

Registered Number 02366640

PENNON GROUP PLC
ANNUAL REPORT AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2016

TUESDAY



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COMPANIES HOUSE

WHO WE ARE

As one of the largest environmental infrastructure groups in the UK, we are at the top end of the FTSE 250

We have assets of around £5.7 billion and a workforce of over 4,800 people

OUR BUSINESSES

WATER AND WASTEWATER

SOUTH WEST WATER

Providing water and wastewater services to a population of c. 7 million in Cornwall, Devon and parts of Dorset and Somerset. South West Water was awarded enhanced status for its 2015-2020 Business Plan, and has the highest potential returns in the water sector.

BOURNEMOUTH WATER

Providing water services to a population of c. 0.5 million in areas of Dorset, Hampshire and Wiltshire. Bournemouth Water was acquired in April 2015 and has been substantially integrated with South West Water to deliver synergies and savings.

WASTE RECYCLING AND RECOVERY

VIRIDOR

A leading UK recycling, energy recovery and waste management company, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 customers across the UK.

OUR VISION

- To be a pre-eminent developer, manager and operator of environmental infrastructure and related services
- To provide first class services to our customers
- To achieve positive outcomes for the communities in which we operate
- To provide sustainable value for our shareholders

OUR MISSION

- To enable and encourage the people and businesses we serve to be more sustainable
- To adopt sustainable practices in our management of the environment
- To invest in new and innovative technologies for the benefit of our businesses and stakeholders

OUR STRATEGY

- To innovate, drive efficiencies and identify opportunities for growth
- To provide high quality, reliable services and a safe working environment for our people and the communities we serve

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To view our online report visit
www.pennonannualreport.co.uk/2016

STRATEGIC REPORT

OVERVIEW

OVERVIEW

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**STRONG FINANCIAL
PERFORMANCE
BENEFITING CUSTOMERS
AND SHAREHOLDERS**

**GROWTH AT VIRIDOR:
ENERGY RECOVERY
ACTIVITIES
PERFORMING WELL**

**STRONG START
TO K6 (2015-2020):
OUTPERFORMING
REGULATORY
CONTRACT**

**SECTOR-LEADING
DIVIDEND POLICY:
+4% GROWTH OVER RPI
YEAR ON YEAR TO 2020**

GROUP FINANCIAL HIGHLIGHTS

REVENUE

£1,352.3m -0.4%

ADJUSTED EBITDA⁽¹⁾ before non-underlying items

£508.4m +9.1%

PROFIT BEFORE TAX before non-underlying items

£211.3m +0.3%
(statutory basis £206.3m)

DIVIDEND

33.58p +5.6%

SHAREHOLDER PROFITS⁽²⁾ (£m)

Profit before tax and non-underlying items	211.3
Non-underlying items impacting profit before tax	(5.0)
Tax charge	(38.0)
Profit attributable to perpetual capital holders	(16.2)
Profit after tax attributable to shareholders	152.1

(1) Earnings before interest, tax, depreciation, amortisation and non-underlying items (EBITDA) (Adjusted EBITDA includes IFRIC 12 interest receivable and share of joint venture EBITDA – see notes 8 and 20 to the financial statements)

(2) Reconciliation of profit before tax and non-underlying items to profit after tax attributable to shareholders

(3) Return on regulated equity. See page 28 for further details

HIGHLIGHTS OF THE YEAR

- Strong start to the new regulatory period for the water business delivering a RoRE of 11.7%⁽³⁾
- Group results benefiting from growth
 - £90 million of EBITDA delivered from Energy Recovery Facilities (ERFs) in 2015/16, up 166% ERFs on track to deliver targeted c £100 million of EBITDA⁽¹⁾ in 2016/17 despite pressure on power prices and the removal of Levy Exemption Certificates (LECs)
 - Bournemouth Water acquired on 15 April 2015, with key aspects of the integration with South West Water delivered
 - licence and trade and assets merged
 - shared services combined
 - debt transferred and security removed
- Group efficiency initiatives underway, expected to deliver future cost savings of c £11 million p a

STRATEGY IN ACTION

- Dividend increased by 5.6% in line with sector-leading policy of 4% year-on-year growth over RPI
- Group remains well funded with efficient long-term financing
- Continued focus on sustainable investment and activities that make a positive impact on communities and the environment
- Implementing improvements in recycling activities

ASSETS

INVESTMENT IN KEY
INFRASTRUCTURECASH AND COMMITTED
FACILITIES TO FUND
CAPITAL PROGRAMME

£5.7bn £317m

£1.7bn

KEY PERFORMANCE INDICATORS⁽¹⁾

REVENUE (£m)

2011/12	1,233.1
2012/13	1,201.2
2013/14	1,321.2
2014/15	1,357.2
2015/16	-0.4% 1,352.3

DIVIDEND PER SHARE (pence)

