK as a whole going to landfill is expected to decline. This is a result of the measures taken by the Government to encourage recycling and comply with the requirements of the EU Landfill Directive. Municipal waste volumes comprise around one third of Vindor's landfill market. However, 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 greenfield sites. In view of the above, Vindor believes that consented landfill void is an increasingly valuable asset.

Vindor is one of the largest landfill site operators in the UK with a total consented landfill capacity of approximately 90 million cubic metres at 31 March 2007. The company is at present filling this at a rate of approximately 6 million cubic metres per annum which results in an average remaining life of 15 years at current rates of fill – significantly longer than the industry as a whole. This capacity is located as shown on the map above.

Gas produced from decomposing waste on landfill sites is increasingly used to generate electricity. It is a form of renewable energy and now represents around 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 a little over 4% to a target of 10% in 2010 and 15% in 2015, with an aspiration of 20% in 2020. Historically, renewable energy projects were supported by the Government through the non fossil fuel obligation (NFFO) scheme. Fixed price Retail Price Index (RPI) contracts with terms of up to 15 years were awarded to the most competitive renewable projects in five tranches of bidding. In April 2002, the NFFO regime was replaced by the renewable obligation certificates (ROCs) regime. The overall price for electricity supplied under ROCs is currently higher than that achieved under the most recent NFFO scheme. This has facilitated the increasing of Vindor's total generation capacity to a current 75 MW at 31 March 2007, compared with 28MW in March 2002. 50% of this is under NFFO and 50% ROCs.

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

In pursuing its strategy, Vindor 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 11 acquisitions in the waste sector for an aggregate consideration of approximately £190 million. They have been integrated into the Vindor group.

## ■ REGULATORY AND 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 around one third of Vindor's landfill market.

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 allowances under the Landfill Allowance Trading Scheme (LATS). 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 of 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 increasing to £2.50 from 1 April 2008. A standard rate of £24 per tonne applies to all other taxable waste which is due to rise by £8 per tonne per annum to reach a level of £48 per tonne in 2010/11.

#### **Planning for landfill sites and waste and recycling infrastructure**

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 sites (and hazardous waste facilities) also require a Pollution Prevention and Control (PPC) permit from the EA.

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

Planning applications are subject to rigorous assessment by local authorities who will consider them against the backdrop of policies contained within waste local plans that have been compiled for their areas. Applications have to address a wide range of issues and the EA is a statutory consultee in this process.

#### **Integrated municipal waste management contracts and the role of Private Finance Initiatives (PFIs) or Public Private Partnerships (PPPs)**

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 and recovery, waste transfer and bulk transport and final disposal (both incineration and landfill).

In a number of instances, these will be financed under PFI arrangements where local authorities apply to the Government for funding of 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.

Councils may also choose to let long-term contracts using PPP arrangements. Under this, they forego the complexities of securing PFI credits. From the waste management contractor's point of view, the nature of the contract is very similar whether it is a PFI or a PPP.

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

Viridor has been operating a PFI contract with West Sussex County Council since April 2005.

In May 2006, Viridor signed a 25 year PPP with Somerset County Council, at the same time acquiring Somerset's Local Authority Waste Disposal Company (LAWDC), Wyvern Waste Services.

In February 2007, a joint venture between Viridor and John Laing Infrastructure Limited was chosen as preferred bidder for the Greater Manchester Waste Disposal Authority PFI and, subject to contract, operations are expected to commence later this year.

Viridor 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 continue seeking 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 the Scottish Environment Protection Agency (SEPA) monitor performance against permit conditions and general environmental law. Breaches are subject to prosecution. The EA and SEPA can also require the operator to undertake upgrades to ensure future compliance and, where a pollution incident has occurred, 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.

**KEY PERFORMANCE INDICATORS**

The Key Performance Indicators (KPIs) used by the Directors to assess the performance of Viridor against stated objectives are as follows

**Profit before interest, tax and amortisation of intangibles (PBITA) and profit before taxation (PBT)**

PBITA and PBT are key measures of Viridor’s performance and are set out in the table below for the seven year period 2001 to 2007. The table also sets out the Compound Annual Growth Rate (CAGR) for these measures, being the rate of growth between 2001 and 2007 expressed as a single average figure over the period.

Year ended 31 March	2001* £m	2002 £m	2003* £m	2004* £m	2005 £m	2006 £m	2007 £m	CAGR 2001 – 07
Operating profit before intangibles amortisation	13.1	15.2	19.1	22.7	30.0	35.9	46.8	24%
Profit before taxation	11.7	13.5	14.2	14.7	20.1	21.9	27.6	15%
Return on equity investment after corporate overheads	6.1%	7.1%	7.4%	7.5%	10.3%	10.6%	13.3%	–

\*UK GAAP

**Consented landfill void**

As at 31 March 2007, Viridor had a consented void capacity of 90 million cubic metres. This can be reconciled with the disclosed consented void capacity in last year’s Annual Report, as follows:

	million cubic metres
As at 31 March 2006	87
Planning gains (net)	4
Acquisition	5
Used in the period	(6)
As at 31 March 2007	90

Graph here

**Return on equity investment**

Return on equity investment is calculated as PBT expressed as a percentage of Pennon Group’s equity investment in Viridor (£207 million at 31 March 2007).

**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 2007, Viridor had 75MW of generating capacity, an increase of 14MW over the year. (These figures exclude 3MW of sub-contract capacity in Suffolk).

Graph here

**CORPORATE RESPONSIBILITY/RELATIONSHIPS**

**EMPLOYEES**

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

Viridor is pursuing a number of occupational health and safety initiatives. It currently has six sites accredited to the OHSAS18001 international health and safety standard and is planning to extend this across further sites. All other sites are covered by the company’s Environmental Management System (EMS) (most accredited to ISO14001), which is the vehicle for delivering health and safety standards and procedure.

Viridor's reportable accident rate per 1,000 employees is an important KPI and is set out below for the five year period 2002 to 2006. It was 18.18 in 2006 compared with 18.10 in 2005. Despite comparing favourably with industry averages, Viridor's focus on health and safety improvement and performance remains strong. The company has recruited additional health and safety professionals during the year and continues to raise the level of training and support available to its staff.

Graph here

Regrettably the company suffered its first health and safety prosecutions during 2006. An accident at Beddington Landfill near Croydon led to a prosecution under the Management of Health and Safety at Work Regulations 1999, for the failure to conduct an adequate risk assessment. The company was fined £2,500 plus costs. Following an accident in 2004 where two employees were struck by a wheel loading shovel, the company was fined £100,000 for breaches of the Health and Safety at Work Act 1974, in that it did not adequately have in place systems and procedures to protect the health and safety of its employees at Bargeddie in Glasgow. The company has learnt key lessons from these incidents and continues to strive to raise health and safety awareness and improve its performance.

## ■ ENVIRONMENT

The most significant positive environmental impacts of Viridor'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 for energy generation or flared), leachate production and potential local impacts such as dust, noise, litter and odour.

Viridor developed 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, resulting in continuous improvement in environmental performance. Viridor was the first UK waste company to achieve ISO 14001 accreditation across all major operational sites and has 50 accredited centres covering 138 operational facilities as at 31 March 2007. It has also played a leading role in developing and reporting against the environmental performance indicators for the waste industry as promoted by the Green Alliance.

The amount of waste recycled by the company increased over the year to 1.1 million tonnes (0.9 million tonnes in 2005/06).

## ■ SOCIAL AND COMMUNITY ISSUES

Landfill (and many other facilities) require waste management licences or PPC permits, issued and monitored by the EA. Viridor maintains a positive working relationship with the EA, proactively liaising on, and managing issues at, both a site-specific and strategic level.

A 'good neighbour' policy is implemented at all facilities managed by Viridor with local liaison groups at most major sites 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, the relevant planning authority and other key local stakeholders.

## ■ KEY CONTRACTUAL AND OTHER ARRANGEMENTS

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

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

## ■ RISKS AND UNCERTAINTIES

### 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), restoration and aftercare costs (see below), leachate management, landfill gas management and general site management. Companies such as Viridor with landfills engineered to modern standards and which 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.

Landfill sites are filled and restored on a cell by cell basis. Final restoration, in accordance with the planning permission, and aftercare of the site, takes place after site closure. The costs related to aftercare are expected to continue for around 30 years post closure. These costs are best estimates based on Viridor's own extensive experience and they are updated at each stage of the capital expenditure programme. Nevertheless, as with any estimate of future costs, there is a risk that circumstances may change which may affect the level of those costs.

The costs are charged on a landfill usage basis, i.e. per tonne input. This is calculated by dividing the total expected cost by the number of tonnes expected to be input into the site up to its closure. This number is derived from the remaining void space, as estimated by external consultants, and estimated compaction rates (tonnes per cubic metre). These are best estimates, based on current information, which are reviewed every year. However, to the extent that tonnages are over or underestimated, there is a risk that the amount provided may be too high or low.

Municipal waste contracts typically last for a number of years. They usually have price increases under formulae related to inflation as measured by the RPI in the UK 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's experience over several years is that prices in general have risen fast enough at least 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.

**The UK Government's Waste Strategy, stemming from the Landfill Directive, may lead to a reduction in volumes of waste being disposed to landfill. The Government's Waste Strategy is currently under review and includes targets for diversion of municipal waste from landfill and increases in landfill tax as previously announced.**

Viridor focuses on the landfill disposal of municipal, industrial and commercial, construction and demolition waste. Of this, around 30% (or 20 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.

Existing Government initiatives are having an impact and the amount of municipal waste being disposed to landfill is now declining. Assuming the EU Landfill Directive targets are met, the total amount of municipal solid waste (MSW) which will 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.

Viridor has seen its underlying landfill volumes holding steady, perhaps reflecting an increase in its share of the landfill market. However, the combined effect of the various Government measures is likely to reduce the total amount of waste being landfilled in the UK in the future.

**Not all landfills may meet the standards of the Integrated Pollution Prevention and Control 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 permitting regime pursuant to the Pollution Prevention and Control (England and Wales) Regulations 2000 (PPC Regulations). Existing landfills opened before July 2001 operated under waste management licences but now require a PPC permit granted under the PPC

Regulations. PPC permits often impose higher standards and costs in general. Any landfills that fail to obtain a PPC permit would need to be subject to a closure plan with the EA or SEPA.

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

All but one of Viridor's operational landfills have achieved PPC permits, though in some cases we are appealing against certain of the conditions proposed, which might have cost or other implications for the landfills. The operational landfill which has not yet received a PPC permit is currently due to close in two years' time. Viridor is in the process of applying for a PPC permit for one new landfill and whilst it is expected that this application will be successful, the company cannot prejudge the regulator's conclusions.

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.

#### Pricing and other risks relating to renewable energy

Renewable energy prices under the current ROCs scheme are primarily a function of the underlying 'brown' energy price and the premium achieved from the sale of ROCs.

Underlying 'brown' energy prices rose significantly in 2006/07 reflecting the general energy supply/demand position in the UK and worldwide. Brown energy prices have fallen back significantly to date in 2007/08 and will affect Viridor's performance in the current year as, in line with its current policy, it has sold energy one year ahead. 'Brown' energy prices will continue to be determined by the world and UK energy market and may go down as well as up. Any changes in underlying energy prices will directly affect Viridor's revenues when its sales contracts come up for renewal.

Without a pricing mechanism such as ROCs, further investment in renewables energy generation 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 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 pricing mechanism.

In its recent consultation on the ROCs regime, the Government concluded that new landfill gas schemes starting from 2009 onwards will have reduced eligibility for ROCs. It is now consulting further on the details of this proposal. However, this is not expected to affect Viridor's existing schemes which are likely to form the bulk of its output.

The value of ROCs is increased by the sharing of the buy-out price monies among holders of ROCs. The value of a ROC depends on the supply of renewable electricity relative to the UK's annual increasing targets. If large amounts of renewable energy generating capacity gained planning permission and commenced operations there is a risk that the value of a ROC would decline. The value of ROCs is also 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 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, as 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 reduce, affecting the 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.

#### **Lakeside EfW construction and technical risks**

The Lakeside joint venture involves building a 400kt waste to energy plant at a cost of circa £160 million and operating it for 25 years. 86% of the project is funded by non-recourse bank debt which limits the risk to Pennon Group. The remainder is funded by the joint venture, of which Viridor has 50% of the equity.

The plant is a modern conventional waste to energy facility. As a result of a competitive procurement procedure it is being supplied by the Japanese consortium Itochu/Takuma. There is a significant number of similar plants operating successfully worldwide.

It is being supplied in accordance with a fixed price contract which was drawn up with the assistance of specialist external consultants. Nevertheless, as with any major infrastructure project, unforeseen circumstances may arise which may affect the construction process.

Efficiencies and output of the plant will be affected by the precise calorific value of the waste throughput. The plant is well proven and it is a robust conventional technology designed to take the currently projected waste mix. Nevertheless, if the mix of the waste changes significantly over the next 25 years, there may be some impact on efficiencies and output.

#### **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 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 recognises that there is a risk of losing staff to competitors and seeks to address this by its employment policies.

#### **Risks associated with long-term integrated contracts**

Any long-term integrated contract has a range of risks associated with it. Indeed, risk transfer is a key part of Government PFI procurement guidelines. The risks include waste volumes and mix, planning technology, input costs and recycle prices. A careful assessment of the risks and apportionment of them between client, main contractor, technology and equipment suppliers, and sub-contractors is a key part of the process of bidding and finalising a contract.

As noted above the Viridor/Laing joint venture is preferred bidder for the Greater Manchester PFI. Final contractual negotiations are not yet complete.

Viridor seeks to protect itself against the risks in such contracts in the first instance by doing extensive due diligence, typically using a combination of external advisers and in-house experts, so that risks are correctly identified.

Viridor will then seek to protect itself against the risks identified through contractual documentation with its client, subcontractors and sub-suppliers. The degree it does so depends of course on the other parties' attitude to risk transfer and on the specific commercial situation.

To the degree that Viridor is not able to (or chooses not to) cover off all the risks identified in the contractual documentation, then it includes in its price an assessment of a reasonable return for accepting such risks. Viridor takes a robust approach on this issue. If it cannot cover off the risks satisfactorily or cannot get a reasonable commercial return for taking such risks, its policy is to accept the loss of such a contract rather than win it on unsatisfactory terms.

Whilst Viridor's policy on such risks is careful and robust, there remains a risk that Viridor's commercial assessment will not be satisfactory and the results from such contracts will be adverse.

## PENNON GROUP

David Dupont  
Group Director of Finance  
Pennon Group Plc

### THE GROUP'S FINANCIAL RESULTS SHOWED GROWTH IN BOTH REVENUE AND PROFIT BEFORE TAX FROM CONTINUING OPERATIONS

#### ■ ANALYSIS OF THE GROUP'S FINANCIAL PERFORMANCE

##### Revenue and operating profit

Revenue rose by 15.9% to £748.3 million

Group operating profit before intangibles amortisation increased by £25.1 million (before exceptional items of £14.5 million in 2005/06 relating to financial restructuring)

Group earnings before interest, taxation, depreciation and intangibles amortisation (EBITDA) increased to £315.5 million (2005/06 £279.2 million) including South West Water £234.5 million (2005/06 £213.4 million) and Vindor £82.8 million (2005/06 £66.7 million)

Total Group operating costs were £548.3 million (2005/06 £470.6 million) and included the following major categories of expenditure

	£m
Depreciation and intangibles amortisation	115.5
Landfill tax	98.2
Manpower	91.0
Transport	28.7
Power	21.0
Property	20.5
Raw materials and consumables	19.9
Abstraction and discharge consents	7.5
Lease rentals – plant and machinery	7.2
Statutory operating licences and royalties	5.7

Revenue from power generation of £27.2 million significantly exceeded power costs

## Finance costs

Net interest payable was £69.2 million (2005/06 £64.3 million before net exceptional costs of £42.3 million) and was 2.9 times covered by Group operating profits (2005/06 2.7 times)

2005/06 exceptional interest costs were

- costs of £50.2 million relating to the financial restructuring which involved the capital return to shareholders and the retirement of the £150 million 10.625% Bond (due 2012)
- £7.9 million proceeds arising from a consent fee received upon the sale of finance leases between financial institutions

Gross interest payable was £98.3 million. Gross interest receivable of £29.1 million included £7.0 million from the investment of temporarily surplus funds.

Net interest payable represents a rate of 4.6% when measured against average net debt (2005/06 5.1%) and demonstrates the Group's effective management of interest rates.

## Profit before tax

Profit before tax was £131.1 million, £20.2 million up on 2005/06 (before net exceptional costs in 2005/06 of £56.8 million), an increase of 18.2%

## Taxation

The corporation tax charge for the year was £23.9 million (2005/06 £14.8 million before tax relief on the exceptional items of £18.7 million). The deferred tax charge for the year was £13.3 million (2005/06 £20.2 million).

## Earnings per share\*

Earnings per share before deferred tax and exceptional items increased by 20.2% to 30.3p. Basic earnings per share increased from 9.9p to 26.5p. Of the total increase of 16.6p, 10.0p was attributable to the exceptional items in 2005/06.

## Dividends and retained earnings\*

The Directors recommend the payment of a final dividend of 12.7p per share for the year ended 31 March 2007. Together with the interim dividend of 5.85p per share paid on 11 April 2007, this gives a total dividend for the year of 18.55p per share, an increase of 7.8% compared with 2005/06.

Proposed dividends of £66.0 million (2005/06 £61.0 million) are covered 1.6 times (2005/06 1.6 times) by profit after tax (before deferred tax). Dividends are recognised in retained earnings in the year in which they are paid.

The profit of £93.9 million has been transferred to reserves.

## Dividend policy and shareholder returns

The Group is committed to a progressive dividend policy of 3% per annum increase in real terms until 2009/10.

In December 2005, Pennon announced its decision to move South West Water to a more highly-g geared structure to enhance the Group's capital efficiency. As a consequence of this, a capital return was made to shareholders by way of a B Share with an associated share consolidation. The Company completed the redemption of the outstanding B Shares for a total of £5.7 million in April 2006. Accordingly circa £145 million has now been returned to shareholders through a B Share issue.

\*Amounts per share for 2006 are restated to reflect the three for one share split in July 2006.

## ■ SUBSIDIARY COMPANY FINANCIAL PERFORMANCE

Details of the financial performance of South West Water and Viridor are set out in the Business Review on pages 4 to 21

## ■ GROUP INVESTMENT

Capital expenditure by the Group on property, plant and equipment was £245.1 million (2005/06 £249.7 million). The major categories of expenditure comprised

South West Water	£m
Water mains	45
Water treatment works	25
Waste water treatment works and sludge	42
Sewerage	26
<b>Viridor</b>	<b>£m</b>
Landfill	33
Power generation	5
Collection	3
Contracts	11
Other	9

In addition, the capital expenditure in the Lakeside joint venture was £26 million

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

### Share capital

The Company completed the redemption of the outstanding B shares for a total of £5.7 million in April 2006. Accordingly circa £145 million has now been returned to shareholders through a B share issue

Permission was obtained from shareholders at the Annual General Meeting in July 2006 to effect a sub-division of the Company's ordinary shares by way of a three-for-one split.

The weighted average number of shares in issue during the year was 353.9 million (2005/06 381.9 million after adjusting for the share split)

The value of net assets per share at book value at 31 March 2007 was 176p

Permission was obtained from shareholders at the Annual General Meeting in July 2006 to purchase up to 10% of the Company's ordinary share capital. During the year £3.5 million of shares were repurchased. Renewal of the authority will be sought at the July 2007 Annual General Meeting

## ■ CAPITAL STRUCTURE

### Overall position

With year end net debt of £1,557 million, the Group year end debt to equity plus debt ratio was 71% (2005/06 71%)

The borrowing powers of the Directors are limited to two and a half times adjusted capital and reserves, as defined in the Company's Articles of Association. At 31 March 2007, the limit was £2.3 billion. The Directors confirm that the Group can meet its short-term requirements from the existing borrowing facilities without breaching covenants or other borrowing restrictions

### South West Water

South West Water's debt to Regulatory Capital Value (RCV) was 62% at 31 March 2007 (2005/06 62%), within Ofwat's 'optimum range' of 55% – 65%. The scale of the remaining K4 investment programme means that this ratio is expected to remain relatively stable up to 2010

### Viridor

Viridor is funded by a combination of Pennon Group equity and debt (raised by Pennon Group) and direct borrowing by Viridor. At the year end, Viridor's net debt stood at £257 million (March 2006 £201 million), equivalent to 3.1 times EBITDA (2005/06 3.0 times)

## ■ 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 2007, loans and finance lease obligations were £1,685 million and the Group held cash and deposits of £128 million

During 2006/07 the following finance initiatives were implemented

- £180 million finance lease extended by 20 years
- £100 million 4.13% private placement issued
- £85 million finance lease drawdown for water mains rehabilitation

In addition, the Group secured £10 million additional term loans and £45 million additional revolving credit facilities

Pennon Group debt has a maturity of 0 – 35 years with average maturity increasing during the year from 12 to 16 years as a result of the initiatives above

The major components of debt finance are

- finance leasing – £1,082 million, of which £135 million is index-linked
- bank bilateral debt – £258 million
- European Investment Bank loans – £232 million
- private placement – £100 million

#### Interest rate management

Net interest costs of £69 million equated to an average interest rate of 4.6% for the Group. South West Water's average interest rate equated to 4.3%.

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. The Group has taken advantage of relatively low interest rates to fix 60% of existing net debt up to 31 March 2008, and 70% up to 31 March 2010. In addition South West Water has index-linked 10% of its current net debt up to 2041. The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and are not, therefore, an exposure for the Group. These instruments are analysed in more detail in note 22 to the financial statements.

#### 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.

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. All deposits are with counterparties that have a credit rating approved by the Board.