2011/12	26.52
2012/13	28.46
2013/14	30.31
2014/15	31.80
2015/16	+5.6% 33.58

ADJUSTED EBITDA⁽²⁾ before non-underlying items (£m)

2011/12	430.8
2012/13	433.0
2013/14	456.9
2014/15	465.9
2015/16	+9.1% 508.4

INTEREST RATE ON ANNUAL NET DEBT (%)

2011/12	4.2
2012/13	4.0
2013/14	3.8
2014/15	3.4
2015/16	3.3

PROFIT BEFORE TAX before non-underlying items (£m)

2011/12	200.5
2012/13	190.0
2013/14	207.3
2014/15	210.7
2015/16	+0.3% 211.3

REGULATORY CAPITAL VALUE as at 31 March (£m)

2012	2,827
2013	2,916
2014	2,959
2015	2,928
2016	+7.6% 3,150

EARNINGS PER SHARE

before non-underlying items and deferred tax (pence)

2011/12	47.3
2012/13	40.3
2013/14	42.6
2014/15	39.8
2015/16	-0.8% 39.5 ⁽³⁾

GROUP ASSETS as at 31 March (£bn)

2012	4.3
2013	4.8
2014	5.0
2015	5.4
2016	+5.6% 5.7

(1) These are the key performance indicators (KPIs) we use to measure the performance of our businesses as described in our business model on page 10

(2) Earnings before interest tax depreciation amortisation and non-underlying items (EBITDA) (Adjusted EBITDA includes IFRIC 12 interest receivable and share of joint venture EBITDA)

(3) Basic earnings per share (statutory basis) 37.0p

GROUP OPERATIONAL HIGHLIGHTS

TOTAL RENEWABLE ENERGY GENERATION

1,496GWh

DRINKING WATER QUALITY

(mean zonal compliance)

SOUTH WEST WATER

BOURNEMOUTH WATER

99.97%

100%

BATHING WATER COMPLIANCE⁽¹⁾

('sufficient quality' or higher)

97.2%

TOTAL WASTE MATERIAL INPUTS

7.8 million tonnes

ERF AVAILABILITY

RECYCLING VOLUMES
TRADED (million tonnes)

85%

1.8

RIDDOR INCIDENCE RATE

(per 100,000 employees)

822

HIGHLIGHTS OF THE YEAR

- High quality drinking water maintained (mean zonal compliance was 99.97% for South West Water and 100% for Bournemouth Water)
- No water restrictions for customers and leakage targets met
- Increase in customer service score in the water business
- 97% of bathing waters in the South West Water region meeting tougher new bathing water standards
- Two-thirds of ERF portfolio now on line
- Recycling and Resources £0.6 million (1%) ahead of 2014/15 EBITDA despite ongoing challenging commodity prices and market conditions

STRATEGY IN ACTION

- Group-wide focus on health and safety to drive cultural and behavioural change
- Investment in new technologies and innovation helping to improve performance in water business
- Construction underway on new £60 million drinking water treatment works for the Plymouth area – first of its kind in the UK
- Merger of South West Water and Bournemouth Water bringing efficiency benefits and sharing of best practice
- New company, Pennon Water Services, established as part of our non-household retail strategy
- Long-term revenue streams for ERFs helping secure consistent risk profile
- Input, Throughput and Output Optimisation (ITOO) programme continuing to deliver further efficiencies and financial benefits in waste management
- New operating model implemented at Viridor to provide a platform for growth in line with business strategy

(1) New standards introduced in 2015 under the EU's revised Bathing Water Directive. The classifications are: poor quality, sufficient quality (the new minimum standard), good quality and excellent quality (the new guideline standard). Prior years not restated.

KEY PERFORMANCE INDICATORS⁽¹⁾

DRINKING WATER QUALITY

mean zonal compliance (%)

2012	99.99
2013	99.97
2014	99.98
2015	99.96
2016 South West Water	99.97
2016 Bournemouth Water	100.00

TOTAL WASTE MATERIAL INPUTS

(million tonnes)

2011/12	3.1	0.7	3.8	7.6
2012/13	2.7	0.7	4.1	7.5
2013/14	2.7	0.7	4.3	7.7
2014/15	2.5	1.2	3.8	7.5
2015/16	2.0	2.1	3.7	7.8
	Landfill	ERFs	Recycling and other	

CUSTOMER SERVICE service incentive mechanism (%)

2011/12	66.9
2012/13	70.5
2013/14	73.9
2014/15	74.8
2015/16 South West Water	78.6
2015/16 Bournemouth Water	86.2⁽³⁾

RECYCLING VOLUMES TRADED (million tonnes)

2011/12	1.8
2012/13	1.9
2013/14	1.8
2014/15	1.7
2015/16 Vindor +7.3%	1.8

BATHING WATER COMPLIANCE (%)

2013	99.3
2013	91.0
2014	99.3
2014	86.3
2015 South West Water	97.2⁽²⁾
2015 South West Water	70.3⁽²⁾

EU minimum standard Guideline standard

ERF INPUT CAPACITY⁽⁴⁾ (million tonnes)

2011/12	0.8
2012/13	0.8
2013/14	0.8
2014/15	1.4
2015/16 Vindor +79%	2.5

RIDDOR INCIDENTS⁽⁵⁾

2011	59
2012	52
2013	40
2014	35
2015 Pennon Group +20%	42

TOTAL RENEWABLE ENERGY GENERATION (GWh)

2011/12	775
2012/13	839
2013/14	795
2014/15	949
2015/16 Pennon Group +57.6%	1,496

(1) These are the key performance indicators (KPIs) we use to measure the performance of our businesses as described in our business model on page 10

(2) See footnote on previous page

(3) Bournemouth Water's service incentive mechanism (SIM) score for 2014/15 was 85.6

(4) Processing capacity available in the year including joint ventures

(5) Incidents involving employees under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations. Change in RIDDOR reporting criteria from 2012. See page 48 for details of each company's performance

CHAIRMAN'S STATEMENT

DEAR SHAREHOLDER

In my first annual statement to you as Chairman of Pennon Group, I am pleased to report another year of strong performance and solid financial results, which translate directly to shareholder value

Following my appointment as Chairman in August 2015, I took time to familiarise myself with the Group's operations and the strengths of the business and concluded that a strong platform exists upon which we can further build to achieve a successful future. It was clear to me that Pennon was ready to move to the next phase, South West Water had embarked on a new five-year regulatory cycle whilst working towards the full integration of Bournemouth Water's business acquired in April 2015, and Viridor was progressing from 'construction' to 'operation', with eight Energy Recovery Facilities (ERFs) operating successfully and the construction of three more progressing well. In addition, I found talented and committed people throughout the organisation, with a very strong executive leadership team in place. The autumn of 2015 was therefore a natural time for reflection in terms of the Group's strategic priorities.

Whilst this strategic review has not given rise to a 'new' Group strategy, it has led to differences of nuance and focus. In particular we identified that with the maturity of Viridor's business, as it moves away from waste disposal to landfill, greater commonality exists between the Group's businesses. We also recognised that we were able to move towards a more homogeneous risk profile across the two businesses, with Pennon's investment proposition now premised on an increased proportion of contracted long-term, index-linked revenues over a long-lived asset base.

As part of the strategic review, the Board decided to create a new role of Group Chief Executive Officer, a position to which Chris Loughlin (who was Chief Executive of South West Water at the time) was appointed with effect from 1 January 2016. Chris has been tasked with driving forward our strategy, which will involve looking across the business at how we can share best practice, deliver synergies and capitalise on emerging opportunities. Both Viridor and South West Water have a breadth and depth of experience in managing large asset bases and in using engineering excellence, technology and innovation to deliver efficiency and effectiveness. By sharing knowledge across the Group and harnessing our combined skills we can provide even better service to our wide customer base of local authorities, major corporate clients and household customers throughout the UK. By driving integration across the Group we will also be able to extract tangible efficiencies and synergies.

HEALTH AND SAFETY

I have been impressed by the level of commitment of the Board and the senior management teams to the health, safety and wellbeing of our people. As reported last year, tragically there was an incident in June 2015 involving a Viridor vehicle, which resulted in the death of a Viridor employee. The Group continues to work with the authorities in relation to this incident.

Reflecting the Board's desire for a consistent and effective Group-wide approach, we have created a new role of director of Safety, Health, Environment, Quality and Sustainability (SHEQS), and recruitment is underway. The Group has strategic improvement plans in place and continues to invest in programmes and initiatives to further embed the change in culture and attitudes necessary to achieve its target of zero accidents and incidents.

SUSTAINABILITY

Environmental, social and governance (ESG) matters are integral to our strategy and business model. The Sustainability Committee of the Board continues to oversee our performance in maintaining a responsible approach to business operations. The Group's notable achievements include another year of high quality drinking water, benefits to local economies as a direct result of our investment in energy recovery infrastructure, strong performance against new EU bathing water standards, preliminary work on a new water treatment works with cutting edge technology for the Plymouth area, investment in further customer service improvements, further work to reduce the risk of sewer flooding, recognition for our apprenticeship programmes and acclaimed education programmes and community engagement activities across the Group.

Further information on the Group's approach to sustainability is provided throughout the strategic report and in the Sustainability Committee report for the year on pages 70 to 73.

DIVIDEND

I am pleased to report that the Board is recommending a final dividend per share of 23.12p, representing a 6.0% increase on last year's final dividend. This will result in a total dividend for the year of 33.58p, an increase of 5.6%, which is in line with our dividend policy of year-on-year growth of 4% above RPI inflation to 2019/20 and reflects the Board's confidence in the future financial performance of the Group. We will again be offering a scrip dividend alternative to shareholders in respect of the final dividend for which the timetable is given on page 173.