#### CASHFLOWS

The net cash inflow from operating activities was £305 million (2005/06 £232 million). Capital expenditure cash outflow in 2006/07 was £251 million, an increase of £32 million from £219 million in 2005/06. The net cash outflow for acquisitions was £37 million (2005/06 £41 million). Equity dividends paid of £61 million and net interest paid of £51 million totalled a cash outflow of £112 million (2005/06 £140 million).

Group net debt increased from £1,427 million at 31 March 2006 to £1,557 million at 31 March 2007.

Cash and cash equivalents increased by £32 million to £112 million compared with a £40 million decrease in 2005/06.

#### 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.

#### KEY PERFORMANCE INDICATORS

The Directors assess the financial performance of the Group through

##### *Profit before tax (PBT)*

PBT before exceptional items has grown by 15.3% CAGR over the five year period.

Graph here

##### *Earnings per share (EPS)*

EPS before exceptional items and deferred tax has grown by 13.4% CAGR over the five year period.

Graph here

## ■ CORPORATE RESPONSIBILITY

Pennon Group endeavours to achieve the appropriate balance between all its stakeholders, the environment and the needs of the Group. It has a social and ethical policy which covers the key areas of finance, employees, customers and suppliers, community, management responsibility and communications.

A key objective of the Group is to uphold its reputation for integrity and fair dealing, which it considers is essential to the long-term well-being of the Group and its key stakeholders.

The Group also has a 'Whistleblowing' policy which 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. This policy is reviewed regularly.

## ■ THE ENVIRONMENT

Significant highlights of the year for the Group were:

- as a major generator of renewable energy, in 2006/07 Group companies produced 460GWh (437GWh in 2005/06) the equivalent of 154% of energy consumed. The Group was a net exporter of energy for the eighth successive year. This supports the Government's objective to reduce greenhouse gas emissions.
- listed as a constituent of the FTSE4Good Index.
- in the Business in the Community Environmental Index 2006, the Group's overall score improved from 92.97% to 97.13%, and the Group was the only FTSE 250 company included in the highest scoring 'platinum' rank of 25 companies.

- the Group passed the stringent criteria in the Orange SenSe Fund, which observes business conduct and socio-environmental practice, and demonstrates good Socially Responsible Investment (SRI) practice.

Sound environmental performance is critical to the success of both South West Water and Vindor. The Group has a long established environmental policy, as set out in its annual Corporate Responsibility Report which will be available on the Group's website – [www.pennon-group.co.uk/CR](http://www.pennon-group.co.uk/CR) by the end of July 2007.

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

## ■ EMPLOYEES

The success of the Group depends to a significant extent on the businesses' ability to attract and retain appropriately qualified and motivated employees. The Company seeks to provide them with a safe working environment and give them the necessary training and development to fulfil their roles.

## ■ SOCIAL AND COMMUNITY ISSUES

The Group is committed to supporting the communities in which it operates. It does this by carefully targeted sponsorship and charitable donations to social and community groups, further details of which can be found in the Group's Corporate Responsibility Report (available end of July 2007).

## ■ KEY CONTRACTUAL AND OTHER ARRANGEMENTS

The majority of the Group's debt is raised by:

- finance leasing
- European Investment Bank loans
- bank bilateral facilities
- private placements

Pennon Group Plc and South West Water Limited each have their own standard covenant packages which are included in the majority of the debt facilities. The standard financial covenant package is based on gearing and interest cover covenants.

Redemption penalties included in the facility documentation can be invoked if debt facilities are redeemed early. The redemption penalties vary in each facility.

## ■ RISKS AND UNCERTAINTIES

### **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 produce sustainable earnings growth. This is dependent upon the correct strategies 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 Vindor and intends to continue to create shareholder value through its strategic focus on water and waste water services and waste management.

### **Pension costs may increase due to factors outside the Group's control**

The Group has defined benefit pension schemes for existing staff of Pennon and South West Water, and for certain employees of Vindor. Pennon Group set up a defined contribution scheme in July 2003 for new entrants to Vindor and employees from certain acquired waste companies. Employer costs were reduced from 1 April 2006 through the closure of the existing defined benefit scheme to new entrants (replaced by a new scheme with reduced benefits) and an increase in employee contributions.

The last actuarial valuation of the Group defined benefit schemes was undertaken at 1 April 2004. The Group pension schemes had net liabilities at 31 March 2007 of £41 million (2006 £42 million). Sound investment performance, an increase in the market interest rate used to discount liabilities, plus a further £9 million prepayment of employer contributions in September 2006 have been offset by an increase in liabilities of which £16 million arises from the use of an updated longevity assumption for pensioners. A full actuarial valuation is being undertaken as at 1 April 2007. The net liabilities (after deferred tax) represent circa 1.3% of the Group's total market capitalisation as at 31 March 2007.

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. 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, which 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. The Group's insurance brokers assist in sourcing appropriate insurance cover from insurance companies that have good credit ratings.

### **Financial covenants**

The financial covenants included in the Group's debt facilities are monitored on a regular basis. The financial covenants offered by the Group include a provision to re-test the covenants applying to Frozen GAAP accounting standards. This is to protect the Group from changes in accounting standards that may have a detrimental impact on the financial covenant testing methodology.

## ■ INTERPRETATION

### ■ LANDFILL VOID SPACE AND POWER GENERATION CALCULATIONS

The landfill void space figures quoted in this review in relation to Vindor are in respect of consented void only (void with planning permission for landfilling)

The void space figures are based upon Vindor'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, Vindor 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 Vindor 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.

## ■ FORWARD LOOKING STATEMENTS

This Business Review 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 Business Review, 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 sections entitled 'Risks and uncertainties' on pages 10 to 13, 19 to 21 and 27.

■ GLOSSARY

The following are descriptions of some of the terms used in this Business Review

BMW	Biodegradable municipal waste
CAGR	Compound Average Growth Rate, being the rate of growth over a period, expressed as a single average figure
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
EFW	Energy from Waste
EMS	Environmental Management System developed by Vindor
GWh	Gigawatt hours
HWRS	Household waste recycling sites
IFRS	International Financial Reporting Standards
Interim Determination or 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
KPIs	Key Performance Indicators
K3	Periodic Review period 2000 – 2005 for South West Water
K4	Periodic Review period 2005 – 2010 for South West Water
LATS	Landfill Allowance Trading Scheme
LAWDC	Local Authority Waste Disposal Company
ML	Megalitres
ML/d	Megalitres per day
MSW	Municipal solid waste
MW	Megawatts
MWh	Megawatt hours
NFFO	Non Fossil Fuel Obligation
Ofwat or water regulator 'percentage population equivalent'	Water Services Regulatory Authority  Waste water treatment works loadings from domestic, industrial and diffuse sources, averaged and stated as a population equivalent load, expressed as percentage
Periodic Review	The process of determining the water industry's price limits and expenditure plans for five-year regulatory periods
PFI	Private Finance Initiative
PPC	Pollution, Prevention and Control
PPP	Public Private Partnership
RCV	Regulatory Capital Value
RIDDOR	Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (1995)
RPI	The UK Government's Retail Price Index
ROCs	Renewable Obligation Certificates
SEPA	Scottish Environment Protection Agency
UK GAAP	United Kingdom Generally Accepted Accounting Principles
Vindor	Vindor Limited (subsidiary of Pennon Group Plc) or, depending on the nature of the activity referred to, Vindor Limited's operating subsidiary, Vindor Waste Management Limited

## ■ OTHER STATUTORY INFORMATION

### ■ PRINCIPAL ACTIVITIES AND BUSINESS REVIEW

The principal activities of the Company and its subsidiaries ('the Group') continue to be the provision of water and waste water services and waste management. 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 Business Review set out on pages 2 to 21 of this Directors' Report. In addition, the Business Review contains a fair review of the business of the Group, key performance indicators and a description of the principal risks and uncertainties facing the Group in accordance with the requirements of Section 234ZZB of the Companies Act 1985 as well as further information on employee, environmental, social and community matters, reflecting the requirements of Section 417 of the Companies Act 2006 (due to come into force on 1 October 2007)

The principal subsidiaries of the Company are listed in note 38 to the financial statements on page 90

### ■ FINANCIAL RESULTS AND DIVIDEND

Group profit on ordinary activities after taxation was £93.9 million. The Directors recommend a final dividend of 12.7p per ordinary share to shareholders on the register on 10 August 2007, making a total for the year of 18.55p, the cost of which will be £66.0 million, leaving a retained surplus of £27.9 million. The Business Review on pages 2 to 29 analyses the results in more detail and sets out other financial information, including the Directors' opinion on asset values (page 24)

### ■ DIRECTORS

Bob Baty retired as Chief Executive of South West Water Limited and from the Board on 31 July 2006. Chns Loughlin was appointed as Bob Baty's successor and as a Director on 1 August 2006.

Following his appointment by the Board, Chns Loughlin is due to retire and offers himself for election at the Annual General Meeting. Gerard Connell is also due to retire at the Annual General Meeting and offers himself for re-election. In addition, as Ken Harvey has now been a Director for over nine years, in accordance with the Combined Code he now offers himself for re-election annually. Resolutions for the above Directors' election or re-election (as appropriate) 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 36. Further details relating to the Directors and their service contracts or contracts for services are set out on pages 33 to 39 and details of the Directors' interests in shares of the Company are given on pages 38 and 39.

### ■ STATEMENT AS TO DISCLOSURE OF INFORMATION TO AUDITORS

- (a) So far as each of the Directors in office at the date of the signing of the report are aware, there is no relevant audit information of which the Company's auditors are unaware, and
- (b) each of the Directors has taken all the steps each Director ought to have taken individually as a director in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

### ■ FINANCIAL INSTRUMENTS

Details of the financial risk management objectives and policies of the Group and the exposure of the Group to price, credit, liquidity and cash flow risks are set out in the Business Review on pages 24 and 25.

### ■ EMPLOYMENT POLICIES AND EMPLOYEE INVOLVEMENT

The Group has a culture of continuous improvement through investment in people at all levels within the Group. The Group 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, applications for employment are welcomed from disabled persons and special arrangements and adjustments as necessary are made 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 their employer. 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 both an Inland Revenue approved sharesave scheme and a Share Incentive Plan.

Further information relating to employee matters is set out in the Business Review on pages 9, 10, 18, 19 and 26.

### ■ RESEARCH AND DEVELOPMENT

Research and development activities within the Group involving water and waste treatment processes amounted to £0.1 million during the year (2005/06 £0.1 million).

## ■ DONATIONS

During the year, donations amounting to £49,600 were made. Details relating to charitable and other donations will be set out in the Corporate Responsibility Report which will be available at the end of July 2007. 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

It is the Group's payment policy for the year ending 31 March 2008 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](http://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 2006/07 and the amount owed to its trade creditors at 31 March 2007, was 17 days.

## ■ PURCHASE OF OWN ORDINARY SHARES

The Company completed the redemption of the outstanding B Shares for a total of £5.7 million in April 2006. Accordingly circa £145 million has now been returned through a B Share issue. Details of the B Share Scheme were set out in the Circular to Shareholders dated 23 January 2006.

The Company has authority from shareholders to purchase up to 10% of its own ordinary shares (as renewed at the Annual General Meeting in 2006) which was valid as at 31 March 2007 and remains currently valid. In connection with the return of cash to shareholders as set out in the Circular to shareholders dated 23 January 2006, the Company during 2006/07 purchased from the market for cancellation 785,000 (part adjusted for three for one share split) ordinary shares (40 p) at a cost of £3.5 million amounting to approximately 0.22% of its issued ordinary shares. Since the year end the Company has purchased from the market up to and including 13 June 2007 a further 376,800 ordinary shares at a cost of £2.35 million amounting to approximately 0.11% of its issued ordinary shares (40 p). These shares are held in Treasury for the purposes of employee share schemes. In total, as at 13 June 2007, the Company has purchased 1,161,800 (part adjusted for the three for one share split) ordinary shares (40 p) at a total cost of £5.82 million amounting to approximately 0.33% of its issued ordinary shares (40 p).

A total of 459,386 (part adjusted for the three for one share split) ordinary shares (40 p) were also purchased during the year by the Pennon Employee Share Trust, Pennon Share Plans Guernsey Limited, for the Group Long-Term Incentive Plans. The total purchase price was £2.3 million and the shares amounted to approximately 0.13% of the Company's issued ordinary shares (40 p).

## ■ SUBSTANTIAL SHAREHOLDINGS

Details are set out in the Shareholder information section on page 95.

## ■ AUDITORS

PricewaterhouseCoopers LLP were appointed auditors until the conclusion of the eighteenth 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.

## ■ 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 13 July 2007 upon application to the Company Secretary at Peninsula House, Rydon Lane, Exeter EX2 7HR.

## ■ ANNUAL GENERAL MEETING

The eighteenth Annual General Meeting will be held at the Plymouth Pavilions, Millbay Road, Plymouth, Devon PL1 3LF on 26 July 2007 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 of the Company
- seek authority to make political donations under the Political Parties, Elections and Referendums Act 2000
- approve a new long-term incentive plan – the Pennon Group Performance and Co-ownership Plan
- elect Mr C Loughlin as a Director of the Company
- re-elect Messrs K G Harvey and G D Connell as Directors of the Company
- amend the Articles of Association to provide further for electronic communications with shareholders and to clarify the provisions relating to the retirement and the re-appointment of Directors.

Details of the resolutions are set out in the separate Notice of Annual General Meeting circulated to shareholders with this Annual Report.

By Order of the Board   
KEN WOODIER, Group General Counsel & Company Secretary  
22 June 2007

## BOARD OF DIRECTORS

### **Kenneth George Harvey** BSc, CEng, 66

#### *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 the senior independent non-executive director of National Grid Plc.

### **Colin Irwin John Hamilton Drummond**

MA, MBA, LTCL, CCMi, 56

#### *Chief Executive, Vinitor 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 chairman of the Sector's Knowledge Transfer Network and he is also Master of the Worshipful Company of Water Conservators.

### **David Jeremy Dupont** MA, MBA, 53

#### *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. He is a member of the CBI Environmental Affairs Committee and the CBI South West Regional Council.

### **Christopher Loughlin** BSc Hons, MICE, CEng, MBA, 54

#### *Chief Executive, South West Water Limited*

Was appointed on 1 August 2006. Chris was most recently chief operating officer with Lloyd's Register and previously was an executive director of British Nuclear Fuels Plc and executive chairman of Magnox Electric Plc. Chris started his career as a chartered engineer and subsequently held a number of senior positions with British Nuclear Fuels. He has been appointed vice chairman of Water UK from May 2007.

### **Gerard Dominic Connell** MA, 49

#### *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, 61

#### *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 Bank 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, 63

#### *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 chair of Groundwork North London and a director of several Trusts.

## COMMITTEES OF THE BOARD

### **Audit**

Gerard Connell (Chairman)  
Kate Mortimer  
Dinah Nichols

### **Corporate Responsibility (Replaced Environment in November 2006)**

Dinah Nichols (Chairman)  
Gerard Connell  
Colin Drummond  
Chris Loughlin  
Kate Mortimer

### **Nomination**

Ken Harvey (Chairman)  
Gerard Connell  
Kate Mortimer  
Dinah Nichols

### **Remuneration**

Kate Mortimer (Chairman)  
Gerard Connell  
Ken Harvey (from 1 June 2007)  
Dinah Nichols

### **Group General Counsel & Company Secretary**

Ken Woodier, Solicitor

### **Registered office**

Penninsula House,  
Rydon Lane,  
Exeter  
EX2 7HR  
Registered in England No 2366640

## ■ THE REMUNERATION COMMITTEE

The Remuneration Committee comprises three Non-executive Directors: Kate Mortimer, who chairs the Committee, Gerard Connell and Dinah Nichols. They are all regarded by the Company as independent. In addition, with effect from 1 June 2007 the Chairman of the Company, Ken Harvey, was appointed a member of the Committee. This is in accordance with the latest edition (June 2006) of the Combined Code, which acknowledges that a company chairman may also be a member of a remuneration committee if he was considered independent upon appointment as chairman.

The Committee's terms of reference includes advising the Board on the framework of executive remuneration for the Group and responsibility for determining the remuneration and terms of engagement of the Chairman, the Executive Directors and senior management of the Group. No Director or any other attendee participates in any discussion on, or determination of, his or her own remuneration.

During the year the Committee met on nine occasions and received advice, or services, that materially assisted the Committee in the consideration of remuneration matters from Ken Harvey (Chairman of the Company) and Ken Woodier (Group General Counsel & Company Secretary). In addition, the Committee received advice from the following advisors, who were appointed directly by the Committee:

- independent remuneration advisors, Deloitte & Touche LLP, on long-term incentive arrangements and remuneration structure generally,
- Allen and Overy LLP, solicitors, in providing legal advice on pensions. They also provide corporate legal advice to the Group, and
- pensions and remuneration consultants, Hewitt Bacon & Woodrow Limited, on executive pensions and calculating Total Shareholder Return for the Company's Restricted Share Plan. They also provide actuarial and investment pensions advice to the Group's Pension Trustee.

## ■ GROUP REMUNERATION POLICY

The policy of the Group, which will be applied by the Remuneration Committee in 2007/08 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 36 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 (or benefit in lieu), car benefit and health cover. In 2007/08 (subject to fluctuations in the Company's share price)

it is expected that around two thirds of Directors' potential direct remuneration (i.e. excluding pensions, car benefit and health cover) will be performance related (three fifths in 2006/07). It is intended that this balance between performance related and that which is not related to performance will continue.

Bob Baty (who retired on 31 July 2006) was, with the Board's consent, a non-executive director of the Royal Devon & Exeter NHS Trust during the year. For this appointment he received in 2006/07 up to the date of his retirement a fee of £4,000 from the Trust which the Board determined he could retain.

With effect from 2007/08, it is the intention of the Committee to introduce a shareholding guideline that Executive Directors and senior management shall hold a substantial personal shareholding in the Company. Executive Directors and senior management will be encouraged to build up their shareholding over a five year period to a value of at least one times basic salary.

**(i) Basic salary and benefits** – These are set out on page 36 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 generally available conducted by independent remuneration consultants and the performance of the individual Executive Directors which the Committee assesses with the advice of Ken Harvey, Chairman of the Company. In 2006/07 a higher than usual increase was made in basic salaries to seek to ensure the retention of key management because it was evident to the Committee from the analysis of independent remuneration consultants' salary surveys that, having regard to the size and complexity of the businesses of the Group compared to other companies within the same or similar sectors, remuneration of the Executive Directors had fallen to a significant extent below market practice. Other benefits, not mentioned below, include contributory pension provision (with four times salary life assurance cover) or a cash alternative, 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 for 2006/07 was 80% of basic salary with half of any bonus awarded being in the form of shares in the Company which must usually 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 maintaining continuous service with the Company, are considered appropriate by the Committee in view of the performance conditions applicable to achieve the initial award of the shares.

The maximum bonus achievable has been increased to 100% for 2007/08 following a review of remuneration by the Committee, based upon an executive director benchmarking review undertaken by Deloitte & Touche. More stretching performance targets have been introduced in respect of the increased bonus opportunity.

## DIRECTORS' REMUNERATION REPORT

The following corporate and individual objectives of the Executive Directors applicable to the performance related bonus award for 2007/08 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 2007/08)

### **Colin Drummond**

– A bonus of up to a maximum of 40% for outperformance of Group earnings per share against budget, up to 40% calculated by reference to outperformance of the profit before tax and net debt budgets of Vindor, and up to 20% for personal objectives relating to key business targets for Vindor

### **David Dupont**

– A bonus of up to a maximum of 40% for outperformance of Group earnings per share against budget, up to 40% for outperformance against budget relating to net debt and net interest of the Group and profit before tax of South West Water and Vindor, and up to 20% for personal objectives relating to Group financing and Group initiatives

### **Chris Loughlin**

– A bonus of up to a maximum of 40% for outperformance of Group earnings per share against budget, up to 20% for personal objectives relating to implementing South West Water's new strategies, and up to 40% 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, profit before tax and net debt budgets of the company, the position the company achieves in the 'Overall Performance Assessment' of water and sewerage companies established by the Water Services Regulatory Authority (WSRA), and the achievement of a range of service standards set for the company by the WSRA)

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 the Chairman of the Company, 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. The Executive Directors received a conditional award of ordinary shares in the Company up to a value of 75% of their basic salary on the basis that they provided 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. During 2006/07 no awards vested under the Plan for Executive Directors because they did not receive any awards in 2003 due to the existence of unpublished price-sensitive information at the time of the operation of the Plan. For each of the years 2004 to 2006 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*

If the TSR 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 and the 75th percentile positions will result in vesting in steps reflecting the number of companies within that third quartile of the comparator group.

The comparator group applicable for awards made during the year to 31 March 2007 was as follows, with the comparator group applicable to the award years for 2004/05 and 2005/06 being similar in content and size:

avg Plc (now de-listed)  
Bristol Water Holdings Plc (now de-listed)  
British Energy Plc  
Centrica Plc  
Dee Valley Group Plc  
International Power Group Plc  
Kelda Plc  
National Grid Plc  
Northumbrian Water Group Plc  
Pennon Group Plc  
Scottish & Southern Energy Plc  
Scottish Power Plc (now de-listed)  
Severn Trent Plc  
United Utilities Plc  
Vindian Plc (now de-listed)

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 TSR 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 50% of the other companies in the comparator group.

## DIRECTORS' REMUNERATION REPORT

The TSR of each company in the comparator group is measured by Hewitt Bacon & Woodrow assuming that all dividends are reinvested 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. No retesting of performance is permitted for any shares that do not vest after the three year performance period and any such shares lapse.

As mentioned in last year's Annual Report, with the Plan having now been operated for 10 years, new long-term incentive arrangements for Executive Directors and senior management have been considered by the Remuneration Committee with advice from independent remuneration consultants, Deloitte & Touche. Accordingly, a new Performance and Co-investment Plan is being proposed to shareholders at this year's AGM, details of which are set out in the Notice of Meeting.