NEW GOVERNANCE FRAMEWORK

On my appointment, I was pleased to see that a strong commitment to the three essential pillars of a successful board – strong financial control, sound administration and good governance – was in evidence in the boardroom. To ensure we are well placed to continue to deliver solid growth and efficiency, I reviewed our Board structures, in consultation with the Non-executive Directors, and identified opportunities for streamlining the Group's governance framework and decision-making processes. Changes were implemented after agreement with Ofwat in respect of South West Water and Bournemouth Water governance arrangements. This involved simplifying the subsidiary board structure to achieve more efficient governance whilst preserving the regulatory ring fence around the water and wastewater business. Further details are provided in the governance report on page 62.

OTHER BOARD DEVELOPMENTS

Ken Harvey, our long-serving and distinguished Chairman of 18 years, retired at last year's AGM. The success of Pennon Group today is in no small measure due to his professional leadership and integrity. Our Senior Independent Director Gerard Connell, also stepped down at the AGM and we acknowledge the significant contribution he made to our Board during his 12 years of service. We also wish both a happy retirement. I am pleased to report that Gill Rider has been appointed as our new Senior Independent Director.

As reported above, Chris Loughlin was appointed to the new role of Group Chief Executive Officer on 1 January 2016. Prior to that, Chris served as an Executive Director of Pennon Group Plc in his capacity as Chief Executive of South West Water. Stephen Bird was promoted to the position of Managing Director of South West Water with effect from the same date. As at 1 April 2016 Susan Davy's title changed from Group Director of Finance to Chief Financial Officer.

Changes to the governance structure, which were implemented on 1 April 2016, have seen our existing independent Non-executive Directors, Martin Angle, Neil Cooper and Gill Rider, additionally being appointed as non-executive directors of South West Water Limited. I continue to serve as chairman of South West Water, an office to which I was appointed on 31 July 2015. In addition, the Board has been pleased to welcome three non-executive directors of South West Water; Martin Hagen, Steve Johnson and Lord Matthew Taylor, to participate in plenary sessions of the Pennon Group Board and its Committees. Steve Johnson resigned subsequent to the year end due to taking up another appointment.

Ken Woodier, our Group General Counsel and Company Secretary decided to retire in the year. He has served the Board in a diligent professional and committed way for some 18 years. We thank him and wish him well in the future. He is succeeded by Helen Barrett-Hague from Alent Plc and we welcome her to Pennon.

DIVERSITY

The Board continues to promote equality and diversity across the Group in all areas, including gender and ethnicity. I am pleased to say we exceeded our target of 25% female representation on the Board by 2015.

We remain committed to ensuring our Board pursues a progressive diversity agenda and you will find further details in our Nomination Committee report on page 74.

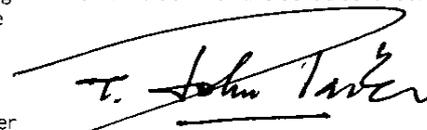
MANAGEMENT AND EMPLOYEES

The success of any company is down to the quality of its leadership, not just in the boardroom, but throughout the organisation. The strong and effective leadership we have along with well-trained and skilled personnel, including our award-winning apprenticeship schemes, underpin the success of Pennon Group.

May I take this opportunity to express my thanks and that of our Board to all our employees who make the difference to our performance and to the service we render to our communities every day.