**(iv) Other Share Schemes** – Executive Directors are entitled to participate in the Sharesave Scheme. It is an all-employee plan to which performance conditions do not apply. In addition, Executive Directors are entitled to participate in the Company's Share Incentive Plan (SIP), which is also an all-employee plan to which performance conditions do not apply.

**(v) Service Agreements** – In accordance with Company policy, all Executive Directors have service agreements subject to one year's notice and which are due to 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 (retired 31 July 2006)	26 February 1996
Colin Drummond	5 March 1992
David Dupont	2 January 2003
Chris Loughlin (appointed 1 August 2006)	16 May 2006

**(vi) Provision for Pension** – With the exception of Chris Loughlin, 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, the Executive Directors were provided with a pension which, dependent on length of service at normal retirement date, would normally amount to two thirds of final pensionable pay.

For service to 5 April 2006 an Earnings Cap applied in these Schemes to Colin Drummond and David Dupont. Both were provided with additional pension benefits under the unapproved funded Supplementary Pension 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.

With effect from 6 April 2006 the Earnings Cap no longer applied to pension schemes as part of the simplification of taxation of pensions legislation. The Remuneration Committee accordingly decided to provide all of the Directors' future service pension benefit above the Earnings Cap level from the Pennon Group Executive Pension Scheme. The Supplementary Pension Scheme was therefore closed and the accrued benefits were paid out to its members in April 2006.

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 lieu of the provision of pension benefits, Chris Loughlin receives an annual payment equivalent to 30% of his annual basic salary.

In determining remuneration arrangements for Executive Directors, the Remuneration Committee gives full consideration to their impact on the pension schemes funds and costs of providing individual pension arrangements or payments in lieu of pension provision.

### TOTAL SHAREHOLDER RETURN (TSR) GRAPH

The graph shows the value, over the five year period ending in March 2007, of £100 invested in Pennon Group on 31 March 2002 compared with the value of £100 invested in the FTSE 250 Index. The other points plotted are the values at intervening financial year ends. This Index is considered appropriate as it is a broad equity market index of which the Company is a constituent.

Graph here

This graph has been produced in accordance with Schedule 7A of the Companies Act 1985.

## DIRECTORS REMUNERATION REPORT

### NON-EXECUTIVE DIRECTORS AND THE CHAIRMAN

Non-executive Directors' remuneration (excluding that of the Chairman, Ken Harvey) consisting of fees only as set out below, is determined by the Board of Directors, including the Chairman, but in the absence of the other Non-executive Directors. It is usually reviewed biennially, although since 2003/04 it has been reviewed each 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 last reviewed in September 2006. In reviewing the fees, the Board takes into account market information on non-executive directors' fees, most recently from the Monks Partnership. Non-executive Directors receive a base fee of £30,000 per annum, the Audit, Remuneration and Corporate Responsibility Committee chairs are paid fees of £8,500, £6,000 and £6,000 per annum respectively and Committee members receive £3,500 each. The policy to be applied in 2007/08 (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 Board believes is appropriate to attract and retain suitably experienced non-executive directors.

The Chairman's remuneration is set by the Remuneration Committee and was reviewed after two years in April 2007. The policy of the Committee to be applied in 2007/08 (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 a fully-expensed car benefit and health cover. No other benefits or remuneration are received by the Chairman.

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 the Non-executive Directors' contracts are

Director	Date of contract	Expiry of contract
Gerard Connell	30 September 2003	30 September 2009
Kate Mortimer	19 March 2005	30 April 2009
Dinah Nichols	10 June 2003	11 June 2009

The Chairman, Ken Harvey, has a contract for services dated 1 April 2005, which is subject to 12 months' notice to provide the Company with reasonable security with regard to his ongoing service. No provision is made for any termination payments under this contract.

The contracts for services of the Chairman and the Non-executive Directors reflect corporate governance best practice and, together with the Executive Directors' service contracts, are available for inspection at the Company's registered office during normal business hours.

The information set out below and on the remaining pages of this Remuneration Report (pages 37 to 39) 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 (or in lieu of pension††) £000	Total 2007 £000	Total 2006 £000
<i>Chairman</i>						
Ken Harvey	175	–	21	–	196	195
<i>Executive Directors</i>						
Bob Baty ( <i>Retired 31 July 2006</i> )	93	24	5	–	122	289
Cohn Drummond	275	107	22	57	461	397
David Dupont	275	102	19	43	439	368
Chris Loughlin ( <i>Appointed 1 August 2006</i> )	160	53	66	48††	327	–
<i>Non-executive Directors</i>						
Gerard Connell	43	–	–	–	43	38
Kate Mortimer	41	–	–	–	41	36
Dinah Nichols	39	–	–	–	39	34
<b>Total</b>	<b>1,101</b>	<b>286</b>	<b>133</b>	<b>148</b>	<b>1,668</b>	<b>1,358</b>

## DIRECTORS REMUNERATION REPORT

### EMOLUMENTS OF DIRECTORS *(continued)*

- \* Other emoluments are car benefit and health cover and £55,000 of relocation costs and expenses paid to Chns Loughlin consequent on his appointment
- † 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 (long-term incentive element)' on page 39
- †† In lieu of any pension provision by the Company, Chns Loughlin receives a cash payment equivalent to 30% of his annual basic salary

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

### DIRECTORS' PENSIONS

Defined benefit pensions accrued and payable on retirement for Directors holding office during 2006/07 are shown in the table below

Director	Increase in accrued pension during 2006/07 (net of inflation) £000 <i>a</i>	Increase in accrued pension during 2006/07 £000 <i>b</i>	Accrued pension at 31 March 2007 £000 <i>c</i>	Transfer value at 31 March 2007 £000 <i>d</i>	Transfer value at 31 March 2006 £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 <i>(Retired 31 July 2006)</i> *	-29	-22	136	2,467	3,016	-554	-523
Colin Drummond	6	10	90	1,967	1,488	463	115
David Dupont	10	13	80	1,511	1,076	419	167

Column *a* above is the increase in accrued pension during 2006/07 (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 2006/07

Column *c* is the accrued pension at 31 March 2007 payable at normal retirement age.

Column *d* is the transfer value of the accrued pension set out in column *c* as at 31 March 2007

Column *e* is the transfer value of the accrued pension at the end of the previous financial year on 31 March 2006

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

\*Bob Baty retired on 31 July 2006 To comply with Companies Act requirements, the change in accrued benefit over the whole year is shown A decrease in the value of his pension is shown because, in accordance with the provisions of the pension scheme, Bob Baty took a lump sum and his pension in payment was commuted accordingly

Under the Company's pension salary deduction arrangements, the Company pays all pension scheme members' contributions to the Group pension schemes and salaries are reduced by the same amount The figures quoted above have not been adjusted to reflect this arrangement

The Supplementary Pension Scheme, which mainly funded pension provision above the Earnings Cap, provided benefits in tax-paid lump sum form at retirement Appropriate figures have been included in the accrued pension totals shown above At the beginning of the year, the Supplementary Pension Scheme was closed by the Company and the accrued pension provision in the Scheme was paid out to the two remaining members of the Scheme Future pension service benefit above the Earnings Cap level is being provided in the Pennon Group Executive Pension Scheme as described in (vi) 'Provision for Pension' on page 35

Directors have the option to pay additional voluntary contributions, neither the contributions nor the resulting benefits are included in the table shown above

## DIRECTORS' REMUNERATION REPORT

### DIRECTORS' SHARE INTERESTS

#### (a) Shareholdings

The number of ordinary shares of the Company in which Directors held beneficial interests at 31 March 2007 (or date of retirement where earlier) and 31 March 2006 were

Director	2007 Ordinary shares <sup>†</sup> (40 7p each)	2006 B Shares (110p each)	2006 Deferred shares* (110p each)	2006 Ordinary shares (122 <sup>1</sup> / <sub>10</sub> p each)	Director	2007 Ordinary shares <sup>†</sup> (40 7p each)	2006 B Shares* (110p each)	2006 Deferred shares* (110p each)	2006 Ordinary shares (122 <sup>1</sup> / <sub>10</sub> p each)
Bob Baty <i>(Retired 31 July 2006)</i>	175,905	111,785	–	55,145	Ken Harvey	7,209	–	–	2,403
Gerard Connell	–	–	–	–	Kate Mortimer	1,951	–	–	250
Colin Drummond	125,043	7,900	24,562	35,541	Dinah Nichols	–	–	–	–
David Dupont	99,655	26,330	33,644	29,882	Chrs Loughlin <i>(Appointed 1 August 2006)</i>	9,734	–	–	–

† On 31 July 2006 the Company's share capital was split such that each then existing 122 <sup>1</sup>/<sub>10</sub>p ordinary share was divided into three new ordinary shares of 40 7p each

\* On 6 April 2006 all the Deferred shares were redeemed for nil value and all the B Shares were redeemed for 110p each, all pursuant to the B Share Scheme approved by shareholders at the Extraordinary General Meeting on 15 February 2006 as part of a return of cash to shareholders. Additional ordinary shares (40 7p each) have been acquired by the Directors since 31 March 2007 as follows as a result of participation in the Company's Dividend Re-investment Plan, Personal Equity Plans, Individual Savings Accounts or the Company's Share Incentive Plan

Colin Drummond	110	David Dupont	35	Chrs Loughlin	132	Kate Mortimer	7
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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 2007 and 30 May 2007

#### (b) Restricted Share Plan (Long-Term Incentive Plan)

In addition to the above beneficial interests, the following Directors have or had a contingent interest in the number of 40 7p ordinary shares shown below, representing the maximum number of shares to which they would become entitled under the Group's Long-Term Incentive Plan with the relevant criterion (as described in (m) 'Long-Term Incentive Plan' on page 34) being met in full

Director and date of award	Conditional awards held at 1 April 2006	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 2007	Date of end of period for qualifying condition to be fulfilled
<b>Bob Baty (Retired 31 July 2006)</b>							
16/9/04 †	101,070	–	269 83p	–	–	64,573*	15/9/07
27/9/05 †	40,140	–	356 67p	–	–	12,266*	26/9/08
<b>Colin Drummond</b>							
16/9/04 †	101,070	–	269 83p	–	–	101,070	15/9/07
27/9/05 †	40,140	–	356 67p	–	–	40,140	26/9/08
18/9/06	–	41,363	498 62p	–	–	41,075	17/9/09
<b>David Dupont</b>							
16/9/04 †	96,015	–	269 83p	–	–	96,015	15/9/07
27/9/05 †	40,140	–	356 67p	–	–	40,140	26/9/08
18/9/06	–	41,363	498 62p	–	–	41,075	17/9/09
<b>Chrs Loughlin</b>							
18/9/06	–	36,099	498 62p	–	–	35,847	17/9/09

\* The outstanding awards made to Bob Baty were reduced upon his retirement on 31 July 2006 pro-rata to his period of employment with the Company during the restricted period of each award

† The amount of the awards (and the market price upon award) for the awards made on 16/9/04 and 27/9/05 have been adjusted in the ratio three for one consequent upon the Company's share capital split on 31 July 2006.

Because of the existence of unpublished price sensitive information, no award was made during 2003 to the Executive directors. Accordingly, with shareholders' approval, the usual award was made in 2004 together with a further award of shares equivalent to 75% of basic salary. It is anticipated that some (but not all) of this award will vest in September 2007 as the performance criterion has been partially met.

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 £24,289, Colin Drummond £24,289, David Dupont £23,419

**DIRECTORS' SHARE INTERESTS** (continued)

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

In addition to the above share interests, the following Directors have or had a contingent interest in the number of ordinary shares shown below, representing the total number of shares to which they have (or would) become entitled under the Group element of the Incentive Bonus Plan (the Plan) at the end of the relevant qualifying period

Director and date of award	Conditional awards held at 1 April 2006	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 2007	Date of end of period for qualifying condition to be fulfilled
<b>Bob Baty (Retired 31 July 2006)</b>							
25/7/03	5,850	–	652 00p	5,850*	84,883	–	–
28/6/04 ††	17,076	–	259 50p	17,076†	80,940	–	–
10/8/05 ††	20,397	–	328 00p	20,397†	96,682	–	–
26/7/06 ††	–	13,395	486 00p	13,395†	63,492	–	–
<b>Colin Drummond</b>							
25/7/03	7,263	–	652 00p	7,263*	105,386	–	–
28/6/04 ††	20,670	–	259 50p	–	–	20,670	27/6/07
10/8/05 ††	18,843	–	328 00p	–	–	18,843	9/8/08
26/7/06 ††	–	16,527	486 00p	–	–	16,527	25/7/09
<b>David Dupont</b>							
25/7/03	5,587	–	652 00p	5,587*	81,067	–	–
28/6/04 ††	15,909	–	259 50p	–	–	15,909	27/6/07
10/8/05 ††	18,606	–	328 00p	–	–	18,606	9/8/08
26/7/06 ††	–	16,095	486 00p	–	–	16,095	25/7/09

\* The July 2003 award vested on 24 July 2006 at a price of 1.451p

† Upon the retirement of Bob Baty from the Company on 31 July 2006, the Remuneration Committee agreed that it was appropriate to release all the outstanding Deferred Bonus shares to him early as permitted by the terms of the Plan. These shares were accordingly released as at 14 August 2006 at a price of 474p per share

†† The amount of the awards made on 28/6/04, 10/8/05 and 26/7/06 have been adjusted in the ratio three for one consequent upon the Company's share capital split on 31 July 2006 and are each of nominal value 40 7p. The 25/7/03 award vested prior to the share capital split and consequently the shares were each of nominal value 122<sup>1</sup>/<sub>10</sub>p.

A further conditional award of shares will be made in 2007/08 to the value of the amount of the performance related cash bonus shown in the Emoluments of Directors table on page 36 (Paragraph (ii) on page 33 sets out the provisions relating to the conditional award of shares pursuant to the 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 Plan as follows: Bob Baty £3,026, Colin Drummond £9,929, David Dupont £8,741

It is anticipated that all of the shares will vest under the 28/6/04 award in 2007/08 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

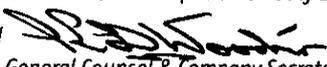
Director and date of grant	Options held at 1 April 2006*	Granted in year	Exercised in year	Exercise price*	Market price on exercising	Options held at 31 March 2007	Exercise period/maturity date
<b>Bob Baty (Retired 31 July 2006)</b>							
8/7/03	3,141	–	3,141	176 66p	471 30p	–	–
<b>Colin Drummond</b>							
8/7/03	5,235	–	5,235	176 66p	471 30p	–	–
4/7/06	–	2,613	–	357 66p	–	2,613	1/9/09 – 28/2/10
<b>David Dupont</b>							
9/7/02	8,772	–	–	188 67p	–	8,772	1/9/07 – 29/2/08

\*The options held and the exercise price have been adjusted for the three for one share split on 31 July 2006

**(f) Share price**

The market price of the Company's shares at 31 March 2007 was 584 50p (2006 447 00p\*) and the range during the year was 408 33p to 584 50p\* (2006 315 67p to 476 33p\*)

\* Adjusted for the three for one share split on 31 July 2006

By Order of the Board  
  
 KEN WOODIER, Group General Counsel & Company Secretary  
 22 June 2007

## CORPORATE GOVERNANCE AND INTERNAL CONTROL

### ■ 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 Combined Code (pre-June 2006 version) have been applied by the Company in practice.

The Company considers that it has complied with the provisions of the Code throughout the year.

### ■ THE BOARD AND ITS COMMITTEES

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 32 demonstrate a broad range of business and financial experience. There is a clear division of responsibilities between the roles of Chairman and the Chief Executives of South West Water and Vindor as recorded in the descriptions of the roles approved by the Board. All Directors are subject to re-election when they have held office for three years.

During the year, the Board met in accordance with its schedule of meetings on ten occasions. At each meeting, all Directors were present with the exception of Colin Drummond on one occasion. In accordance with Group Policy, the Board has a schedule of matters reserved for its decision and delegates more detailed consideration of certain matters to Board Committees, to the subsidiary boards of South West Water and Vindor, to the Executive Directors, and to the 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 in the Group. Under the guidance of the Chairman, all matters before the Board are discussed openly and presentations and advice are received on occasions from other senior executives within the Group or from 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 administered 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 including, for example, more visits by the Board to strategic business locations of the Group within the UK to gain additional understanding of new developments. The Chairman's performance was evaluated separately by the Non-executive Directors, led by the Senior Independent Non-executive Director. The Chairman's other significant commitments outside the Group have not changed during the year and the Board is satisfied that such commitments do not prejudice the Chairman's performance in relation to his Group role.

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 that 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 the Committees of the Board. In addition, the Chairman during the year holds meetings with the Non-executive Directors without the Executive Directors present, to discuss performance and strategic issues.

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 set out below.

#### AUDIT COMMITTEE

The Audit Committee was chaired by Gerard Connell, who has current 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 at each meeting. In discharging its Terms of Reference, the Committee receives reports and meets regularly in particular to

- 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, re-appointment and removal and in addition monitor their independence and objectivity including the supply of non-audit services, and
- 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.

In addition, the Committee periodically reviews the arrangements for, and the effectiveness of, the Group's "Whistleblowing Policies" (details of which are set out on page 26 of the Business Review).

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 6 to the financial statements on page 61. The Executive Directors, the auditors, the Group Financial Controller and the Company's internal auditor attend meetings of the Committee by invitation. In addition, both the external and internal auditors have the right of direct access to the Committee without the presence of any Executive Director.

At the beginning of the year a review of the provision of external audit services was completed following the consideration of submissions and presentations from a number of audit firms on their proposals for audit services. Following this review, as recommended by the Committee, PricewaterhouseCoopers LLP was appointed at the Annual General Meeting last year to continue as the auditors of the Group.

#### REMUNERATION COMMITTEE

The Remuneration Committee was chaired by Kate Mortimer. Gerard Connell and Dinah Nichols were the other members of the Committee. The Committee met on nine occasions during the year at which all members were present with the exception of Dinah Nichols 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 33 to 39.

#### 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 three occasions (at which all members were present with the exception of Kate Mortimer and Dinah Nichols each on one occasion) to consider the annual performance evaluation

results for the Committee, to finalise the appointment of an Executive Director, to consider the appointment of a senior executive, and to consider the appointment for a third three year term of two Non-executive Directors.

#### CORPORATE RESPONSIBILITY/ 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 Vindor. The Committee met three times during the year with all members present. In November 2006, the Committee was formally disbanded and its functions were subsumed into the newly formed Corporate Responsibility Committee.

This new Committee was chaired by Dinah Nichols and also comprises Gerard Connell and Kate Mortimer and the Chief Executives of South West Water and Vindor. It met on two occasions towards the end of 2006/07 at which all members were present. The Committee's duties, in the context of the requirement for companies to conduct their business in a responsible manner (including in relation to environmental, social and governance (ESG) matters), are to review the strategies, policies, management, initiatives, targets and performance of the Pennon Group of companies in the areas of occupational health and safety and security, environment, workplace policies, corporate policies, non-financial regulatory compliance and the role of the Group in society.

In reporting on corporate responsibility, the Company has sought to comply with the Association of British Insurers' Guidelines on Responsible Investment Disclosure. The Business Review on page 26 contains details of ESG matters and additional information is contained in the Group's annual report on corporate responsibility for environmental and social issues. The 2007 report will be available from the Company Secretary from the end of July 2007 and will also be set out on the Company's website at [www.pennon-group.co.uk](http://www.pennon-group.co.uk).

#### COMMITTEES' TERMS OF REFERENCE

The Terms of Reference of the Audit, Remuneration, Nomination and Corporate Responsibility 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](http://www.pennon-group.co.uk).

#### ■ INTERNAL CONTROL

##### Wider aspects of internal control

The Board is responsible for the Group's system of internal 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 Group that has been in place throughout the year 2006/07 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 Combined Code and the 'Guidance on Internal Control'

## CORPORATE GOVERNANCE AND INTERNAL CONTROL

(The Turnbull Guidance) which suggests means of applying the internal control part of the 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 completes (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 Vindor 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 Business Review on pages 10 to 13, 19 to 21 and 27.

### Internal control framework

As well as the risk management policy of the Group 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.

### Internal control review

An evaluation of the effectiveness of overall internal control compliance by the Group is undertaken in respect of each calendar year to assist the Audit Committee in considering the Group internal audit plan for the forthcoming financial year and also the Business Review for the Annual Report. The Group General Counsel & Company Secretary initially carries out the review with Directors and senior management, for consideration by the Audit Committee and subsequently for final evaluation by the Board.

In addition, the Audit Committee regularly reviews the operation and effectiveness of the internal control 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. For 2006 and up to the date of the approval of the Annual Report and Accounts, both the Audit Committee and the Board were satisfied with the effectiveness of the risk management policy and the internal control framework and their operation within the Group.

## ■ 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 responsible for preparing the Annual Report, the Directors' remuneration report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Group and Company financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The financial statements are required by law to give a true and fair view of the state of affairs of the Group and the Company and of the profit or loss of the Group for the year.

In preparing these financial statements the Directors are required to

- select suitable accounting policies and then apply them consistently
- make judgements and estimates that are reasonable and prudent
- state that the financial statements comply with IFRS as adopted by the European Union

The Directors confirm that they have complied with the above requirements in preparing the financial statements.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and the Company and to enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 1985 and, as regards the Group financial statements, article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and the Company 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 comprehensive investor relations programme. During the year, meetings with institutional shareholders were held and attended by the Group Director of Finance and the Company's Investor Relations Manager. On certain occasions the Chairman, the Chief Executive of South West Water and the Chief Executive of Vindor 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. Further, surveys of shareholder opinion conducted, usually on an annual basis, are evaluated and reported on to the Board.

The Group was awarded Overall Winner (main market) for its communication skills in the South West Financial and Corporate Communications Awards 2006.

By Order of the Board  
  
KEN WOODIER, Group General Counsel & Company Secretary  
22 June 2007

**INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF PENNON GROUP PLC**

We have audited the Group and Company financial statements (the "financial statements") of Pennon Group Plc for the year ended 31 March 2007 which comprise the Group income statement, the Group statement of recognised income and expense, the Company statement of recognised income and expense, the Group balance sheet, the Company balance sheet, the Group cash flow statement, the Company cash flow statement and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' remuneration report that is described as having been audited.

**RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS**

The Directors' responsibilities for preparing the Annual Report, the Directors' remuneration report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Directors' responsibilities statement.

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

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' report is consistent with the financial statements.

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

We review whether the Corporate governance statement reflects the Company's compliance with the nine provisions of the Combined Code (2003) 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 form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Chairman's statement, the Chief Executives' overviews, the Business review, the Directors' report, the audited part of the Directors' remuneration report and the Corporate governance statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

**BASIS OF AUDIT OPINION**

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

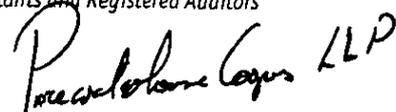
We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' remuneration report to be audited are free from 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 and the part of the Directors' remuneration report to be audited.

**OPINION**

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 March 2007 and of its profit and cash flows for the year then ended,
- the Company financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the Company's affairs as at 31 March 2007 and cash flows for the year then ended,
- the financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation, and
- the information given in the Directors' report is consistent with the financial statements.

PricewaterhouseCoopers LLP  
Chartered Accountants and Registered Auditors  
Bristol  
22 June 2007



GROUP INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2007

	Notes	2007 £m	Before exceptional items 2006 £m	Exceptional items (note 9) 2006 £m	Total 2006 £m
<b>Revenue</b>	5	<b>748.3</b>	645.7	–	645.7
<b>Operating costs</b>	6				
Manpower costs		(91.0)	(79.9)	–	(79.9)
Raw materials and consumables used		(47.2)	(40.7)	–	(40.7)
Other operating expenses		(294.6)	(245.9)	(14.5)	(260.4)
Depreciation		(113.7)	(102.5)	–	(102.5)
Amortisation of intangibles		(1.8)	(1.6)	–	(1.6)
<b>Operating profit</b>	5	<b>200.0</b>	175.1	(14.5)	160.6
Interest payable and similar charges	7	(98.3)	(96.8)	(50.2)	(147.0)
Interest receivable	7	29.1	32.5	7.9	40.4
Share of post-tax profit from joint ventures		0.3	0.1	–	0.1
<b>Profit before tax</b>	5	<b>131.1</b>	110.9	(56.8)	54.1
Tax on ordinary activities	8	(37.2)	(35.0)	18.7	(16.3)
<b>Profit for the year</b>		<b>93.9</b>	75.9	(38.1)	37.8
Profit attributable to equity shareholders		93.9	75.9	(38.1)	37.8
<b>Earnings per share (pence per share)*</b>	11				
– Basic		26.5			9.9
– Diluted		26.3			9.8
<b>Proposed dividend per share (pence per share)*</b>	12	<b>18.55</b>			17.2
<b>Proposed dividend for the year (£m)</b>	12	<b>66.0</b>			61.0

All operating activities are continuing operations

\* The earnings per share and dividend per share for March 2006 have been restated to reflect the sub-division of the Company's ordinary shares by way of a three for one split on 31 July 2006 (note 31)

The notes on pages 48 to 93 form part of these financial statements

	Notes	Group		Company	
		2007 £m	2006 £m	2007 £m	2006 £m
<b>Profit for the year</b>		<b>93.9</b>	37.8	<b>93.8</b>	214.9
Actuarial losses on defined benefit schemes	28	(1.2)	(2.8)	(0.4)	0.7
<i>Cash flow hedges</i>					
Net fair value gains		15.7	1.0	1.1	0.6
Tax on items taken directly to equity		0.4	0.8	0.1	(0.2)
<b>Net gains/(losses) not recognised directly in income statement</b>	34	<b>14.9</b>	(1.0)	<b>0.8</b>	1.1
<b>Total recognised income for the year</b>		<b>108.8</b>	36.8	<b>94.6</b>	216.0
Adjustments on adoption of IAS 32/39 1 April 2005 (net of tax)		~	8.6	-	-
		<b>108.8</b>	45.4	<b>94.6</b>	216.0
<b>Attributable to equity shareholders</b>		<b>108.8</b>	45.4	<b>94.6</b>	216.0

The notes on pages 48 to 93 form part of these financial statements

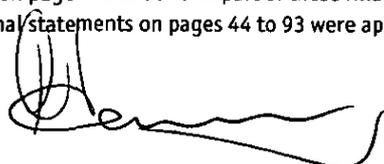
## BALANCE SHEETS AT 31 MARCH 2007

	Notes	Group		Company	
		2007 £m	2006 £m	2007 £m	2006 £m
<b>Assets</b>					
<b>Non-current assets</b>					
Goodwill	15	134.3	98.6	-	-
Other intangible assets	16	7.8	5.7	-	-
Property, plant and equipment	17	2,559.4	2,415.9	0.2	0.1
Trade and other receivables	18	6.9	6.0	171.2	128.4
Deferred tax asset	29	-	-	1.8	1.8
Investment in subsidiary undertakings	19	-	-	943.8	943.8
Investments accounted for using equity method	19	1.4	1.3	-	-
		<b>2,709.8</b>	<b>2,527.5</b>	<b>1,117.0</b>	<b>1,074.1</b>
<b>Current assets</b>					
Inventories	20	5.1	5.0	-	-
Trade and other receivables	21	122.5	94.5	56.0	45.7
Derivative financial instruments	22	16.0	3.1	1.7	0.6
Current tax recoverable	25	-	-	1.2	-
Cash and cash equivalents	23	127.9	99.4	24.1	60.8
		<b>271.5</b>	<b>202.0</b>	<b>83.0</b>	<b>107.1</b>
<b>Liabilities</b>					
<b>Current liabilities</b>					
Borrowings	26	(85.8)	(54.7)	(303.3)	(283.1)
Derivative financial instruments	22	-	(3.0)	-	-
Trade and other payables	24	(175.9)	(170.1)	(19.0)	(25.2)
Current tax liabilities	25	(36.5)	(24.0)	-	-
Provisions for liabilities and charges	30	(13.2)	(11.4)	-	-
		<b>(311.4)</b>	<b>(263.2)</b>	<b>(322.3)</b>	<b>(308.3)</b>
<b>Net current liabilities</b>		<b>(39.9)</b>	<b>(61.2)</b>	<b>(239.3)</b>	<b>(201.2)</b>
<b>Non-current liabilities</b>					
Borrowings	26	(1,599.4)	(1,471.8)	(130.0)	(157.4)
Other non-current liabilities	27	(2.1)	(2.2)	(8.7)	(8.7)
Retirement benefit obligations	28	(41.2)	(41.7)	(3.4)	(3.3)
Deferred tax liabilities	29	(313.7)	(302.8)	-	-
Provisions for liabilities and charges	30	(86.3)	(66.6)	-	-
		<b>(2,042.7)</b>	<b>(1,885.1)</b>	<b>(142.1)</b>	<b>(169.4)</b>
<b>Net assets</b>		<b>627.2</b>	<b>581.2</b>	<b>735.6</b>	<b>703.5</b>
<b>Shareholders' equity</b>					
Share capital	31	144.9	184.2	144.9	184.2
Share premium account	32	11.7	10.2	11.7	10.2
Capital redemption reserve	33	143.8	98.4	143.8	98.4
Retained earnings and other reserves	34	326.8	288.4	435.2	410.7
<b>Total shareholders' equity</b>		<b>627.2</b>	<b>581.2</b>	<b>735.6</b>	<b>703.5</b>

The notes on pages 48 to 93 form part of these financial statements

The financial statements on pages 44 to 93 were approved by the Board of Directors on 22 June 2007 and were signed on its behalf by

K G Harvey  
Chairman



CASH FLOW STATEMENTS FOR THE YEAR ENDED 31 MARCH 2007

	Notes	Group		Company	
		2007 £m	2006 £m	2007 £m	2006 £m
<b>Cash flows from operating activities</b>					
Cash generated/(outflow) from operations	35	305.1	232.1	(54.5)	104.5
Interest paid*		(58.1)	(128.9)	(8.6)	(24.7)
Tax (paid)/Group relief received		(12.0)	(2.2)	(2.3)	1.7
<b>Net cash generated/(outflow) from operating activities</b>		<b>235.0</b>	<b>101.0</b>	<b>(65.4)</b>	<b>81.5</b>
<b>Cash flows from investing activities</b>					
Interest received*		6.7	22.5	14.3	22.7
Dividends received		-	-	90.1	212.3
Acquisition of subsidiary undertakings (net of cash acquired)	37	(37.0)	(44.7)	-	-
Investment in subsidiary undertaking		-	-	-	(12.0)
Investment in joint venture	19	-	(1.1)	-	-
Return of loan from joint venture		0.1	-	-	-
Proceeds from business disposal		-	5.0	-	-
Proceeds from investment disposal		0.6	-	-	-
Purchase of property, plant and equipment		(251.4)	(218.6)	(0.2)	-
Proceeds from sale of property, plant and equipment		5.0	4.8	-	-
<b>Net cash (used in)/from investing activities</b>		<b>(276.0)</b>	<b>(232.1)</b>	<b>104.2</b>	<b>223.0</b>
<b>Cash flows from financing activities</b>					
Net proceeds from issue of ordinary share capital		1.9	1.6	1.9	1.6
Purchase of ordinary shares subsequently cancelled		(3.5)	-	(3.5)	-
Purchase of ordinary shares by the Pennon Employee Share Trust		(2.3)	-	-	-
(Deposit)/release of restricted funds		(4.1)	177.1	-	-
Net proceeds from new borrowing		110.0	182.5	243.2	7.5
Repayment of borrowings		(71.1)	(224.3)	(250.4)	(136.8)
Finance lease drawdowns		130.2	141.6	-	-
Finance lease principal repayments		(21.4)	(15.8)	-	-
Dividends paid		(61.0)	(34.1)	(61.0)	(34.1)
B Share payments	31	(5.7)	(137.8)	(5.7)	(137.8)
<b>Net cash received/(outflow) from financing activities</b>		<b>73.0</b>	<b>90.8</b>	<b>(75.5)</b>	<b>(299.6)</b>
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>32.0</b>	<b>(40.3)</b>	<b>(36.7)</b>	<b>4.9</b>
Cash and cash equivalents at beginning of the year		80.3	120.6	60.8	55.9
<b>Cash and cash equivalents at end of the year</b>		<b>112.3</b>	<b>80.3</b>	<b>24.1</b>	<b>60.8</b>

\*Interest paid and received in 2006 included exceptional items, note 9

The notes on pages 48 to 93 form part of these financial statements

## NOTES TO THE FINANCIAL STATEMENTS

### 1. GENERAL INFORMATION

Pennon Group Plc is a company incorporated in the United Kingdom under the Companies Act 1985. The address of the registered office is given on page 32. The nature of the Group's operations and its principal activities are set out in the Directors' report on pages 2 to 31.

These financial statements were approved by the Board of Directors on 22 June 2007.

### 2. SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented.

#### (a) Basis of preparation

These financial statements have been prepared under the historical cost convention, except for derivative financial instruments, and in accordance with International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations as adopted by the European Union, with those parts of the Companies Act 1985 applicable to companies reporting under IFRS and the requirements of the Financial Services Authority. A summary of the main accounting policies is set out below, together with an explanation where changes have been made to previous policies on the adoption of new accounting standards in the year.

At the date of approval of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue, but not yet effective:

IFRS 7	"Financial instruments disclosures" and the related amendment to IAS 1 "Presentation of Financial Statements" on capital disclosures
IFRS 8	"Operating segments "
IFRIC 8	"Scope of IFRS 2 "
IFRIC 9	"Reassessment of embedded derivatives "
IFRIC 10	"Interim financial reporting and impairment "
IFRIC 11	"IFRS 2 Group and treasury share transactions "
IFRIC 12	"Service concession arrangements "

The Directors expect that the adoption of these standards and interpretations in future periods will have no material impact on the financial statements of the Group. Additional disclosures on capital and financial instruments will be made when the relevant standards come into effect for periods commencing on or after 1 April 2007. The presentational impact of IFRIC 12 is being assessed.

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best assessment of the amounts, events or actions, actual results ultimately may differ from those estimates.

#### (b) Adoption of IFRS

The Group's date of transition to IFRS was 1 April 2004. The Company's date of transition to IFRS was 1 April 2005 and all comparative information for the Company in these financial statements has been restated to reflect the adoption of IFRS, except where otherwise required or permitted by IFRS 1 "First Time Adoption of International Financial Reporting Standards".

**2 SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

**(c) Basis of consolidation**

The Group financial statements include the results of Pennon Group Plc and its subsidiary and joint venture undertakings

The results of subsidiary and joint venture undertakings are included from the date of acquisition or incorporation, and excluded from the date of disposal. The results of subsidiaries are consolidated where the Group has the power to control a subsidiary. The results of joint venture undertakings are accounted for on an equity basis where the company exercised joint control under a contractual arrangement.

On acquisition, the assets and liabilities and contingent liabilities of a subsidiary or joint venture acquired are measured at their fair values and any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired is credited to profit and loss in the year of acquisition.

**(d) Revenue recognition**

Revenue represents the fair value of consideration receivable, excluding value added tax, trade discounts and inter-company sales, in the ordinary course of business for goods and services provided.

Revenue is not recognised until the service has been provided to the customer, or the goods which the sale relates to have been despatched to the customer.

Income from mains water and waste water charges includes an estimation of the amount of unbilled charges at the period end based upon a defined methodology reflecting historical consumption and current tariffs.

**(e) Landfill tax**

Landfill tax is included within both revenue and operating costs.

**(f) Segmental reporting**

Each of the Group's business segments provides services which are subject to risks and returns which are different from those of the other business segments. The Group's internal organisation and management structure and its system of internal financial reporting is based primarily on business segments. The business segments comprise the regulated water and sewerage services undertaken by South West Water Limited and the waste management business of Vindor Limited. Segmental revenue, expense and results, include transactions between businesses. Inter-segmental transactions are eliminated on consolidation.

**(g) Goodwill**

Goodwill arising on consolidation from the acquisition of subsidiary and joint venture undertakings represents the excess of the purchase consideration over the fair value of net assets acquired.

Goodwill is recognised as an asset and reviewed for impairment at least annually. Any impairment is recognised immediately in the income statement and is not subsequently reversed. Further details are contained in accounting policy (1).

When a subsidiary or joint venture undertaking is sold, the profit or loss on disposal is determined after including the attributable amount of unamortised goodwill.

Goodwill arising on acquisitions before 1 April 2004, the Group's date of transition to IFRS, has been retained at the previous UK GAAP amounts subject to being tested for impairment at that date and annually thereafter. Goodwill written off to reserves under UK GAAP prior to 1998 was not reinstated on transition to IFRS and will not be included in determining any subsequent profit or loss on disposal.

## NOTES TO THE FINANCIAL STATEMENTS

### 2 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (h) Other intangible assets

Other intangible assets acquired in a business combination are capitalised at fair value at the date of acquisition. Following initial recognition, finite life intangible assets are amortised on a straight-line basis over their estimated useful economic lives, with the expense taken to the income statement through operating expenses.

#### (i) Property, plant and equipment

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

Infrastructure assets were included at fair value on transition to IFRS and subsequent additions are recorded at cost less accumulated depreciation. Expenditure to increase capacity or enhance infrastructure assets is capitalised where it can be reliably measured and it is probable that incremental future economic benefits will flow to the entity. The cost of day-to-day servicing of infrastructure components is recognised in the income statement as it arises.

Infrastructure assets are depreciated over their useful economic lives, which are principally

Dams and impounding reservoirs	200 years
Water mains	40 – 100 years
Sewers	40 – 100 years

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

##### 11) Landfill sites

Landfill sites are included within land and buildings at cost less accumulated depreciation. Cost includes acquisition and development expenses. The cost of a landfill is depreciated to its residual value (which is linked to gas production at the site post-closure) over its estimated operational life taking account of the usage of void space.

Where the obligation to restore a landfill site is an integral part of its future economic benefits, a non-current asset within property, plant and equipment is recognised. The asset recognised is depreciated based on the usage of void space.

##### 11) Other assets (including properties, over-ground plant and equipment)

Other assets are included at cost less accumulated depreciation.

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives to their residual value, which are principally

Freehold buildings	30 – 60 years
Leasehold buildings	Over the period of the lease
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 which are incremental to the Group. Borrowing costs that are directly attributable to the construction of a qualifying asset (an asset which necessarily takes a substantial period of time to be prepared for its intended use) are capitalised as part of the asset.

Asset lives and residual values are reviewed annually.

**2 SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

**(j) Grants and contributions**

Grants and contributions receivable in respect of property, plant and equipment are deducted from the cost of those assets

Grants and contributions receivable in respect of expenditure charged against profits in the year have been included in the income statement

**(k) Leased assets**

Assets held under finance leases are included in the balance sheet as property, plant and equipment 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 borrowings. 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.

**(l) Impairment of assets**

Assets which have an indefinite useful life are not subject to amortisation and are tested annually for impairment, or whenever events or changes in circumstance indicate that the carrying amount may not be recoverable.

Assets which are subject to amortisation are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Value in use represents the present value of projected future cash flows expected to be derived from a cash-generating unit, discounted using a pre-tax discount rate which reflects an assessment of the cost of capital of the cash-generating unit.

Impairments are charged to the income statement in the year in which they arise.

**(m) Investment in subsidiary undertakings**

Investments in subsidiary undertakings are initially recorded at cost, being the fair value of the consideration paid, including associated acquisition costs. Subsequently, investments are reviewed for impairment on an individual basis annually, or if events or changes in circumstances indicate that the carrying value may not be fully recoverable.

**(n) Joint ventures**

Joint ventures are entities over which the Group has joint control. Investments in joint ventures are accounted for using the equity method of accounting. Any excess of the cost of acquisition over the Group's share of the fair values of the identifiable net assets of the joint venture at the date of acquisition is recognised as goodwill and is included in the carrying value of the investment in the joint venture.

The carrying value of the Group's investment is adjusted for the Group's share of post-acquisition profits or losses recognised in the income statement. Losses of a joint venture in excess of the Group's interest are not recognised unless the Group has a legal or constructive obligation to fund those losses.

**(o) Inventories**

Inventories and work in progress is stated at the lower of cost and net realisable value. Cost includes labour, materials and attributable overheads.

**(p) Cash and cash equivalents**

Cash and cash equivalents comprise cash in hand, short-term deposits held at banks and other short-term highly liquid deposits subject to insignificant risk of changes in value. Bank overdrafts are shown within current borrowings.

## NOTES TO THE FINANCIAL STATEMENTS

### **2 SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

#### **(q) Derivatives and other financial instruments**

The Group classifies its financial instruments in the following categories

##### *i) Loans and receivables*

All loans and borrowings are initially recognised at cost, being the net fair value of the consideration received. Following initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost.

Gains and losses are recognised in the income statement when the instruments are derecognised or impaired. Premia, discounts and other costs and fees are recognised in the income statement through the amortisation process.

Borrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

##### *ii) Derivative financial instruments*

The Group uses derivative financial instruments, principally interest rate swaps, to hedge its risks associated with interest rate fluctuations. Such derivative instruments are initially recorded at cost and subsequently remeasured at fair value for the reported balance sheet.

The gain or loss on remeasurement is taken to the income statement except for cash flow hedges that meet the conditions for hedge accounting, when the portion of the gain or loss on the hedging instrument which is determined to be an effective hedge is recognised directly in equity, and the ineffective portion in the income statement. The gains or losses deferred in equity in this way are subsequently recognised in the income statement in the same period in which the hedged underlying transaction or firm commitment is recognised in the income statement.

In order to qualify for hedge accounting, the Group is required to document in advance the relationship between the item being hedged and the hedging instrument. The Group is also required to document and demonstrate an assessment of the relationship between the hedged item and the hedging instrument, which shows that the hedge will be highly effective on an on-going basis. This effectiveness testing is re-performed at the end of each reporting period to ensure that the hedge remains highly effective.

##### *iii) Trade receivables*

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts and the impact of discounting.

##### *iv) Trade payables*

Trade payables are not interest bearing and are stated at their nominal value.

#### **(r) Taxation including deferred tax**

Tax payable for the year is provided at current rates that are substantively enacted. Deferred taxation is provided in full, using the liability method, on temporary differences between the tax basis of assets and liabilities and their carrying amounts in the financial statements. A deferred tax asset is only recognised to the extent it is probable that sufficient taxable profits will be available in the future for it to be utilised.

**2 SIGNIFICANT ACCOUNTING POLICIES** *(continued)*

**(s) Provisions for liabilities and charges**

Provisions are made where there is a present legal or constructive obligation as a result of a past event and it is probable that there will be an outflow of economic benefits to settle this obligation and a reliable estimate of this amount can be made. The Group's policy on provisions for specific areas is

*i) Landfill restoration costs*

Provisions for the cost of restoring landfill sites are made when the obligation arises. Where the obligation recognised as a provision gives access to future economic benefits, a non-current asset in property, plant and equipment is recognised. Provisions are otherwise charged against profits.

*ii) Environmental control and aftercare costs*

Environmental control and aftercare costs are incurred over the operational life of each landfill site and may be incurred for a considerable period thereafter. Provision for all such costs is made over the operational life of the site and charged to the income statement on the basis of the usage of void space.

Provisions for restructuring costs are recognised when a detailed formal plan for the restructuring has been communicated to affected parties.

Where the effect of the time value of money is material, the current amount of a 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 interest payable and similar charges.

**(t) Share capital and treasury shares**

Ordinary shares are classified as equity.

The Group balance sheet incorporates the shares held by the Pennon Employee Share Trust and which have not vested by the balance sheet date. These are shown as a deduction from shareholders' equity until such time as they vest.