LOOKING TO THE FUTURE

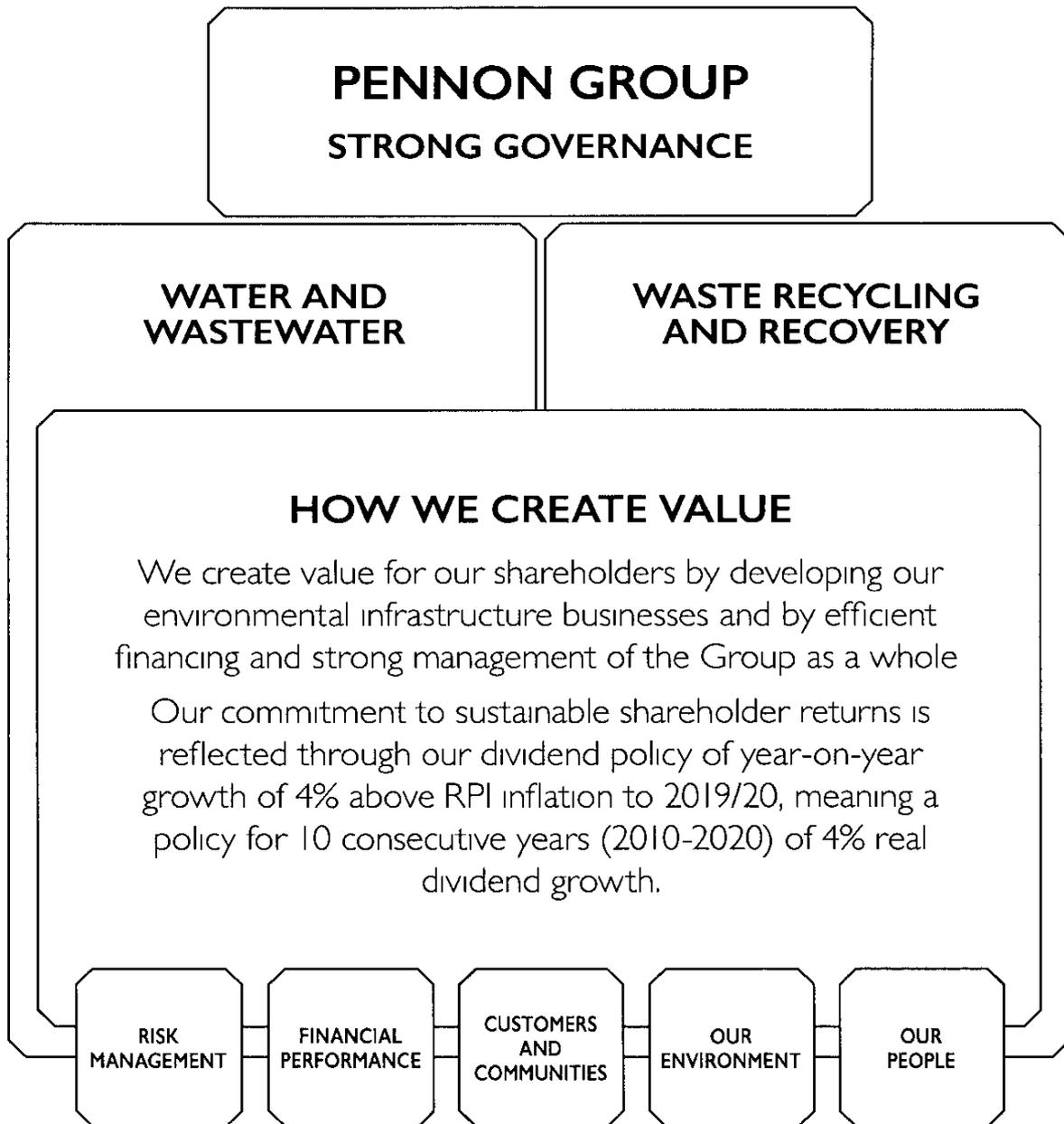
With its refreshed strategy Pennon will continue to capitalise on strategic opportunities whilst developing our people, protecting the environment, helping the communities in which we operate and enhancing shareholder value. We have built a solid foundation for the future.



Sir John Parker
Chairman
Pennon Group Plc
24 May 2016

BUSINESS MODEL

Our business model is the framework through which we deliver our strategy and shareholder value to innovate, drive efficiencies and identify opportunities for growth, and to provide high quality, reliable services and a safe working environment for our people and the communities we serve



HOW WE MANAGE OUR BUSINESSES TO CREATE VALUE

We create shareholder value by focusing on six core areas, underpinned by our commitment to creating and maintaining a sustainable business

STRONG GOVERNANCE

Pennon provides oversight and support to its businesses through a strong governance framework which includes robust processes for decision-making and oversight of the Group's performance
More information on governance can be found on pages 58 to 76

RISK MANAGEMENT

Our operating framework includes a comprehensive and fully embedded risk management process which assists us in identifying and managing risks and opportunities to deliver the Group's strategy and the other essential elements of our business model

Further information on our risk management framework and control environment is provided on pages 51 and 65, and our principal risks and uncertainties and how we mitigate them are set out on pages 52 to 54

FINANCIAL PERFORMANCE

We have set challenging financial targets through a range of key performance indicators (KPIs). These are set out on page 5
Our focus in setting such targets is to achieve sustainable performance over the short and long term. Our financial performance is set out in more detail on pages 18 to 25

CUSTOMERS AND COMMUNITIES

The Group is fully committed to meeting the needs of its customers and developing and maintaining good relationships with the wider community and stakeholders in general. This is the key to the success of each of our businesses

How we respond to our stakeholders' needs and assess customer satisfaction is set out on pages 36 to 41

OUR ENVIRONMENT

We are aware that our businesses can, and do, have a material impact on the environment in which they operate. To address this we take a responsible and transparent approach to environmental matters

Our sustainable practices ensure the long-term success of our businesses. More information on our environmental impacts is provided on pages 42 to 47

OUR PEOPLE

We know that the success of our Group is due to the talent, commitment and hard work of our employees, and we aim to be a responsible employer

We are focused on ensuring employee wellbeing, retention, training and development, and productivity. Essential to this is our commitment to the health and safety of our workforce

More information on the initiatives we have introduced to improve employee engagement and health and safety in our businesses is set out on pages 48 to 50

STRATEGIC REPORT

GROUP PERFORMANCE

GROUP PERFORMANCE

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**STRONG RESULTS
BENEFITING FROM
GROWTH**

**MAINTAINING AND
GROWING OUR
ASSET BASE**

**DRIVING VALUE
THROUGH EFFICIENCY**

**WELL PREPARED FOR
THE FUTURE**

GROUP CHIEF EXECUTIVE OFFICER'S OVERVIEW

The year 2015/16 has been transformative for Pennon Group. While continuing to deliver market-leading performance in many areas of our businesses, we have been fine-tuning our strategic focus to meet the changing demands of our sector, evolving our governance and internal structures and beginning to draw new synergistic benefits from the closer alignment of our subsidiaries.