**(u) Dividend distributions**

Dividend distributions are recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's shareholders. Interim dividends are recognised when paid, final dividends when authorised in general meeting by shareholders.

## NOTES TO THE FINANCIAL STATEMENTS

### 2 SIGNIFICANT ACCOUNTING POLICIES *(continued)*

#### **(v) Employee benefits**

##### *i) Pension obligations*

The Group operates defined benefit and defined contribution pension schemes

##### **Defined benefit schemes**

Defined benefit pension scheme assets are measured using bid price. Defined benefit pension scheme liabilities are measured by an independent actuary using the projected unit credit method and discounted at the current rate of return on high quality corporate bonds of equivalent term to the liability. The increase in the present value of the liabilities of the Group's defined benefit pension schemes expected to arise from employee service in the period is charged to operating profit. The expected return on scheme assets and the increase during the period in the present value of scheme liabilities, arising from the passage of time, are included in other finance income or cost. Changes in past service costs arising from changes in benefits are recognised immediately in income.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity and recorded in the statement of recognised income and expense.

##### **Defined contribution schemes**

Costs of the defined contribution pension scheme are charged to the income statement in the period in which they arise.

##### *ii) Share-based payment*

The Group operates a number of equity settled, share-based payment plans for employees. The fair value of the employee services required in exchange for the grant is recognised as an expense over the vesting period of the grant.

Fair values are calculated using an appropriate pricing model. Non-market based vesting conditions are adjusted for in assumptions as to the number of awards which are expected to vest.

#### **(w) Pre-contract costs**

Pre-contract costs are expensed as incurred, except where it is virtually certain that the contract will be awarded, in which case they are recognised as an asset which is amortised to the income statement over the life of the contract.

#### **(x) Fair values**

The fair value of the interest rate swaps is based on the market price of comparable instruments at the balance sheet date if they are publicly traded.

The fair values of short-term deposits, loans and overdrafts with a maturity of less than one year are assumed to approximate to their book values. In the case of bank loans and other loans due in more than one year the fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate available to the Group for similar financial instruments.

### 3 FINANCIAL RISK MANAGEMENT

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

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

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

The principal financial risks faced by the Group relate to interest rate and counterparty risk.

#### *i) Interest rate risk*

The Group has both interest bearing assets and interest bearing liabilities. The Group has a policy of maintaining at least 50% of interest bearing liabilities at fixed rates. The Group uses a combination of fixed rate and index-linked borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. At the year end 66% of net borrowings were at fixed rates and 9% index-linked. The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and are not, therefore, an exposure for the Group. These instruments are analysed in more detail in note 26.

#### *ii) Counterparty risk management*

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. The Group has no other significant concentration of credit risk. 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 a credit rating threshold approved by the Board.

#### *iii) Liquidity risk*

The Group actively maintains a mixture of long-term and short-term committed facilities that are designed to ensure the Group has significant available funds for operations and planned expansions and facilities equivalent to at least one year's forecast requirements are maintained at all times. Details of undrawn committed facilities and short-term uncommitted facilities are provided in note 26.

#### *iv) Refinancing risk management*

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

## NOTES TO THE FINANCIAL STATEMENTS

### 4 CRITICAL ACCOUNTING JUDGEMENTS

The Group's principal accounting policies are set out in note 2 to these financial statements. Management is required to exercise significant judgement and make use of estimates and assumptions in the application of these policies.

Areas which management believes require the most critical accounting judgements are:

#### **Exceptional items**

The Directors consider that items of income or expense which are material and non-recurring by virtue of their nature and amount should be disclosed separately if the financial statements are to fairly present the financial position and financial performance of the Group. The Directors label these items collectively as "exceptional items".

#### **Landfill 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 income statement as a financial item with interest payable.

Where a provision gives access to future economic benefits, an asset is recognised and depreciated in accordance with the Group's depreciation policy.

#### **Joint ventures**

The results, assets and liabilities of joint ventures are accounted for using the equity method of accounting as this reflects the contractual and control arrangements with the joint venture partners.

#### **Borrowing costs**

The Group capitalises borrowing costs which are material and directly attributable to the construction of qualifying assets, which are assets that necessarily take a substantial period of time to be prepared for their intended use. Currently only the assets under construction in the Lakeside Energy from Waste joint venture meet the criteria for capitalisation.

#### **Retirement benefit obligations**

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

The pension cost under IAS 19 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 principal assumptions used to measure schemes' liabilities, sensitivities to changes in these assumptions and future funding obligations are disclosed in note 28 of the financial statements.

#### **Cash-generating units**

For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). The waste management segment is considered to be a single cash-generating unit as it is an integrated business.

**4 CRITICAL ACCOUNTING JUDGEMENTS** *(continued)*

Areas which management believes requires the most critical accounting estimations are

**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 and gas production at the site post closure. 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 property, plant and equipment is set out in note 2 to these financial statements. The carrying value of property, plant and equipment as at 31 March 2007 was £2,559.4 million. In the year ended 31 March 2007 additions to tangible fixed assets totalled £245.1 million and the depreciation charge was £115.2 million. Estimated useful economic lives 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 capital investment to the Group, variations between actual and estimated useful lives could impact operating results both positively and negatively. Historically, only minor 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.

**Provision for doubtful debts**

At each balance sheet date, each subsidiary evaluates the collectability of trade receivables and records provisions for doubtful debts based on experience including, 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 2007 current trade receivables were £118.0 million.

**Impairment of intangible assets**

The Group records all assets and liabilities acquired in business acquisitions, including goodwill, at fair value. Intangible assets which have an indefinite useful life, principally goodwill, are assessed annually for impairment.

The initial goodwill recorded and subsequent impairment analysis require management to make estimations of future cash flows, terminal values and an assessment of the long-term pre-tax discount rate to be applied to those cash flows to reflect an assessment of the cost of capital of the cash-generating unit.

## NOTES TO THE FINANCIAL STATEMENTS

### 5 SEGMENTAL REPORTING

	2007 £m	2006 £m
<b>Revenue</b>		
Water and sewerage	381.5	348.5
Waste management	367.7	298.9
Other	7.6	7.3
Less intra-segment trading *	(8.5)	(9.0)
	<b>748.3</b>	<b>645.7</b>
<b>Segment result</b>		
<b>Operating profit before depreciation, amortisation and exceptional items (EBITDA)</b>		
Water and sewerage	234.5	213.4
Waste management	82.8	66.7
Other	(1.8)	(0.9)
	<b>315.5</b>	<b>279.2</b>
<b>Operating profit before amortisation and exceptional items</b>		
Water and sewerage	156.8	141.5
Waste management	46.8	35.9
Other	(1.8)	(0.7)
	<b>201.8</b>	<b>176.7</b>
<b>Operating profit before exceptional items</b>		
Water and sewerage	156.8	141.5
Waste management	45.0	34.3
Other	(1.8)	(0.7)
	<b>200.0</b>	<b>175.1</b>
<b>Operating profit</b>		
Water and sewerage	156.8	127.0
Waste management	45.0	34.3
Other	(1.8)	(0.7)
	<b>200.0</b>	<b>160.6</b>
<b>Profit before tax and exceptional items</b>		
Water and sewerage	98.9	87.4
Waste management	27.6	21.9
Other	4.6	1.6
	<b>131.1</b>	<b>110.9</b>

The exceptional items are detailed in note 9

All operating activities are continuing operations

\*Intra-segment trading between and to other segments by the water and sewerage and waste management segments is under normal commercial terms and conditions that would also be available to unrelated third parties. Intra-segment revenue of the Other segment is at cost

NOTES TO THE FINANCIAL STATEMENTS

5 SEGMENTAL REPORTING (continued)

	Water and sewerage £m	Waste management £m	Other £m	Eliminations £m	Group £m
<b>Balance sheet</b>					
<b>31 March 2007</b>					
Assets (excluding investment in joint ventures)	2,429.2	590.7	553.1	(593.1)	2,979.9
Investments in joint ventures	-	1.4	-	-	1.4
<b>Total assets</b>	<b>2,429.2</b>	<b>592.1</b>	<b>553.1</b>	<b>(593.1)</b>	<b>2,981.3</b>
Liabilities	(1,659.9)	(477.2)	(810.1)	593.1	(2,354.1)
<b>Net assets/(liabilities)</b>	<b>769.3</b>	<b>114.9</b>	<b>(257.0)</b>	<b>-</b>	<b>627.2</b>
<b>31 March 2006</b>					
Assets (excluding investment in joint ventures)	2,229.3	472.7	534.0	(507.8)	2,728.2
Investments in joint ventures	-	1.3	-	-	1.3
<b>Total assets</b>	<b>2,229.3</b>	<b>474.0</b>	<b>534.0</b>	<b>(507.8)</b>	<b>2,729.5</b>
Liabilities	(1,493.2)	(360.2)	(802.7)	507.8	(2,148.3)
<b>Net assets/(liabilities)</b>	<b>736.1</b>	<b>113.8</b>	<b>(268.7)</b>	<b>-</b>	<b>581.2</b>

Segment liabilities of the water and sewerage and waste management segments comprise operating liabilities. The other segment liabilities include the Company's financing of business acquisitions and Group taxation liabilities.

	Water and sewerage £m	Waste management £m	Other £m	Group £m
<b>Other information</b>				
<b>31 March 2007</b>				
Amortisation of intangible assets (note 16)	-	1.8	-	1.8
Capital expenditure (including acquisitions)	184.0	97.9	0.2	282.1
Depreciation	77.7	36.0	-	113.7
<b>31 March 2006</b>				
Amortisation of intangible assets (note 16)	-	1.6	-	1.6
Capital expenditure (including acquisitions)	191.0	104.5	-	295.5
Depreciation	71.9	30.8	(0.2)	102.5
			2007	2006
<b>Employees (average number)</b>				
The average monthly number of employees (including executive directors) was				
Water and sewerage			1,301	1,299
Waste management			1,686	1,388
Other			38	35
<b>Group totals</b>			<b>3,025</b>	<b>2,722</b>

## NOTES TO THE FINANCIAL STATEMENTS

### **5 SEGMENTAL REPORTING** *(continued)*

The total number of employees at 31 March 2007 was 3,204 (2006 2,775)

The water and sewerage business comprises the regulated water and sewerage services undertaken by South West Water Limited. The waste management business is the waste treatment, recycling and disposal services provided by Vindor Limited. Other includes parent company financing of business acquisitions made before 1999. Segment assets include goodwill and other intangible assets, property, plant and equipment, inventories, trade and other receivables and cash and cash equivalents. Segment liabilities comprise operating liabilities and exclude taxation. Capital expenditure comprises additions to property, plant and equipment, including additions resulting from acquisitions through business combinations.

#### **Geographical segments**

Separate disclosure by geographical segment is not shown since the operations of the Group are all located in the United Kingdom.

NOTES TO THE FINANCIAL STATEMENTS

**6. OPERATING COSTS**

	2007 £m	2006 £m
Manpower costs (note 13)	<b>91 0</b>	79 9
Raw materials and consumables	<b>47.2</b>	40 7
<b>Other operating expenses include</b>		
Profit on disposal of fixed assets	<b>(2 6)</b>	(1 1)
Operating lease rentals payable		
– Plant and machinery	<b>7 2</b>	6 9
– Property	<b>1.5</b>	1 3
Research and development expenditure	<b>0.1</b>	0 1
Trade receivables impairment	<b>5.6</b>	5 6
Depreciation of property, plant and equipment		
– Owned assets	<b>90 7</b>	77 7
– Under finance leases	<b>23 0</b>	24 8
Amortisation of intangible assets (note 16)	<b>1 8</b>	1 6

Fees payable to the Group's auditors in the year were as follows

	2007 £000	2006 £000
Fees payable to the Company's auditors for the audit of the Company's accounts	<b>37</b>	31
<i>Fees payable to the Company's auditors for other services to the Group</i>		
Audit of the Company's subsidiaries pursuant to legislation	<b>243</b>	279
Other services pursuant to legislation	<b>17</b>	15
Tax services	<b>162</b>	158
Services relating to corporate finance transactions	<b>188</b>	75
All other services	<b>97</b>	297
	<b>744</b>	855
<i>Fees payable to the Company's auditors in respect of Pennon Group pension schemes</i>		
Audit	<b>22</b>	18

Other services in 2006 include costs relating to the transition to IFRS and the financial restructuring in the Company

A description of the work of the Audit Committee is set out in its report on pages 40 and 41 which includes an explanation of how auditor objectivity and independence are safeguarded when non-audit services are provided by the auditors

## NOTES TO THE FINANCIAL STATEMENTS

### 7 NET FINANCE COSTS

	2007 £m	2006 £m
<b>Interest payable</b>		
Bank borrowings and overdrafts	(33.3)	(25.7)
Interest element of finance lease rentals	(41.9)	(39.4)
Other finance costs	(0.6)	(11.7)
Interest cost on retirement benefit obligations	(18.4)	(16.6)
Unwinding of discounts in provisions	(4.1)	(3.4)
<b>Interest payable and similar charges</b>	<b>(98.3)</b>	<b>(96.8)</b>
<b>Interest receivable</b>	<b>7.0</b>	<b>14.7</b>
Expected return on pension scheme assets	22.1	17.8
<b>Interest receivable and similar income</b>	<b>29.1</b>	<b>32.5</b>
<b>Net finance costs</b>	<b>(69.2)</b>	<b>(64.3)</b>

The above exclude the 2006 exceptional items, totalling a net £42.3 million interest payable, which are detailed in note 9

### 8 TAXATION

	2007 £m	Before exceptional items 2006 £m	Exceptional items (note 9) 2006 £m	Total 2006 £m
<b>Analysis of charge in year</b>				
Current tax	23.9	14.8	(18.7)	(3.9)
Deferred tax (note 29)	13.3	20.2	–	20.2
	<b>37.2</b>	<b>35.0</b>	<b>(18.7)</b>	<b>16.3</b>

UK Corporation tax is calculated at 30% (2006 30%) of the estimated assessable profit for the year. The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK (30%). The differences are

	2007 £m	2006 £m
Profit before tax	131.1	54.1
Profit before tax multiplied by standard rate of corporation tax in the UK of 30% (2006 30%)	39.3	16.2
Effects of		
Expenses not deductible for tax purposes	0.7	1.9
Sale of assets and finance leasing	(3.8)	(0.5)
Other	0.6	(1.4)
Adjustments to tax charge in respect of prior year	0.4	0.1
<b>Tax charge for year</b>	<b>37.2</b>	<b>16.3</b>

The average applicable tax rate for the year was 28% (2006 30%)

In addition to the amount charged to the income statement, a deferred tax credit relating to actuarial losses on defined benefit schemes of £0.4 million (2006 £0.8 million) has been credited directly to equity. In 2006 a deferred tax credit relating to share-based payment of £1.2 million was also credited directly to equity.

## NOTES TO THE FINANCIAL STATEMENTS

### 8 TAXATION (continued)

The Finance Bill 2007 contains provisions relating to the reduction in the rate of corporation tax from 30% to 28% with effect from 1 April 2008. It was also announced that industrial building allowances will be phased out over three years commencing 1 April 2008.

At 31 March 2007, the above changes were not substantively enacted. If the change in corporation tax rate is fully enacted then the deferred tax liability would reduce by £21 million. The provisions to abolish industrial building allowances are expected to be contained in the Finance Bill 2008 and if fully enacted, are likely to increase the deferred tax liability by an estimated £37 million. The combined impact would therefore be to increase the deferred tax liability by £16 million.

### 9 EXCEPTIONAL ITEMS

	2007 £m	2006 £m
The exceptional items are		
Customer payment	-	(14.5)
<b>Operating profit</b>	<b>-</b>	<b>(14.5)</b>
Bond retirement	-	(50.2)
Receipt on transfer of lease	-	7.9
Net finance costs	-	(42.3)
<b>Profit before tax</b>	<b>-</b>	<b>(56.8)</b>
Tax arising on exceptional items	-	18.7
<b>Profit after tax</b>	<b>-</b>	<b>(38.1)</b>

The customer payment and bond retirement related to financial restructuring in the Company and South West Water Limited.

The receipt on transfer of lease related to a consent fee paid to South West Water Limited arising from the sale of finance leases between financial institutions.

### 10 PROFIT OF PARENT COMPANY

	2007 £m	2006 £m
Profit attributable to equity shareholders dealt with in the accounts of the parent company	<b>93.8</b>	214.9

As permitted by Section 230 of the Companies Act 1985 no income statement is presented for the Company.

### 11. EARNINGS PER SHARE

Basic earnings per share are calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in the employee share trust (note 31), which are treated as cancelled.

For diluted earnings per share, the weighted average number of ordinary shares in issue is adjusted to include all dilutive potential ordinary shares. The Group has two types of dilutive potential ordinary shares – those share options granted to employees where the exercise price is less than the average market price of the Company's ordinary shares during the year and the contingently issuable shares under the Group's Restricted Share Plan and the deferred shares element of the Performance Related Bonus Plan to the extent that the performance criteria for vesting of the awards are expected to be met.

## NOTES TO THE FINANCIAL STATEMENTS

### 11 EARNINGS PER SHARE (continued)

The reconciliation of the weighted average number of shares and earnings used in the calculations is

	2007	2006 (Restated)
<b>Number of shares (millions)</b>		
<b>For basic earnings per share</b>	<b>353.9</b>	381.9
Effect of dilutive potential ordinary shares		
Share options	3.2	3.3
<b>For diluted earnings per share</b>	<b>357.1</b>	385.2

The weighted average number of ordinary shares at March 2006 has been restated to reflect the sub-division of the Company's ordinary shares by way of a three for one split on 31 July 2006 (note 31)

#### Adjusted basic and diluted earnings per share

Adjusted earnings per share have been calculated to exclude the impact of the 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. Adjusted earnings have been calculated

	2007			2006		
	Profit after tax £m	Basic p	Earnings per share Diluted p	Profit after tax £m	Basic p	Earnings per share (Restated) Diluted p
Earnings per share	93.9	26.5	26.3	37.8	9.9	9.8
Exceptional items (net of tax)	-	-	-	38.1	10.0	9.9
Deferred tax	13.3	3.8	3.7	20.2	5.3	5.2
<b>Adjusted earnings per share</b>	<b>107.2</b>	<b>30.3</b>	<b>30.0</b>	96.1	25.2	24.9

All operating activities are continuing operations

### 12. DIVIDENDS

	2007 £m	2006 £m
Amounts recognised as distributions to equity holders in the year		
Interim dividend paid for the year ended 31 March 2006 5.5p (2005 4.6p) per share	19.4	17.7
Final dividend paid for the year ended 31 March 2006 11.7p (2005 9.7p) per share	41.6	37.4
	<b>61.0</b>	55.1
<b>Proposed dividends</b>		
Proposed interim dividend for the year ended 31 March 2007 5.85p (2006 5.5p) per share	20.8	19.4
Proposed final dividend for the year ended 31 March 2007 12.7p (2006 11.7p) per share	45.2	41.6
	<b>66.0</b>	61.0

Dividends per share for 2006 have been restated to reflect the sub-division of the Company's ordinary shares by way of a three for one split on 31 July 2006 (note 31)

The proposed interim and final dividends have not been included as liabilities in these financial statements. The proposed interim dividend for 2007 was paid on 11 April 2007 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

**13. EMPLOYMENT COSTS**

	2007 £m	2006 £m
Wages and salaries	77.9	72.5
Social security costs	6.7	6.5
Pension costs	14.2	9.8
Share-based payments	2.1	1.7
<b>Total employment costs</b>	<b>100.9</b>	<b>90.5</b>
<b>Charged</b>		
Manpower costs	91.0	79.9
Capital schemes	9.9	10.0
Restructuring provision	-	0.6
<b>Total employment costs</b>	<b>100.9</b>	<b>90.5</b>

Details of Directors' emoluments are set out in note 14. There are no personnel, other than Directors, who as key management exercise authority and responsibility for planning, directing and controlling the activities of the Group.

**14. DIRECTORS' EMOLUMENTS**

	2007 £000	2006 £000
<b>Executive Directors</b>		
Salary	803	630
Performance related bonus payable	286	223
Vesting of Restricted Share Plan awards	-	276
Vesting of Performance Related Bonus Plan awards	512	199
Other emoluments	112	54
Payment in lieu of pension provision	48	-
Payments related to supplementary pension	100	148
<b>Non-executive Directors</b>	<b>319</b>	<b>303</b>
<b>Total emoluments</b>	<b>2,180</b>	<b>1,833</b>

The 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.

Total gains made by Directors on the exercise of share options were £15,000 (2006 nil).

Total emoluments include £1,074,000 (2006 £828,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2007 retirement benefits were accruing to two Directors under defined benefit pension schemes (2006 three).

The accrued pension entitlement at 31 March 2007 under defined benefit schemes of the highest paid Director was £90,000 (2006 £81,000). No pension contributions were payable to defined contribution schemes in 2007 or 2006 but in 2007 one Director received payment in lieu of pension provision by the Company.

More detailed information concerning Directors' emoluments (including pensions) and share interests is shown in the audited part of the Directors' remuneration report.

## NOTES TO THE FINANCIAL STATEMENTS

### 15. GOODWILL

	£m
Cost	
At 1 April 2005	64.4
Recognised on acquisition of subsidiaries	34.2
At 1 April 2006	98.6
Recognised on acquisition of subsidiaries (note 37)	35.7
At 31 March 2007	134.3
Carrying amount	
At 31 March 2006	98.6
<b>At 31 March 2007</b>	<b>134.3</b>

Goodwill acquired in a business combination is allocated at acquisition to the cash-generating unit (CGU) expected to benefit from that business combination. All of the carrying amount of goodwill is allocated to the waste management segment which is considered to be a single CGU, as it is an integrated business.

Goodwill is reviewed annually or when other events or changes in circumstance indicate that the carrying amount may not be fully recoverable.

The recoverable amount of the waste management segment is determined from value in use calculations. The key assumptions in those calculations relate to discount rates, cash flows, price increases and for landfill, the compaction rate. Cash flow projections are based on approved budgets and plans for the next five years and beyond this period on long-term growth rates for the waste sector based on GDP. The cash flows have been discounted using a pre-tax discount rate of 11.4% which reflects the overall business risks associated with the waste management segment activities.

### 16 OTHER INTANGIBLE ASSETS

	Customer contracts £m	Patents £m	Total £m
<i>Acquired intangible assets</i>			
Cost			
At 1 April 2005	7.2	0.2	7.4
Acquisitions	1.3	-	1.3
At 31 March 2006	8.5	0.2	8.7
Acquisitions	3.9	-	3.9
At 31 March 2007	12.4	0.2	12.6
Amortisation			
At 1 April 2005	1.4	-	1.4
Charge for year	1.6	-	1.6
At 31 March 2006	3.0	-	3.0
Charge for year	1.8	-	1.8
At 31 March 2007	4.8	-	4.8
Carrying amount			
At 31 March 2006	5.5	0.2	5.7
<b>At 31 March 2007</b>	<b>7.6</b>	<b>0.2</b>	<b>7.8</b>

**16. OTHER INTANGIBLE ASSETS (continued)**

Customer contracts are amortised over the useful economic life of each contract which at acquisition ranged between 2 and 15 years  
The average remaining life is 6 years

Patents are amortised over their estimated useful economic lives which at acquisition was 13 years The average remaining life is 10 years

The carrying value of other intangible assets are reviewed annually or when events or changes in circumstance indicate that the carrying amount may not be fully recoverable

**17. PROPERTY, PLANT AND EQUIPMENT**

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant vehicles and computers £m	Landfill restoration £m	Construction in progress £m	Total £m
<b>Cost</b>							
At 1 April 2005	232.7	1,029.1	547.3	939.1	-	70.4	2,818.6
Arising on acquisitions	18.4	-	-	5.1	3.1	-	26.6
Additions	26.7	56.4	3.5	66.8	-	96.3	249.7
Other	-	-	-	-	32.3	-	32.3
Grants and contributions	-	(1.1)	-	(2.5)	-	-	(3.6)
Disposals	(13.1)	-	(5.8)	(68.7)	-	-	(87.6)
Transfers/reclassifications	0.6	23.6	12.3	30.3	-	(66.8)	-
<b>At 31 March 2006</b>	<b>265.3</b>	<b>1,108.0</b>	<b>557.3</b>	<b>970.1</b>	<b>35.4</b>	<b>99.9</b>	<b>3,036.0</b>
Arising on acquisitions	7.4	-	-	5.3	1.4	-	14.1
Additions	31.5	60.7	2.1	72.9	-	77.9	245.1
Other (note 30)	-	-	-	-	6.8	-	6.8
Grants and contributions	-	(3.6)	-	(1.3)	-	-	(4.9)
Disposals	(0.5)	(0.7)	-	(6.2)	-	-	(7.4)
Transfers/reclassifications	0.3	32.5	11.4	41.4	-	(85.6)	-
<b>At 31 March 2007</b>	<b>304.0</b>	<b>1,196.9</b>	<b>570.8</b>	<b>1,082.2</b>	<b>43.6</b>	<b>92.2</b>	<b>3,289.7</b>
<b>Depreciation</b>							
At 1 April 2005	93.2	11.6	116.9	378.4	-	-	600.1
Charge for year	14.1	13.2	10.3	63.6	2.7	-	103.9
Disposals	(10.2)	-	(5.8)	(67.9)	-	-	(83.9)
<b>At 31 March 2006</b>	<b>97.1</b>	<b>24.8</b>	<b>121.4</b>	<b>374.1</b>	<b>2.7</b>	<b>-</b>	<b>620.1</b>
Charge for year	18.3	15.1	10.6	68.1	3.1	-	115.2
Disposals	(0.2)	(0.7)	-	(4.1)	-	-	(5.0)
<b>At 31 March 2007</b>	<b>115.2</b>	<b>39.2</b>	<b>132.0</b>	<b>438.1</b>	<b>5.8</b>	<b>-</b>	<b>730.3</b>
<b>Net book value</b>							
At 31 March 2006	168.2	1,083.2	435.9	596.0	32.7	99.9	2,415.9
<b>At 31 March 2007</b>	<b>188.8</b>	<b>1,157.7</b>	<b>438.8</b>	<b>644.1</b>	<b>37.8</b>	<b>92.2</b>	<b>2,559.4</b>

Out of the total depreciation charge of £115.2 million (2006 £103.9 million), £1.5 million (2006 £1.4 million) has been charged to capital projects and £113.7 million (2006 £102.5 million) against profits

Asset lives and residual values are reviewed annually

## NOTES TO THE FINANCIAL STATEMENTS

### 17 PROPERTY, PLANT AND EQUIPMENT *(continued)*

Assets held under finance leases included on the previous page

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant vehicles and computers £m	Landfill restoration £m	Construction in progress £m	Total £m
<b>Cost</b>							
At 31 March 2006	–	181.2	380.2	261.2	–	84.1	906.7
At 31 March 2007	–	271.3	387.3	277.1	–	52.3	988.0
<b>Depreciation</b>							
At 31 March 2006	–	3.5	54.6	126.5	–	–	184.6
At 31 March 2007	–	6.5	59.9	137.9	–	–	204.3
<b>Net book amount</b>							
At 31 March 2006	–	177.7	325.6	134.7	–	84.1	722.1
At 31 March 2007	–	264.8	327.4	139.2	–	52.3	783.7

#### Company

	Fixed and mobile plant, vehicles and computers £m
<b>Cost</b>	
At 1 April 2005	0.3
Disposals	(0.1)
At 31 March 2006	0.2
Additions	0.2
Disposals	(0.1)
At 31 March 2007	0.3
<b>Depreciation</b>	
At 1 April 2005	0.1
Charge for year	0.1
Disposals	(0.1)
At 31 March 2006	0.1
Charge for year	0.1
Disposals	(0.1)
At 31 March 2007	0.1
<b>Net book value</b>	
At 31 March 2006	0.1
At 31 March 2007	0.2

Asset lives and residual values are reviewed annually

**18. TRADE AND OTHER RECEIVABLES – NON-CURRENT**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Amounts owed by subsidiary undertakings	–	–	170.1	127.4
Amounts owed by joint ventures	5.8	2.8	–	–
Other debtors	1.1	3.2	1.1	1.0
	<b>6.9</b>	<b>6.0</b>	<b>171.2</b>	<b>128.4</b>

The fair values of trade and other receivables are as follows

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Amounts owed by subsidiary undertakings	–	–	170.3	127.9
Amounts owed by joint ventures	9.2	4.8	–	–
Other debtors	1.1	3.3	1.1	1.0
	<b>10.3</b>	<b>8.1</b>	<b>171.4</b>	<b>128.9</b>

**19. INVESTMENTS**

	Joint ventures		Total £m
	Shares £m	Loans £m	
<b>Group</b>			
At 1 April 2005	–	–	–
Acquisitions	–	0.2	0.2
Additions	1.1	–	1.1
At 31 March 2006	1.1	0.2	1.3
Share of profit	0.2	–	0.2
Part repayment of loans	–	(0.1)	(0.1)
<b>At 31 March 2007</b>	<b>1.3</b>	<b>0.1</b>	<b>1.4</b>

	Subsidiary undertakings £m
<b>Company</b>	
At 1 April 2005	931.8
Additions	207.2
Disposals	(195.2)
At 31 March 2006	943.8
<b>At 31 March 2007</b>	<b>943.8</b>

Details of principal subsidiary and joint venture undertakings of the Group are set out in note 38

## NOTES TO THE FINANCIAL STATEMENTS

### 19. INVESTMENTS (continued)

The Group's share of the results of its joint ventures and its share of the joint ventures' assets and liabilities are

	Assets		Liabilities		Revenues £m	Profit £m
	Non-current £m	Current £m	Current £m	Non-current £m		
<b>2006</b>						
Echo South West Limited	0.1	0.7	(0.9)	(0.1)	4.9	0.1
Lakeside Energy from Waste Holdings Limited	25.3	1.6	(1.5)	(25.7)	-	-
	25.4	2.3	(2.4)	(25.8)	4.9	0.1
<b>2007</b>						
Echo South West Limited	0.1	0.6	(0.8)	-	5.2	0.1
Lakeside Energy from Waste Holdings Limited	38.3	2.8	(0.9)	(36.9)	0.3	0.2
	38.4	3.4	(1.7)	(36.9)	5.5	0.3

### 20. INVENTORIES

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Raw materials and consumables	5.0	4.8	-	-
Work in progress	0.1	0.2	-	-
	5.1	5.0	-	-

### 21. TRADE AND OTHER RECEIVABLES - CURRENT

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Trade receivables	118.0	91.2	-	-
Less provision for impairment of receivables	(34.3)	(27.6)	-	-
Trade receivables	83.7	63.6	-	-
Amounts owed by subsidiary undertakings	-	-	55.6	45.3
Amounts owed by joint ventures	0.9	1.1	-	-
Other receivables	3.2	4.6	0.3	0.3
Other prepayments and accrued income	34.7	25.2	0.1	0.1
	122.5	94.5	56.0	45.7

The Directors consider that the carrying amount of trade and other receivables approximates to their fair value

### 22. DERIVATIVE FINANCIAL INSTRUMENTS

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
<i>Interest rate swaps - cash flow hedges</i>				
Assets	16.0	3.1	1.7	0.6
Liabilities	-	(3.0)	-	-

**22 DERIVATIVE FINANCIAL INSTRUMENTS** *(continued)*

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50% of Group net borrowings is at fixed rate. At 31 March 2007 66% of Group net borrowings was at fixed rate (2006 68%)

At 31 March 2007, the Group had interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £636.0 million and a weighted average maturity of 3.1 years (2006 £676.0 million, with 3.5 years). The weighted average interest rate of the swaps for their nominal amount was 4.8% (2006 4.9%)

At 31 March 2007, the Company had interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £50.0 million and a weighted average maturity of 3.0 years (2006 £50.0 million, with 4.0 years). The weighted average interest rate of the swaps was 4.5% (2006 4.5%)

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date. All the interest rate swaps are designated and effective as cash flow hedges and the fair values have been deferred in equity.

**23. CASH AND CASH EQUIVALENTS**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash at bank and in hand	8.9	7.7	24.1	20.8
Short-term bank deposits	114.3	91.1	-	40.0
Other deposits	4.7	0.6	-	-
	<b>127.9</b>	<b>99.4</b>	<b>24.1</b>	<b>60.8</b>

The effective interest rate on Group short-term deposits was 5.3% (2006 4.7%) and these deposits have an average maturity of three days.

Other deposits include £4.1 million (2006 nil) of restricted funds to settle long-term lease liabilities (note 26).

Cash and cash equivalents comprise the following for the purposes of the cash flow statement:

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash and cash equivalents as above	127.9	99.4	24.1	60.8
Bank overdrafts (note 26)	(10.9)	(18.5)	-	-
	<b>117.0</b>	<b>80.9</b>	<b>24.1</b>	<b>60.8</b>
Less deposits with a maturity of three months or more	4.7	0.6	-	-
	<b>112.3</b>	<b>80.3</b>	<b>24.1</b>	<b>60.8</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 24. TRADE AND OTHER PAYABLES – CURRENT

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Trade payables	84.8	93.8	0.1	0.5
Amounts owed to subsidiary undertakings	–	–	14.5	14.1
Amounts owed to joint venture	0.3	0.4	–	–
Other tax and social security	42.7	24.8	0.3	0.2
Other creditors	9.9	17.6	3.1	8.8
Accruals	38.2	33.5	1.0	1.6
	<b>175.9</b>	<b>170.1</b>	<b>19.0</b>	<b>25.2</b>

The Directors consider that the carrying amount of trade and other payables approximates to their fair value

### 25. CURRENT TAX LIABILITIES/(RECOVERABLE)

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Corporation tax	36.5	24.0	(1.2)	–

### 26. BORROWINGS

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
<b>Current</b>				
Bank overdrafts	10.9	18.5	–	–
Short-term loans	7.6	0.1	7.5	–
European Investment Bank	16.3	4.2	–	–
Unsecured loan stock notes	2.1	3.9	2.1	3.9
Amounts owed to subsidiary undertakings	–	–	293.7	279.2
	<b>36.9</b>	<b>26.7</b>	<b>303.3</b>	<b>283.1</b>
Obligations under finance leases	48.9	28.0	–	–
	<b>85.8</b>	<b>54.7</b>	<b>303.3</b>	<b>283.1</b>
<b>Non-current</b>				
Bank and other loans	350.1	312.7	130.0	157.4
European Investment Bank	215.9	232.2	–	–
	<b>566.0</b>	<b>544.9</b>	<b>130.0</b>	<b>157.4</b>
Obligations under finance leases	1,033.4	926.9	–	–
	<b>1,599.4</b>	<b>1,471.8</b>	<b>130.0</b>	<b>157.4</b>
<b>Total borrowings</b>	<b>1,685.2</b>	<b>1,526.5</b>	<b>433.3</b>	<b>440.5</b>

The Directors consider that the carrying amounts of current borrowings approximate to their fair value

NOTES TO THE FINANCIAL STATEMENTS

**26. BORROWINGS** (continued)

The fair values of the non-current borrowings were

	2007		2006	
	Book value £m	Fair value £m	Book value £m	Fair value £m
<b>Group</b>				
Bank and other loans	350.1	349.7	312.7	312.7
European Investment Bank	215.9	210.9	232.2	226.9
	<b>566.0</b>	<b>560.6</b>	<b>544.9</b>	<b>539.6</b>
Obhgations under finance leases	1,033.4	921.8	926.9	884.5
	<b>1,599.4</b>	<b>1,482.4</b>	<b>1,471.8</b>	<b>1,424.1</b>
<b>Company</b>				
Bank loans	130.0	130.0	157.4	157.4

Where market values are not available, fair values of borrowings have been calculated by discounting expected future cash flows at prevailing interest rates

The exposure to interest rate changes and the repricing dates at the balance sheet was

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
6 months or less	1,012.1	384.0	138.2	159.7
6 – 12 months	450.5	140.7	1.4	1.6
1 – 5 years	222.6	896.8	–	–
Over 5 years	–	105.0	–	–
	<b>1,685.2</b>	<b>1,526.5</b>	<b>139.6</b>	<b>161.3</b>

The maturity of non-current borrowings was

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Between 1 and 2 years	93.2	64.4	–	–
Between 2 and 5 years	442.0	150.4	130.0	157.4
Over 5 years	1,064.2	1,257.0	–	–
	<b>1,599.4</b>	<b>1,471.8</b>	<b>130.0</b>	<b>157.4</b>

The effective interest rates at the balance sheet date were

	Group		Company	
	2007 %	2006 %	2007 %	2006 %
Bank overdrafts	6.2	5.5	–	–
Short-term loans	5.8	5.5	5.7	–
European Investment Bank	5.6	4.7	–	–
Unsecured loan stock notes	4.8	4.0	4.8	4.0
Bank and other loans	5.3	4.9	5.8	5.0
Finance leases	4.4	3.8	–	–

## NOTES TO THE FINANCIAL STATEMENTS

### 26. BORROWINGS (continued)

Finance lease liabilities – minimum lease payments

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Within one year	64.4	38.8	-	-
In the second to fifth years inclusive	270.0	219.1	-	-
After five years	1,866.7	1,379.2	-	-
	<b>2,201.1</b>	<b>1,637.1</b>	-	-
Less future finance charges	(1,118.8)	(682.2)	-	-
	<b>1,082.3</b>	<b>954.9</b>	-	-

Included above are accrued finance charges arising on obligations under finance leases totalling £126.4 million (2006 £109.2 million), of which £36.5 million (2006 £23.8 million) is repayable within one year

Within obligations under finance leases, South West Water Limited has utilised finance lease facilities of £180.0 million for certain water and sewerage business property, plant and equipment that are secured by bank letters of credit issued by United Kingdom financial institutions. These letters of credit, covering the full period of the finance leases, are renewable between the financial institutions and South West Water Limited at five-yearly intervals, the next being March 2011.

During the year the period for repayment of these leases was extended with an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits, £4.1 million at 31 March 2007, are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

Undrawn committed borrowing facilities

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Floating rate				
Expiring within one year	120.0	50.0	45.0	-
Expiring after one year	150.0	160.0	105.0	95.0
	<b>270.0</b>	<b>210.0</b>	<b>150.0</b>	<b>95.0</b>

In addition, the Group has short-term uncommitted bank facilities of £90.0 million. The Company has £80.0 million short-term uncommitted bank facilities.

### 27 OTHER NON-CURRENT LIABILITIES

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Amounts owed to subsidiary undertakings	-	-	8.7	8.7
Other creditors	2.1	2.2	-	-
	<b>2.1</b>	<b>2.2</b>	<b>8.7</b>	<b>8.7</b>

**28. RETIREMENT BENEFIT OBLIGATIONS**

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 trustees of the funds are required to act in the best interest of the funds' beneficiaries. The appointment of schemes' trustees is determined by the schemes' trust documentation. The Group has a policy that one-half of all trustees other than the Chairman are nominated by members of the fund, including current pensioners.

**Defined contribution schemes**

Pension costs for defined contribution schemes were £0.8 million (2006 £0.5 million)

**Defined benefit schemes**

The principal actuarial assumptions at the balance sheet date were:

	2007 %	2006 %
Expected return on scheme assets	6.9	6.7
Rate of increase in pensionable pay	4.0	3.8
Rate of increase for present and future pensions	3.0	2.8
Rate used to discount schemes' liabilities	5.4	5.0
Inflation	3.0	2.8

**Mortality**

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience.

The average life expectancy in years of a pensioner retiring at age 62 on the balance sheet date is projected at:

	2007	2006
Male	23.8	22.0
Female	26.6	25.0

The average life expectancy in years of a pensioner retiring at age 62, 20 years after the balance sheet date is projected at:

	2007	2006
Male	24.5	22.9
Female	27.3	25.8

The sensitivities regarding the principal assumptions used to measure the schemes' liabilities are:

	Change in assumption	Impact on schemes liabilities
Rate of increase in pensionable pay	+/- 0.5%	+/-2.4%
Rate of increase in present and future pensions	+/- 0.5%	+/-6.0%
Rate used to discount schemes' liabilities	+/- 0.5%	+/-10.0%
Inflation	+/- 0.5%	+/-10.0%
Mortality rate	+/- 1 year	+/-2.5%

NOTES TO THE FINANCIAL STATEMENTS

**28. RETIREMENT BENEFIT OBLIGATIONS** *(continued)*

The amounts recognised in the income statement were.

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Current service cost	(12.6)	(8.3)	(0.8)	(0.4)
Past service cost	(0.8)	(1.0)	-	-
<b>Total included within employment costs</b>	<b>(13.4)</b>	<b>(9.3)</b>	<b>(0.8)</b>	<b>(0.4)</b>
Expected return on pension schemes' assets	22.1	17.8	1.7	2.4
Interest cost on retirement benefit obligations	(18.4)	(16.6)	(1.4)	(1.4)
<b>Total included within net finance costs</b>	<b>3.7</b>	<b>1.2</b>	<b>0.3</b>	<b>1.0</b>
<b>Total (charge)/credit</b>	<b>(9.7)</b>	<b>(8.1)</b>	<b>(0.5)</b>	<b>0.6</b>

The actual return on schemes' assets was £23.6 million (2006 £52.0 million)

The amounts recognised in the statement of recognised income and expense were

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Actuarial (losses)/gains recognised in the year	(1.2)	(2.8)	(0.4)	0.7

The amounts recognised in the balance sheet were

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Fair value of schemes' assets	347.6	317.5	27.0	25.4
Present value of defined benefit obligations	(388.8)	(359.2)	(30.4)	(28.7)
<b>Net liability recognised in the balance sheet</b>	<b>(41.2)</b>	<b>(41.7)</b>	<b>(3.4)</b>	<b>(3.3)</b>

The schemes' assets and the expected long-term rates of return at the year end were

	Expected return %	2007 Value £m	Fund %	Expected return %	2006 Value £m	Fund %
	Equities	8.0	194.3	56	7.7	198.5
Property/currency	7.8	40.2	11	7.7	14.9	5
Bonds	4.7	112.5	33	4.7	91.6	29
Other	5.0	0.6	-	4.7	12.5	4
		<b>347.6</b>	<b>100</b>		<b>317.5</b>	<b>100</b>

The Company's share of the schemes' assets at the balance sheet date were

	2007 £m	2006 £m
Equities	15.2	15.9
Property/currency	2.9	1.2
Bonds	8.9	7.3
Other	-	1.0
	<b>27.0</b>	<b>25.4</b>

**28. RETIREMENT BENEFIT OBLIGATIONS** *(continued)*

The expected return on plan assets is determined by considering the long-term returns and the balance between risk and reward on the various categories of investment assets held. Expected returns on equity and property investments reflect long-term rates of return experienced in the respective markets. Expected yields on fixed interest investments are based on gross redemption yields as at the balance sheet date.

In conjunction with the trustees and investment advisers, the Group has restructured its portfolio of defined benefit pension investments during the year following a review of strategy. This led to a new asset allocation structure with the objective of increasing investment returns whilst reducing risk. The revised asset allocation has three main elements:

- an increased holding of bonds which are expected to be less volatile than most other asset classes and are a better match for the schemes' liabilities
- a reduction in the proportion of equities, but with fund managers having more freedom in making investment decisions to maximise returns
- investment of a relatively small proportion of the schemes' assets (circa 10%) in alternative asset classes which give the potential for gaining higher returns (property and currency)

Equities held by the scheme are spread between the UK (circa 55%) and international markets (circa 45%) excluding emerging markets.

The Group provides retirement benefits to some of its former and approximately 54% of current employees through defined benefit schemes. The level of retirement benefit is principally based on final annual salary earned in employment.