As the new Group Chief Executive Officer, I am pleased to report that Pennon has performed very well in 2015/16.

South West Water is outperforming its regulatory contract having begun the K6 (2015-2020) period in a position of confidence following a successful Price Review, which saw its business plan deemed best-in-class. The drive towards further efficiency and improved performance has been complemented by the successful acquisition and merger with Bournemouth Water. Integration is substantially complete and the bringing together of these two good companies is allowing for substantial efficiency savings, the sharing of best practice and operational synergies. The combined water business is well placed for the regulatory changes ahead including the opening of the non-household retail market in 2017, and there is a 94% probability it will set the efficiency frontier at the 2019 Price Review⁽¹⁾.

In waste management, Viridor has also performed well. The company has made a clear transition from landfill to a greater focus on recycling and the recovery of energy from waste. Eight of the 11 committed Energy Recovery Facilities (ERFs) are now on stream with the remainder under construction (at Glasgow, Dunbar and Beddington).

The ERF portfolio is being progressively de-risked with demand expected to exceed capacity over the long term. Approximately 80% of the total ERF portfolio volumes have been secured under long-term, index-linked contracts with short and medium-term contracts in place for the remaining 20%.

As Viridor completes its move from the investment phase to the delivery phase with the completion of the ERF portfolio, we are moving towards a more homogeneous risk profile across the Group. We are increasing the predictability and visibility of our revenues over the long term and putting Pennon in the strongest position possible to capitalise on future growth opportunities.

STRONG OPERATIONAL PERFORMANCE

Both South West Water and Bournemouth Water have made considerable progress on their K6 business plan commitments.

At South West Water, drinking water quality remains high (99.97% compliance⁽²⁾), customer service continues to increase, and accelerated investment in bathing water improvements has helped the region perform very well against the revised EU standards, which came into force in 2015. Of the 145 bathing waters tested, 141 met the required standard. The failure of the other four was unrelated to the performance of any South West Water asset.

Bournemouth Water achieved 100% compliance with drinking water quality standards and continued to deliver customer service improvements, building on its already impressive track record of customer service excellence. In both the South West Water and Bournemouth Water service areas, leakage rates were kept within target levels and there were no water restrictions placed on customers.

(1) Oxera modelling for South West Water and Bournemouth Water submission to the Competition and Markets Authority. This estimate provides the probability of the merged company with synergy savings being within the UQ (the efficiency benchmark as used by Ofwat in PR14) at PR19.

(2) As measured by mean zonal compliance.

In the waste management sector, Viridor has been a consistent leader and is well on track to increase Pennon's future earnings growth. This is being achieved through the delivery and ramp-up of ERFs, which are expected to contribute c £100 million to Viridor's EBITDA in 2016/17.

In landfill energy, Viridor continues to maximise value from its assets, managing the ongoing reduction in inputs and moving from the 14 remaining operational sites to a smaller number of strategic sites by 2020. Landfill gas will remain a significant earnings stream after the sites have closed to waste inputs, and the company is maximising opportunities to use existing grid connections.

AREAS OF FOCUS

South West Water delivered a step change in customer service performance during K5 (2010-2015) through a combination of operational improvements and initiatives to improve the customer service experience, including a more proactive approach to communications.

In 2015/16 the company's customer service score⁽¹⁾ continued to increase, and further improvements are anticipated as best practice is shared with Bournemouth Water (which consistently delivers SIM performance in the upper quartile of the industry).

In wastewater services, areas for operational improvement remain, particularly with regards to reducing the risk of flooding and pollution. South West Water is working resolutely towards its 2020 targets, making the most of new techniques in activities such as forecasting and monitoring, and working closely alongside its supply chain partners to deliver the necessary enhancements.

In recycling, Viridor is accelerating the optimisation and rationalisation of its assets and contracts through the Input, Throughput and Output Optimisation (ITOO) programme (see page 33). By moving towards a more efficient cost base and more profitable activity, this is designed to overcome lower commodity prices. The programme is targeting a substantial enhancement in the company's EBITDA margin through restructuring and improvements in source material quality (including contract renegotiation where required), asset efficiency, productivity and yield, and specific quality control of outputs.

A number of input contracts have been successfully renegotiated to enhance value and the quality of inputs. New recycling contracts reflect the sharing of recycle price risks with customers through better gate fees and a better specified quality of inputs.