The liabilities of the defined benefit schemes are measured by using the projected unit credit method which is an accrued benefits valuation method in which the scheme liabilities make allowance for projected earnings.

An alternative method of valuation to the projected unit credit method is a solvency basis which is estimated using the cost of buying out benefits with a suitable insurer. This amount represents the amount that would be required to settle the schemes' liabilities at the balance sheet date rather than the Group continuing to fund the on-going liabilities. The Group estimates the amount required to settle the schemes' liabilities at the balance sheet date was £549 million.

Movements in the balance sheet net liability were:

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 April	(41.7)	(79.8)	(3.3)	(6.4)
Income statement	(9.7)	(8.1)	(0.5)	0.6
Statement of recognised income and expenditure	(1.2)	(2.8)	(0.4)	0.7
Regular contributions	2.8	4.8	-	0.2
Prepayment of regular contributions	8.6	44.2	0.8	1.6
<b>At 31 March</b>	<b>(41.2)</b>	<b>(41.7)</b>	<b>(3.4)</b>	<b>(3.3)</b>

Movements in the fair value of schemes' assets were:

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 April	317.5	223.8	25.4	17.9
Expected return on schemes' assets	22.1	17.8	1.7	2.4
Actuarial gains	1.5	34.2	0.1	3.9
Members' contributions	0.3	2.0	-	0.1
Benefits paid	(13.1)	(9.3)	(1.0)	(0.7)
Group regular contributions	2.8	4.8	0.5	0.2
Prepayment of Group regular contributions	8.6	44.2	0.3	1.6
Acquisition of subsidiary	7.9	-	-	-
<b>At 31 March</b>	<b>347.6</b>	<b>317.5</b>	<b>27.0</b>	<b>25.4</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 28. RETIREMENT BENEFIT OBLIGATIONS (continued)

Movements in the present value of defined benefit obligations were

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
At 1 April	(359.2)	(303.6)	(28.7)	(24.3)
Service cost	(13.4)	(9.3)	(0.8)	(0.4)
Interest cost	(18.4)	(16.6)	(1.4)	(1.4)
Actuarial losses	(2.7)	(37.0)	(0.5)	(3.2)
Members' contributions	(0.3)	(2.0)	-	(0.1)
Benefits paid	13.1	9.3	1.0	0.7
Acquisition of subsidiary	(7.9)	-	-	-
<b>At 31 March</b>	<b>(388.8)</b>	<b>(359.2)</b>	<b>(30.4)</b>	<b>(28.7)</b>

The Group's transition date to IFRS was 1 April 2004 and the following historical data has been presented from that date. The historical data will be built up to a rolling five-year record over the next two years.

	2007 £m	2006 £m	2005 £m
<b>Group</b>			
Fair value of schemes' assets	347.6	317.5	223.8
Present value of defined benefit obligations	(388.8)	(359.2)	(303.6)
<b>Net liability recognised</b>	<b>(41.2)</b>	<b>(41.7)</b>	<b>(79.8)</b>
Experience gains on schemes' assets			
Amount (£m)	1.5	34.2	9.8
Percentage of schemes' assets	0.4%	10.8%	4.4%
Experience losses on defined benefit obligations			
Amount (£m)	(2.7)	(37.0)	(7.9)
Percentage of defined benefit obligations	(0.7)%	(10.3)%	(2.6)%

The experience loss in 2007 of £2.7 million includes an increase in liabilities of £16.0 million arising from the use of an updated longevity assumption for pensioners.

The cumulative actuarial losses recognised in the Group statement of recognised income and expense at 31 March 2007 were £2.1 million (2006 £0.9 million).

	2007 £m	2006 £m	2005 £m
<b>Company</b>			
Fair value of schemes' assets	27.0	25.4	17.9
Present value of defined benefit obligations	(30.4)	(28.7)	(24.3)
<b>Net liability recognised</b>	<b>(3.4)</b>	<b>(3.3)</b>	<b>(6.4)</b>
Experience gains on schemes' assets			
Amount (£m)	0.1	3.9	0.9
Percentage of schemes' assets	-	15.3%	5.0%
Experience losses on defined benefit obligations			
Amount (£m)	(0.4)	(0.3)	(1.1)
Percentage of defined benefit obligations	(0.1)%	(0.1)%	(4.5)%

The cumulative actuarial gains recognised in the Company statement of recognised income and expense at 31 March 2007 were £3.1 million (2006 £3.4 million).

**28 RETIREMENT BENEFIT OBLIGATIONS** *(continued)*

The most recently completed triennial actuarial valuation of the Group's defined benefit schemes was carried out as at 1 April 2004. The Group's current service cost has increased from 11.5% of pensionable earnings in 2004/05 to 21.7% in 2006/07. On 1 April 2006 the existing schemes were closed to new entrants (replaced by a new scheme with reduced benefits) and contribution rates for most employees were increased from 5% to 7%. In August 2005 a prepayment of Group regular pension contributions to March 2010 of £44.2 million was made. A further £8.6 million prepayment was made in September 2006. As a result of these prepayments no further Group regular contributions are expected to be paid to the schemes during the year ending 31 March 2008.

The Group has agreed with the trustees that it will aim to eliminate the actuarially calculated on-going funding deficit of circa £59 million as at 31 March 2004 over the remaining service life of scheme members, which is expected to be circa 13 years. The Group monitors funding levels on an annual basis and a further formal review will be undertaken following the results of the next triennial valuation, as at 1 April 2007.

Contribution levels are based on the current service costs and the expected future cash flows of the defined benefit schemes. The cash flows arising from the payment of the defined benefits contained in the April 2004 actuarial valuation are expected to be settled from that date as shown in the graph below.

Graph here

**29 DEFERRED TAX**

Deferred tax is provided in full on temporary differences under the liability method using a tax rate of 30% (2006 30%).

Movement on the deferred tax account were

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Liability/(asset) at 1 April	302.8	282.8	(1.8)	(2.1)
Charged/(credited) to the income statement	13.3	20.2	0.1	(0.4)
(Credited)/charged to equity	(0.4)	(2.0)	(0.1)	0.7
Arising on acquisitions	(2.0)	1.8	-	-
<b>Liability/(asset) at 31 March</b>	<b>313.7</b>	<b>302.8</b>	<b>(1.8)</b>	<b>(1.8)</b>

Deferred tax assets have been recognised in respect of all temporary differences giving rise to deferred tax assets because it is probable that these assets will be recovered.

## NOTES TO THE FINANCIAL STATEMENTS

### 29. DEFERRED TAX (continued)

All deferred tax assets and liabilities are within the same jurisdiction and may be offset as permitted by IAS12. The movement in deferred tax assets and liabilities is shown below.

#### Group

##### Deferred tax liabilities

	Accelerated tax depreciation £m	Leased assets £m	Other £m	Total £m
At 1 April 2005	293.4	4.3	21.4	319.1
Charged/(credited) to the income statement	15.9	0.8	(2.1)	14.6
Arising on acquisitions	(3.2)	-	5.3	2.1
<b>At 31 March 2006</b>	<b>306.1</b>	<b>5.1</b>	<b>24.6</b>	<b>335.8</b>
Charged/(credited) to the income statement	6.3	4.9	(2.1)	9.1
Arising on acquisitions	(2.4)	-	2.0	(0.4)
<b>At 31 March 2007</b>	<b>310.0</b>	<b>10.0</b>	<b>24.5</b>	<b>344.5</b>

##### Deferred tax assets

	Provisions £m	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2005	(9.4)	(23.9)	(3.0)	(36.3)
Charged/(credited) to the income statement	2.0	12.2	(8.6)	5.6
Credited to equity	-	(0.8)	(1.2)	(2.0)
Arising on acquisitions	(0.3)	-	-	(0.3)
<b>At 31 March 2006</b>	<b>(7.7)</b>	<b>(12.5)</b>	<b>(12.8)</b>	<b>(33.0)</b>
Charged/(credited) to the income statement	0.4	0.5	3.3	4.2
Credited to equity	-	(0.4)	-	(0.4)
Arising on acquisitions	(1.6)	-	-	(1.6)
<b>At 31 March 2007</b>	<b>(8.9)</b>	<b>(12.4)</b>	<b>(9.5)</b>	<b>(30.8)</b>

##### Net deferred tax liability

At 31 March 2006	302.8
<b>At 31 March 2007</b>	<b>313.7</b>

#### Company

##### Deferred tax assets

	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2005	(1.9)	(0.2)	(2.1)
Charged/(credited) to the income statement	0.7	(0.4)	0.3
Charged/(credited) to equity	0.2	(0.2)	-
<b>At 31 March 2006</b>	<b>(1.0)</b>	<b>(0.8)</b>	<b>(1.8)</b>
Charged to the income statement	0.1	-	0.1
Credited to equity	(0.1)	-	(0.1)
<b>At 31 March 2007</b>	<b>(1.0)</b>	<b>(0.8)</b>	<b>(1.8)</b>

**29 DEFERRED TAX (continued)**

The deferred tax credited/(charged) to equity during the year was

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Actuarial gains/(losses) on defined benefit schemes	0.4	0.8	0.1	(0.2)
Share-based payments (note 34)	-	1.2	-	0.2
	<b>0.4</b>	<b>2.0</b>	<b>0.1</b>	<b>-</b>

**30. PROVISIONS FOR LIABILITIES AND CHARGES**

	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Total 2007 £m
At 1 April 2006	76.6	1.2	0.2	78.0
Charged/(credited) to the income statement	5.7	(0.2)	-	5.5
Arising on acquisitions	18.0	-	-	18.0
Landfill restoration	6.8	-	-	6.8
Utilised during year	(7.8)	(1.0)	-	(8.8)
<b>At 31 March 2007</b>	<b>99.3</b>	<b>-</b>	<b>0.2</b>	<b>99.5</b>

The additional landfill restoration provision of £6.8 million recognised in the year has been matched with an addition to property, plant and equipment

The analysis of provisions between current and non current is

	2007 £m	2006 £m
Current	13.2	11.4
Non-current	86.3	66.6
	<b>99.5</b>	<b>78.0</b>

Environmental and landfill restoration provisions are expected to be substantially utilised over the period from 2008 to beyond 2035. 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 related to severance costs.

**31. SHARE CAPITAL**

	2007 £m	2006 £m
<b>Authorised</b>		
429,975,270 ordinary shares of 40.7p each	175.0	-
2006 (143,325,090 ordinary shares of £1.221/10 each)	-	175.0
131,818,190 B Shares of £1.10 each, 35,858,521 converted to Deferred Shares of £1.10 each)	-	145.0
<b>Allotted, called-up and fully paid</b>		
356,123,879 ordinary shares of 40.7p each	144.9	-
2006 (118,608,847 ordinary shares of £1.221/10 each)	-	144.8
35,858,521 Deferred Shares of £1.10 each)	-	39.4
	<b>144.9</b>	<b>184.2</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 31 SHARE CAPITAL (continued)

#### Ordinary shares allotted during the year

	2007 number		2006 number	
	Ordinary shares of 40 7p each	Ordinary shares of £1 22 1/10 each	Ordinary shares of £1 22 1/10 each	Ordinary shares of £1 11 each
In lieu of £21.0 million cash under scrip dividend alternative	-	-	-	2,087,293
For consideration of £1.9 million under the Company's Sharesave Scheme (2006 £1.6 million)	1,082,338	-	5,683	314,962
Issued in respect of share options granted	-	-	-	116,886
For consideration of £3.5 million, shares purchased and subsequently cancelled (2006 nil)	(50,000)	(245,000)	-	-
	<b>1,032,338</b>	<b>(245,000)</b>	<b>5,683</b>	<b>2,519,141</b>

On 31 July 2006 each of the Company's issued and unissued existing ordinary shares of £1 22 1/10 each were sub-divided into three new Ordinary shares of 40 7p each

During 2006 a capital return to shareholders was made by way of the B Share Scheme amounting to £143.5 million, of which £39.4 million was by way of the initial dividend payment and £104.1 million was through share redemption. The B Shares which received the initial dividend were subsequently converted into Deferred Shares, redeemed at the close of business on 6 April 2006 for a total aggregate consideration of one pence and were then cancelled. At 31 March 2006, £39.4 million of the capital return via the B Share Scheme was outstanding and held in Share Capital and £5.7 million of the B Shares not redeemed until 6 April 2006 were held within other payables, note 24

On 17 February 2006 there was a consolidation of the ordinary shares of the Company whereby for every 11 existing ordinary shares of £1 11 each held, shareholders received 10 new ordinary shares of £1 22 1/10 each. As a result, the number of ordinary shares in issue was reduced by 11,860,317

#### Employee share schemes

The Group operates a number of share plans for the benefit of employees. Details of each plan are set out below. In each table the price and number of shares for the comparative periods has been restated to reflect the sub-division of the Company's ordinary shares by way of the three for one split on 31 July 2006

##### 1) Sharesave Scheme

An all-employee savings related plan is operated that enables employees, including executive directors, to invest up to a maximum of £250 per month for three or five years. These savings can then be used to buy ordinary shares at a price set at a 20% discount to the market value at the start of the savings period at the third, fifth or seventh anniversary of the option being granted. Options expire six months following the exercise date and, except for certain specific circumstances such as redundancy, lapse if the employee leaves the Group before the option exercise period commences

Outstanding options to subscribe for ordinary shares of 40 7p each under the Company's share option schemes are

Date granted and subscription price fully paid	Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March		
		2007	2006	
6 July 1999	275p	2002 - 2006	1	18
5 July 2000	154p	2003 - 2007	189	201
4 July 2001	163p	2004 - 2008	33	180
9 July 2002	189p	2005 - 2009	236	246
8 July 2003	177p	2006 - 2010	351	1,251
6 July 2004	200p	2007 - 2011	803	852
5 July 2005	270p	2008 - 2012	669	717
4 July 2006	358p	2009 - 2013	643	-
			<b>2,925</b>	<b>3,465</b>

At 31 March 2007 there were 1,145 participants in the Scheme (2006 1,121)

**31 SHARE CAPITAL (continued)**

**Employee share schemes (continued)**

*i) Sharesave Scheme (continued)*

The number and weighted average exercise price of Sharesave options are

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average exercise price per share p	Number of ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	3,465	201	3,846	180
Granted	665	358	744	270
Exercised	(1,082)	177	(963)	169
Expired	(123)	248	(162)	196
<b>At 31 March</b>	<b>2,925</b>	<b>244</b>	<b>3,465</b>	<b>201</b>

The weighted average price of the Company's shares at the date of exercise of Sharesave options during the year was 477p (2006 345p). The options outstanding at 31 March 2007 had a weighted average exercise price of 244p (2006 201p) and a weighted average remaining contractual life of 2.0 years (2006 2.0 years).

The aggregate fair value of Sharesave options granted during the year was £0.7 million (2006 £0.6 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model at the date of issue of the options were

	2007	2006
Weighted average share price	321p	260p
Weighted average exercise price	257p	208p
Expected volatility	22.3%	23.7%
Expected life	4.2 years	3.9 years
Risk-free rate	4.6%	4.5%
Expected dividend yield	4.6%	5.2%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous two years.

*ii) Restricted Share Plan*

Under this plan Executive Directors and senior management receive a conditional award of shares in the Company. The eventual number of shares, if any, which vest is dependent upon the achievement of the performance condition of the plan over the restricted period, being not less than three years.

The number of weighted average price shares in the Restricted Share Plan are

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average exercise price per share p	Number of ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	1,347	287	1,536	246
Granted	366	499	423	357
Vested	(95)	195	(225)	213
Lapsed	(120)	270	(252)	213
Share consolidation	-	-	(135)	-
<b>At 31 March</b>	<b>1,498</b>	<b>346</b>	<b>1,347</b>	<b>287</b>

The awards outstanding at 31 March 2007 had a weighted average price of 346p (2006 287p) and a weighted average remaining contractual life of 1.2 years (2006 1.7 years). The Company's share price at the date of the awards ranged from 195p to 499p.

## NOTES TO THE FINANCIAL STATEMENTS

### 31 SHARE CAPITAL (continued)

#### Employee share schemes (continued)

##### ii) Restricted Share Plan (continued)

The aggregate fair value of awards granted during the year was £1.0 million (2006 £0.9 million), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were

	2007	2006
Weighted average share price	346p	287p
Expected volatility	22.6%	23.6%
Risk-free rate	4.7%	4.6%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous two years.

##### iii) Incentive Bonus Plan – Deferred Shares

Awards under the plan to Executive Directors and senior management involve the release of ordinary shares in the Company to participants.

The number and weighted average price of shares in the Incentive Bonus Plan are

	2007		2006	
	Number of ordinary shares (thousands)	Weighted average exercise price per share p	Number of ordinary shares (thousands)	Weighted average exercise price per share p
At 1 April	501	269	534	232
Granted	139	484	186	328
Vested	(234)	255	(162)	217
Lapsed	-	-	(9)	217
Share consolidation	-	-	(48)	-
At 31 March	406	350	501	269

The awards outstanding at 31 March 2007 had a weighted average price of 350p (2006 269p) and a weighted average remaining contractual life of 1.4 years (2006 1.5 years). The Company's share price at the date of the awards ranged from 253p to 484p.

The aggregate fair value of awards granted during the year was £0.6 million (2006 £0.6 million), determined from market value. No option pricing issues arise as dividends declared on the shares are receivable by the participants in the scheme and there is no performance condition since vesting is usually conditional upon continuous service with the Group for a period of three years from the date of the award.

Options granted to Directors, included above, are shown in the audited part of the Directors' remuneration report.

### 32 SHARE PREMIUM ACCOUNT

	£m
At 1 April 2005	153.7
Adjustment for shares issued under the scrip dividend alternative	(2.3)
Premium on shares issued for cash consideration	2.3
Utilised on creation of 130,463,483 B Shares of £1.10 each	(143.5)
At 31 March 2006	10.2
Premium on shares issued for cash consideration	1.5
At 31 March 2007	11.7

**33 CAPITAL REDEMPTION RESERVE**

	£m
At 1 April 2005	–
Transferred from retained earnings on redemption of 89,404,091 B Shares of £1 10 each	98 4
<b>At 31 March 2006</b>	<b>98 4</b>
Transferred from retained earnings on redemption of 5,200,871 B Shares of £1 10 each	5 7
35,858,521 Deferred shares cancelled	39 4
Own shares purchased and subsequently cancelled	0 3
<b>At 31 March 2007</b>	<b>143 8</b>

**34 RETAINED EARNINGS AND OTHER RESERVES**

	Hedging reserve £m	Own shares £m	Retained earnings £m	Total £m
<b>Group</b>				
At 1 April 2005	–	(5 9)	419 1	413 2
Adjustments on adoption of IAS 32/39 1 April 2005	(0 9)	–	9 5	8 6
Profit for the year	–	–	37 8	37 8
Other recognised income and expense for the year	1 0	–	(2 0)	(1 0)
Adjustment for shares issued under the scrip dividend alternative	–	–	21 0	21 0
Dividends paid	–	–	(55 1)	(55 1)
Adjustment in respect of share-based payments	–	–	1 7	1 7
Deferred tax in respect of share-based payments	–	–	1 2	1 2
Own shares issued to the Pennon Employee Share Trust in respect of share options granted	–	(1 2)	–	(1 2)
Adjustment in respect of share options vesting	–	1 1	(1 1)	–
B Share payments	–	–	(137 8)	(137 8)
<b>At 31 March 2006</b>	<b>0 1</b>	<b>(6 0)</b>	<b>294 3</b>	<b>288 4</b>
Profit for year	–	–	93 9	93 9
Other recognised income and expense for the year	15 7	–	(0 8)	14 9
Dividends paid	–	–	(61 0)	(61 0)
Adjustment in respect of share-based payments	–	–	2 1	2 1
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	–	(2 3)	–	(2 3)
Adjustment in respect of share options vesting	–	1 1	(1 1)	–
B Share payments	–	–	(5 7)	(5 7)
Own shares purchased and subsequently cancelled	–	–	(3 5)	(3 5)
<b>At 31 March 2007</b>	<b>15.8</b>	<b>(7.2)</b>	<b>318.2</b>	<b>326.8</b>

The own shares reserve represents the cost of ordinary shares in Pennon Group Plc issued to or purchased in the market and held by the Pennon Employee Share Trust to satisfy awards under the Group's Restricted Share Plan and Incentive Bonus Plan

During the year the trustees of the Pennon Employee Share Trust acquired 46,684 of the Company's ordinary shares of £1 22<sup>1</sup>/<sub>10</sub> each and 319,334 ordinary shares of 40 7p each, financed through non-interest bearing advances made by sponsoring group companies (2006 117,000 ordinary shares of £1 11 each)

The market value of the 1,980,000 ordinary shares of 40 7p each (2006 616,000 ordinary shares of £1 22<sup>1</sup>/<sub>10</sub> each) held by the trust at 31 March 2007 was £11 6 million (2006 £8 3 million)

## NOTES TO THE FINANCIAL STATEMENTS

### 34. RETAINED EARNINGS AND OTHER RESERVES *(continued)*

	Hedging reserve £m	Retained earnings £m	Total £m
<b>Company</b>			
At 1 April 2005	–	366.3	366.3
Adjustments on adoption of IAS 32/39 1 April 2005	–	–	–
Profit for the year	–	214.9	214.9
Other recognised income and expense for the year	0.6	0.5	1.1
Adjustment for shares issued under the scrip dividend alternative	–	21.0	21.0
Dividends paid	–	(55.1)	(55.1)
Adjustment in respect of share-based payments	–	0.4	0.4
Deferred tax in respect of share-based payments	–	0.2	0.2
Adjustment in respect of share options vesting	–	(0.3)	(0.3)
B Share payments	–	(137.8)	(137.8)
<b>At 31 March 2006</b>	<b>0.6</b>	<b>410.1</b>	<b>410.7</b>
Profit for the year	–	93.8	93.8
Other recognised income and expense for the year	1.1	(0.3)	0.8
Dividends paid	–	(61.0)	(61.0)
Adjustment in respect of share-based payments	–	0.5	0.5
Adjustment in respect of share options vesting	–	(0.4)	(0.4)
B Share payments	–	(5.7)	(5.7)
Own shares purchased and subsequently cancelled	–	(3.5)	(3.5)
<b>At 31 March 2007</b>	<b>1.7</b>	<b>433.5</b>	<b>435.2</b>