DRIVING VALUE THROUGH EFFICIENCY

South West Water is striving for ever greater efficiency in K6, building on its strong track record from K5. Recognised by Ofwat as delivering industry-leading cost efficiency, it was awarded an enhanced business plan assessment with the largest element of potential operational outperformance over K6 coming from total expenditure (Totex) savings.

Plans to merge Bournemouth Water with South West Water were given unconditional clearance by the Competition and Markets Authority (CMA) in November 2015. The merger became official on 1 April 2016 and the integration process has been progressing well with a new management structure in place.

During K6 (2015-2020) c £27 million of synergies (net of restructuring costs) is set to be achieved through a combination of:

- the merging of the two companies' wholesale and retail operations
- the creation of a single centralised support function
- the sharing of best practice to form common systems and processes
- supply chain efficiencies

A new single legally separate company, Pennon Water Services, has been created which will provide retail and water management services for our c 85,000 non-household customers, who will be eligible for the new water retail market in 2017. The new market will move into a period of shadow operation in October 2016 prior to formal opening in April 2017.

In addition to Viridor's operational delivery, overheads are being streamlined as part of the announced reorganisation and restructuring. This is expected to deliver c £9 million a year of enduring financial benefits from 2018/19.

(1) As measured by service incentive mechanism (SIM)

GROUP CHIEF EXECUTIVE OFFICER'S OVERVIEW CONTINUED

GROUP-WIDE SYNERGY

Pennon is focused on driving greater synergies and savings across the Group, sharing best practice and ensuring it is well placed to capitalise on emerging opportunities

Both Viridor and South West Water have a breadth and depth of experience in managing large asset bases and in using engineering excellence, technology and innovation to deliver efficiency and effectiveness. By sharing knowledge across the Group and harnessing our combined skills we can provide even better services to our extensive customer base of local authorities, major corporate clients and household customers

A more joined-up Group brings benefits in a variety of ways. Looking ahead to the opening of the non-household retail market for water services, a key differentiator for Pennon is the link that can be forged between Pennon Water Services and Viridor's customer base. By capitalising on Viridor's commercial relationships and culture we can add value and improve our service offering

Furthermore, as part of the evolution in Pennon's structure, a shared services review is underway assessing where we can unlock opportunities to create additional value through integrating back office functions

SUSTAINABLE AND RESPONSIBLE BUSINESS

Through innovation, the use of new technologies and the application of best practice, we continue to focus on sustainability

By improving the efficiency and effectiveness of our business activities we ensure sustainable value for both shareholders and customers while minimising our environmental impacts. This spans everything from our holistic approach to water and wastewater management at catchment level (see Upstream Thinking and Downstream Thinking on pages 29 and 31) to our strategic purpose of giving resources new life

At a community level we do our best to be a 'good neighbour' through community engagement, high operational standards, support for education and the provision of access and recreation

South West Water continues to offer an industry-leading range of affordability schemes to those customers who genuinely struggle to pay. We continue to provide a social tariff and expand our innovative work with housing providers to help reduce customer debt

At Viridor a network of active community liaison groups continues to ensure close dialogue with people living and working in areas close to our major operational sites, enabling focused community benefit programmes

In 2015 both South West Water and Viridor were recognised as responsible businesses within Business in the Community's Corporate Responsibility (CR) Index. Pennon Group also retained its inclusion in the FTSE4Good Index following independent assessment in 2015 of its Environmental, Social and Governance (ESG) performance

PROUD OF OUR PEOPLE

Pennon has more than 4,800 employees. Their health and safety remains our top priority and we continue to refine our policies and make enhancements where necessary in order to protect their wellbeing and comply with best practice. Further detail can be found on page 48

Across the Group we are focused on attracting, nurturing and retaining a high calibre workforce. South West Water, a significant employer in the south west of England, is ranked as a top 100 apprenticeship employer nationally, and has recruited 85 apprentices since 2011

Meanwhile at Viridor there is a growing focus on apprenticeships with 23 apprentices in the business today and a commitment to expand this at each of the ERFs

The efforts and achievements of our employees have made 2015/16 a successful year and I would like to take this opportunity to thank them for their ongoing professionalism and dedication

OUTLOOK

As an environmental infrastructure business, Pennon is continually looking to the future to anticipate, influence and manage regulatory change and the policy environment. This is crucial to our success.

Through Vindor, we are well positioned with services reflecting the waste hierarchy, leading with reduction and recycling, through to energy recovery and finally to disposal.

We expect demand for ERFs to continue to exceed capacity into the long term. The option to commit to an additional ERF at Avonmouth remains and would take the total portfolio to 12 plants nationwide.

We remain cautious about future recycle price growth but are not relying on a near-term price recovery and are instead driving forward self-help measures through Vindor's ITOO programme which is delivering margin improvement. We continue to target new long-term and medium-term commercial and industrial recycling and recovery contracts.