The B Share payments of £137.8 million in 2006 comprise £98.4 million for shares redeemed and £39.4 million for amounts paid as dividend

NOTES TO THE FINANCIAL STATEMENTS

**35. CASH FLOW FROM OPERATING ACTIVITIES**

Reconciliation of profit for the year to cash generated from operations

**Cash generated from operations**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
<b>Continuing operations</b>				
Profit for the year	93.9	37.8	93.8	214.9
Adjustments for				
Employee share schemes	2.1	1.7	0.5	0.4
Deferred income released to profits	-	(0.3)	-	-
Profit on disposal of property, plant and equipment	(2.6)	(1.1)	-	-
Profit on disposal of investment	(0.6)	-	-	-
Depreciation charge	113.7	102.5	0.1	0.1
Amortisation of intangible assets	1.8	1.6	-	-
Share of post-tax profit from joint venture	(0.3)	(0.1)	-	-
Interest payable and similar charges	98.3	147.0	9.9	23.3
Interest receivable	(29.1)	(40.4)	(16.1)	(25.1)
Dividends receivable	-	-	(90.1)	(212.3)
Taxation	37.2	16.3	1.2	(1.0)
Changes in working capital (excluding the effect of acquisition of subsidiaries)				
Increase in inventories	(0.1)	(0.3)	-	-
(Increase)/decrease in trade and other receivables	(20.7)	2.0	(53.4)	100.2
Increase/(decrease) in trade and other payables	16.9	8.4	(0.4)	5.4
Increase/(decrease) in retirement benefit obligations	2.0	(39.7)	-	(1.4)
Decrease in provisions for liabilities and charges	(7.4)	(3.3)	-	-
<b>Cash generated/(outflow) from operations</b>	<b>305.1</b>	<b>232.1</b>	<b>(54.5)</b>	<b>104.5</b>

**36 NET BORROWINGS**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Cash and cash equivalents	127.9	99.4	24.1	60.8
<b>Borrowings – current</b>				
Bank overdrafts	(10.9)	(18.5)	-	-
Other current borrowings	(26.0)	(8.2)	(9.6)	(3.9)
Finance lease obligations	(48.9)	(28.0)	-	-
Amounts owed to subsidiary undertakings	-	-	(293.7)	(279.2)
<b>Total current borrowings</b>	<b>(85.8)</b>	<b>(54.7)</b>	<b>(303.3)</b>	<b>(283.1)</b>
<b>Borrowings – non current</b>				
Bank and other loans	(350.1)	(312.7)	(130.0)	(157.4)
Other non-current borrowings	(215.9)	(232.2)	-	-
Finance lease obligations	(1,033.4)	(926.9)	-	-
<b>Total non-current borrowings</b>	<b>(1,599.4)</b>	<b>(1,471.8)</b>	<b>(130.0)</b>	<b>(157.4)</b>
<b>Total net borrowings</b>	<b>(1,557.3)</b>	<b>(1,427.1)</b>	<b>(409.2)</b>	<b>(379.7)</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 37 ACQUISITIONS

On 13 May 2006 the entire issued share capital of Wyvern Waste Services Limited, (now renamed Vindor Waste (Somerset) Limited), was purchased by Vindor Waste Management Limited for a cash consideration of £25.4 million, including costs of £0.4 million. The acquisition has been accounted for using the acquisition method.

Vindor Waste (Somerset) Limited contributed revenues of £26.7 million and net profit of £2.8 million for the period from 13 May 2006 to 31 March 2007. If the acquisition had occurred on 1 April 2006 Group revenues for the year would have been £29.3 million and profit for the year would have been £3.3 million. These amounts have been calculated after applying the Group's accounting policies, adjusting the results to reflect the fair value adjustments as if they had applied from 1 April 2006 and include the costs of integrating the acquisition with the existing business.

All intangible assets have been recognised at their respective fair values. The residual excess over the net assets acquired has been recognised as goodwill. The goodwill is attributed to the profitability of the acquired business and the anticipated future operating synergies arising from the combination.

	Book value £m	Fair value adjustment £m	Fair value £m
Other intangible assets	-	3.6	3.6
Property, plant and equipment	14.3	(2.9)	11.4
Receivables	5.9	-	5.9
Payables	(4.2)	-	(4.2)
Provisions – environmental	(8.2)	(9.8)	(18.0)
Taxation – current	(0.4)	-	(0.4)
Taxation – deferred	1.6	0.7	2.3
Cash and cash equivalents	3.0	-	3.0
<b>Net assets acquired</b>	<b>12.0</b>	<b>(8.4)</b>	<b>3.6</b>
Goodwill			21.8
<b>Total consideration</b>			<b>25.4</b>
<b>Satisfied by:</b>			
Cash			25.0
Directly attributable costs			0.4
			25.4
<b>Net cash outflow arising on acquisition</b>			
Cash consideration			25.4
Cash and cash equivalents acquired			(3.0)
			22.4

The intangible assets acquired as part of the acquisition relate to customer contracts.

**37 ACQUISITIONS** *(continued)*

On 13 February 2007 the entire issued share capital of Skipaway Holdings Limited, (now renamed Vindor Waste (Medway) Limited), was purchased by Vindor Waste Management Limited for a cash consideration of £15.1 million, including costs of £0.4 million. The acquisition has been accounted for using the acquisition method.

Vindor Waste (Medway) Limited contributed revenues of £1.9 million and net loss of £0.6 million for the period from 13 February 2007 to 31 March 2007. If the acquisition had occurred on 1 April 2006 Group revenues for the year would have been £16.5 million and profit for the year would have been nil. These amounts have been calculated after applying the Group's accounting policies, adjusting the results to reflect the fair value adjustments as if they had applied from 1 April 2006 and include the costs of integrating the acquisition with the existing business.

All intangible assets have been recognised at their respective provisional fair values. The residual excess over the net assets acquired has been recognised as goodwill. The provisional goodwill is attributed to the profitability of the acquired business and the anticipated future operating synergies arising from the combination.

	Book value £m	Fair value adjustment £m	Provisional fair value £m
Other intangible assets	0.2	0.1	0.3
Property, plant and equipment	2.7	–	2.7
Receivables	2.2	–	2.2
Payables	(2.6)	–	(2.6)
Taxation – current	(0.2)	–	(0.2)
Taxation – deferred	(0.3)	–	(0.3)
Finance leases	(1.4)	–	(1.4)
Cash and cash equivalents	0.5	–	0.5
<b>Net assets acquired</b>	<b>1.1</b>	<b>0.1</b>	<b>1.2</b>
Goodwill			13.9
<b>Total consideration</b>			<b>15.1</b>
<b>Satisfied by:</b>			
Cash			14.7
Directly attributable costs			0.4
			15.1
<b>Net cash outflow arising on acquisition</b>			
Cash consideration			15.1
Cash and cash equivalents acquired			(0.5)
			14.6

The intangible assets acquired as part of the acquisition relate to customer contracts.

## NOTES TO THE FINANCIAL STATEMENTS

### 38 PRINCIPAL SUBSIDIARY AND JOINT VENTURE UNDERTAKINGS AT 31 MARCH 2007

	Country of incorporation, registration and principal operations
<b>Water and sewerage</b>	
South West Water Limited*	England
Peninsula Leasing Limited	England
Peninsula Properties (Exeter) Limited	England
South West Water Finance Plc	England
<b>Waste management</b>	
Vindor Limited*	England
Vindor Waste Limited	England
Vindor Waste Disposal Limited	England
Vindor Waste Exeter Limited	England
Dragon Waste Limited	England
Vindor Waste Management Limited	England
Vindor EnviroScot Limited	Scotland
Vindor Glass Recycling Limited	England
Vindor Parkwood Holdings Limited	British Virgin Islands †
Parkwood Group Limited	England
Vindor Waste (Bristol Holdings) Limited	England
Vindor Waste (Bristol) Limited	England
Vindor Waste Kent Limited	England
Vindor Waste (Landfill Restoration) Limited	England
Vindor Waste (Medway) Holdings Limited	England
Vindor Waste (Somerset) Limited	England
Vindor Waste (Thames) Limited	England
Vindor Waste (Suffolk) Limited	England
Vindor Waste (West Sussex) Limited	England
<b>Other</b>	
Peninsula Insurance Limited*	Guernsey
Peninsula Water Limited*	England

\* Indicates the shares are held directly by Pennon Group Plc, the Company

† Operations are carried out in England

During the year South West Water Finance Plc was established

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 Vindor Waste Limited. All companies above are consolidated in the Group financial statements.

#### Joint ventures

Both joint ventures and the subsidiary undertakings of Lakeside Energy from Waste Holdings Limited are incorporated and registered in England which is also their country of operation.

	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			
Lakeside Energy from Waste Holdings Limited	1,000,000 A Ordinary shares 1,000,000 B Ordinary shares	- 100%	
Lakeside Energy from Waste Limited			Waste management
Lakeside Energy Limited			Waste management

Shares in Lakeside Energy from Waste Holdings Limited are held by Vindor Waste Management Limited

**39 OPERATING LEASE COMMITMENTS – MINIMUM LEASE PAYMENTS**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Commitments under non-cancellable operating leases expiring				
Within one year	5.6	4.4	-	-
Later than one year and less than five years	16.0	12.1	-	-
After five years	79.8	70.1	-	-
	<b>101.4</b>	<b>86.6</b>	<b>-</b>	<b>-</b>

The Group leases various offices, depots and workshops under non-cancellable operating lease agreements. The leases have various terms, escalation clauses and renewal rights. Property leases are negotiated for an average term of 25 years and rentals are reviewed on average at five yearly intervals.

The Group also leases plant and machinery under non-cancellable operating lease agreements.

**40. CONTINGENT LIABILITIES**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Guarantees				
Borrowing facilities of subsidiary undertakings	-	-	322.0	657.9
Performance bonds	81.6	80.8	81.6	80.8
Letters of credit	5.1	7.6	-	-
Other	6.9	6.9	6.9	6.9
	<b>93.6</b>	<b>95.3</b>	<b>410.5</b>	<b>745.6</b>

Guarantees in respect of performance bonds are entered into in the normal course of business. No liability is expected to arise in respect of the guarantees.

The guarantee in respect of letters of credit has been given by Vindor Waste Limited in support of the borrowings of the joint venture of Vindor Waste Management Limited, Lakeside Energy from Waste Holdings Limited. In addition, Vindor Waste Management Limited has given a commitment to supply 200,000 tonnes of waste per annum (or pay market price based compensation) to the energy from waste plant of the joint venture. The plant is expected to be commissioned during the financial year 2008/09. The Directors consider that the committed waste volume will be available in the ordinary course of business.

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.

**41. CAPITAL COMMITMENTS**

	Group		Company	
	2007 £m	2006 £m	2007 £m	2006 £m
Contracted but not provided	71.7	66.6	-	-
Share of commitment contracted but not provided by joint venture	41.7	64.2	-	-
	<b>113.4</b>	<b>130.8</b>	<b>-</b>	<b>-</b>

## NOTES TO THE FINANCIAL STATEMENTS

### 42 RELATED PARTY TRANSACTIONS

During the year, Group companies entered into the following transactions with related parties who are not members of the Group

	2007 £m	2006 £m
<i>Sales of goods and services</i>		
Echo South West Limited	2.6	2.5
<i>Purchase of goods and services</i>		
Echo South West Limited	9.5	9.0

#### Year end balances

	2007 £m	2006 £m
<i>Receivables due from related parties (notes 18 and 21)</i>		
Echo South West Limited	0.9	1.2
Lakeside Energy from Waste Limited	5.8	2.7
	6.7	3.9
<i>Payables due to related parties (note 24)</i>		
Echo South West Limited	0.3	0.4

All amounts relate to trading balances except £5.5 million of loans included within receivables due for repayment in instalments between 2009 and 2030. Interest is charged at 6% until 2008 then 15% thereafter.

#### Company

The following transactions with subsidiary undertakings occurred in the year

	2007 £m	2006 £m
Sales of goods and services (management fees)	6.5	5.7
Purchase of goods and services (support services)	0.5	0.5
Interest receivable (loans)	12.3	20.4
Interest payable (short-term funding)	0.6	1.2
Dividends received	90.1	212.3

Sales of goods and services to subsidiary undertakings are at cost. Purchases of goods and services from subsidiary undertakings are under normal commercial terms and conditions that would also be available to unrelated third parties.

#### Year end balances

*Receivables due from subsidiary undertakings (notes 18 and 21)*

	2007 £m	2006 £m
Loans	224.7	169.8
Trading balances	0.3	2.4

Interest on £119.9 million of the loans is charged at a fixed rate of 6.0% (2006 £84.9 million, 6.0%). Interest on the balance of the loans is charged at Barclays Bank PLC base rate +1% (2006 Barclays Bank PLC base rate +1%). The loans are repayable in instalments over the period 2008 to 2012. During the year £0.2 million (2006 £0.1 million) was provided in respect of loans to subsidiaries not expected to be repaid.

**42. RELATED PARTY TRANSACTIONS (continued)**

	2007 £m	2006 £m
<i>Payables due to subsidiary undertakings (notes 24, 26 and 27)</i>		
Loans	293.7	279.2
Trading balances	23.2	22.8

The loans from subsidiary undertakings are unsecured and interest free without any terms for repayment

**43. EXPLANATION OF TRANSITION TO IFRS BY THE COMPANY**

Pennon Group Plc, the Company, reported under UK GAAP in its previously published financial statements for the year ended 31 March 2006. The date of transition to IFRS for the Company was 1 April 2005.

The transition to IFRS did not result in any change to net assets from that previously reported under UK GAAP. The only presentational impact on assets and liabilities was as a result of IAS19, "Employee Benefits," in respect of the treatment of the deferred tax asset on the retirement benefit obligation. Under UK GAAP, FRS17 "Retirement benefits," the pension deficit was shown net of the deferred tax asset. Under IAS19 the retirement benefit obligation is shown gross and the related deferred tax asset is included as part of other deferred tax assets or liabilities.

The restatements of the balance sheet at 31 March are

	2006 £m	2005 £m
<i>Deferred tax asset</i>		
Reported under UK GAAP	0.8	0.2
IAS 19 Pensions	1.0	1.9
Reported under IFRS	1.8	2.1
<i>Retirement benefit obligations</i>		
Reported under UK GAAP	(2.3)	(4.5)
IAS 19 Pensions	(1.0)	(1.9)
Reported under IFRS	(3.3)	(6.4)

Similarly, in the income statement the change in the deferred tax asset related to the pension deficit is part of tax on ordinary activities other than in respect of any actuarial loss or gain which is included within the statement of recognised income and expense.

The restatements of the profit for the year and net gains not recognised directly in the income statement for the year ended 31 March 2006 are

	2006 £m
<i>Profit for the year</i>	
Reported under UK GAAP	215.6
IAS 19 Pensions	(0.7)
Reported under IFRS	214.9
<i>Net gains not recognised directly in the income statement</i>	
Reported under UK GAAP	(0.2)
IAS 19 Pensions	0.7
Reported under IFRS	0.5

## FIVE YEAR FINANCIAL SUMMARY

	IFRS 2007 £m	IFRS 2006 £m	IFRS 2005 £m	UK GAAP 2004 £m	UK GAAP 2003 £m
<b>Income statement</b>					
Revenue	748.3	645.7	551.4	471.3	417.2
Operating profit before exceptional items	200.0	175.1	150.9	136.3	127.0
Net interest payable	(69.2)	(106.6)	(62.0)	(57.2)	(52.1)
Share of profit/(loss) in joint ventures	0.3	0.1	0.1	(0.3)	(0.7)
Profit before tax and exceptional items	131.1	110.9	89.0	78.8	74.2
Net exceptional items before tax	-	(56.8)	0.1	(6.5)	-
Taxation	(37.2)	(16.3)	(23.5)	(10.8)	(17.1)
Profit for the year	93.9	37.8	65.6	61.5	57.1
Dividends proposed	66.0	61.0	55.1	51.1	144.3
<b>Earnings per share (basic)</b>					
<i>From continuing operations</i>					
Before exceptional items and deferred tax	30.3p	25.2p	21.4p	19.2p	18.3p
Exceptional items	-	(10.0)p	(1.3)p	(1.7)p	-
Deferred tax	(3.8)p	(5.3)p	(4.1)p	(0.9)p	(3.5)p
After exceptional items and deferred tax	26.5p	9.9p	16.0p	16.6p	14.8p
Declared dividend per share	18.55p	17.2p	14.3p	13.8p	13.1p*
Earnings per share and dividend per share for March 2006 and earlier years have been restated to reflect the sub-division of the Company's ordinary shares by way of a three for one split on 31 July 2006					
*Excluding special interim dividend of 23.3p per share					
<b>Capital expenditure</b>					
Acquisitions	37.0	45.8	30.8	19.8	41.8
Property, plant and equipment	245.1	249.7	181.0	170.0	204.6
<b>Balance sheet</b>					
Non-current assets	2,709.8	2,527.5	2,292.2	2,191.3	2,084.6
Net current (liabilities)/assets	(39.9)	(61.2)	193.1	75.9	17.5
Non-current liabilities	(2,042.7)	(1,885.1)	(1,776.4)	(1,367.6)	(1,213.3)
Net assets	627.2	581.2	708.9	899.6	888.8
<b>Number of employees (average for year)</b>					
Water and sewerage business	1,301	1,299	1,336	1,341	1,343
Waste management	1,686	1,388	1,169	895	685
Other businesses	38	35	39	39	35
	3,025	2,722	2,544	2,275	2,063

Information prior to 31 March 2004 was reported under UK GAAP which may differ materially from IFRS. The main differences relate to the treatment of infrastructure assets, retirement benefits, goodwill and intangibles, deferred tax, dividends payable and financial instruments.

**FINANCIAL CALENDAR**

Financial year end	31 March
Eighteenth Annual General Meeting	26 July 2007
2007 Final dividend payable	2 October 2007
2007 Half yearly financial report announcement	November 2007
2008 Interim dividend payable	April 2008
2008 Preliminary results announcement	May 2008
Nineteenth Annual General Meeting	July 2008
2008 Final dividend payable	October 2008

**SHAREHOLDER ANALYSIS AT 31 MARCH 2007**

Range	Number of shareholders	Percentage of total shareholders	Percentage of ordinary shares
1 – 100	2,290	10.06	0.02
101 – 1,000	8,932	39.25	1.25
1,001 – 5,000	9,913	43.56	5.87
5,001 – 50,000	1,308	5.75	3.95
50,001 – 100,000	80	0.35	1.58
100,001 – HIGHEST	235	1.03	87.33
	<b>22,758</b>	<b>100.0</b>	<b>100.0</b>
<b>Holder</b>			
Individuals	20,514	90.14	8.47
Companies	175	0.77	2.58
Trust companies (pension funds, etc)	2	0.01	–
Banks and nominees	2,067	9.08	88.95
	<b>22,758</b>	<b>100.0</b>	<b>100.0</b>

**SUBSTANTIAL SHAREHOLDINGS**

At 13 June 2007, the following interests in the issued share capital had been notified pursuant to the Financial Services Authority's Disclosure and Transparency Rules

Amenpnse Financial Inc	12.58%
Pictet Asset Management SA	7.19%
AXA SA and its Group companies	5.49%
Prudential Plc group of companies	5.00%
Legal & General Group plc	3.56%
Standard Life Investments Ltd	3.52%
Lansdowne Partners Ltd	3.23%

Further shareholder information may be found at:  
[www.pennon-group.co.uk](http://www.pennon-group.co.uk)

## SHAREHOLDER INFORMATION

### 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.

#### Dividend re-investment plan

The Company is operating a Dividend Re-investment Plan. The plan provides Shareholders with the opportunity to invest the whole of the cash dividend they receive on their Pennon Group shares to buy further shares in the Company at favourable commission rates. Full details of the Plan, including how to join, will be sent out to shareholders on 24 August 2007.

Details of the above shareholder services are available from the Company Secretary's Department, telephone 01392 443024.

#### 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](http://www.shareview.co.uk)

#### Pennon Group Plc

Registered office

Peninsula House, Rydon Lane, Exeter EX2 7HR

Registered in England No 2366640

#### Electronic communications

Shareholders can elect to receive shareholder communications electronically by signing up through [www.shareview.co.uk](http://www.shareview.co.uk) – a website operated by Lloyds TSB Registrars. Shareholders need only their 'shareholder reference' printed on the proxy form enclosed with this Annual Report. There is no charge to register and shareholders will also have access to information about their shareholding.

#### ANNUAL GENERAL MEETING

The 2007 Annual General Meeting will be held on Thursday 26 July 2007. Further details are set out in the Notice of Annual General Meeting sent to all shareholders.

#### Appointing a proxy

A Form of Proxy is enclosed with the Notice of Annual General Meeting and instructions for its use are shown on the form.

#### Electronic proxy voting

Shareholders also have the opportunity to register the appointment of a proxy for any general meeting of the Company once notice of the meeting has been given and may do so for the 2007 Annual General Meeting and any adjournment(s) thereof via [www.sharevote.co.uk](http://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 2007 Annual General Meeting and any adjournment(s) thereof by following the procedures described in the CREST manual.

#### THE PENNON WEBSITE

The Pennon website at [www.pennon-group.co.uk](http://www.pennon-group.co.uk) provides news and details of the Company's activities plus links to Group websites. The investor information section contains up-to-date information including dividend payment dates and amounts. It also holds historical details and a comprehensive share price information section.

Visit [www.pennon-group.co.uk](http://www.pennon-group.co.uk)