In the water industry we are well placed to capitalise on structural changes and resilience challenges, making the most of opportunities for future consolidation and growth while continuing to deliver our business plans effectively. As Bournemouth Water becomes fully integrated with South West Water, we anticipate further synergistic benefits together with performance improvements derived from the sharing of best practice.

At a wider industry level South West Water is fully engaged in Water 2020 as we prepare and position ourselves for PR19. The company is in an extremely good position to anticipate and influence future regulatory reforms and is working hard to ensure involvement in shaping the future of the industry.

In a changing sector Pennon is evolving with confidence and ambition. We continue to build on a strong platform, recognising areas for further improvement and efficiencies while remaining focused on delivering sustainable business value.

Chris Loughlin
Group Chief Executive Officer
Pennon Group Plc

CHIEF FINANCIAL OFFICER'S REPORT

FINANCIAL REVIEW

Pennon Group delivered a strong financial performance, underpinned by a robust funding position, continuing to support our dividend policy of 4% growth above RPI inflation to 2020

PERFORMANCE OVERVIEW

The principal measures used to assess the Group's financial performance are

ADJUSTED EBITDA⁽¹⁾

before non-underlying items (£m)

2011/12	430.8
2012/13	433.0
2013/14	456.9
2014/15	465.9
2015/16 +9.1%	508.4

EARNINGS PER SHARE

before non-underlying items and deferred tax (pence)

2011/12	47.3
2012/13	40.3
2013/14	42.6
2014/15	39.8
2015/16 -0.8%	39.5

PROFIT BEFORE TAX before non-underlying items (£m)

2011/12	200.5
2012/13	190.0
2013/14	207.3
2014/15	210.7
2015/16 +0.3%	211.3 ⁽²⁾

DIVIDEND PER SHARE (pence)

2011/12	26.52
2012/13	28.46
2013/14	30.31
2014/15	31.80
2015/16 +5.6%	33.58

RECONCILIATION OF EARNINGS⁽³⁾

	2015/16 Profit after tax £m	2015/16 Basic earnings per share p	2014/15 Profit after tax £m	2014/15 Basic earnings per share p
Statutory earnings attributable to shareholders	152.1	370	126.3	32.3
Deferred tax before non-underlying items	39.2	9.5	18.2	4.7
Non-underlying items (post-tax)	(29.1)	(70)	11.0	2.8
Earnings before non-underlying items and deferred tax	162.2	39.5	155.5	39.8

(1) Earnings before interest tax depreciation amortisation and non-underlying items (EBITDA) adjusted EBITDA includes IFRIC 12 interest receivable and share of joint venture EBITDA

(2) Statutory basis £206.3m

(3) Earnings per ordinary share in this strategic report exclude non-underlying items and deferred tax. The Directors believe excluding non-underlying items and deferred tax provides a more useful comparison on business trends and performance. Deferred tax distorts earnings per share through the effects of changes in corporation tax rates and the level of long-term capital investment.

Group EBITDA is ahead of 2014/15, reflecting growth from Viridor's ERF business and the acquisition of Bournemouth Water. The growth across the Group has mitigated to a large extent the expected water business regulatory revenue reset.

FINANCIAL KPIs FOR OUR BUSINESSES

WATER BUSINESS

REVENUE (£m)

2011/12	474.0
2012/13	498.6
2013/14	520.0
2014/15	522.2
2015/16 +4.7%	547.0

EBITDA⁽¹⁾ before non-underlying items (£m)

2011/12	305.2
2012/13	317.1
2013/14	330.9
2014/15	331.3
2015/16 +1.2%	335.2

PROFIT BEFORE TAX before non-underlying items (£m)

2011/12	141.5
2012/13	146.7
2013/14	162.5
2014/15	167.9
2015/16 -1.3%	165.7

CAPITAL INVESTMENT (£m)

2011/12	130.8
2012/13	116.5
2013/14	141.6
2014/15	145.1
2015/16 -7.6%	134.1

WASTE BUSINESS

REVENUE (£m)

2011/12	761.1
2012/13	703.8
2013/14	802.0
2014/15	835.9
2015/16 -3.6%	806.2

EBITDA⁽¹⁾ before non-underlying items (£m)

2011/12	110.3
2012/13	77.7
2013/14	76.3
2014/15	80.4
2015/16 +44.9%	116.5

PROFIT BEFORE TAX before non-underlying items (£m)

2011/12	57.6
2012/13	34.3
2013/14	27.6
2014/15	27.7
2015/16 +10.8%	30.7

CAPITAL INVESTMENT (£m)

2011/12	145.5
2012/13	322.6
2013/14	292.0
2014/15	262.2
2015/16 -30.3%	182.8

(1) Earnings before interest tax depreciation amortisation and non underlying items

CHIEF FINANCIAL OFFICER'S REPORT CONTINUED

THE YEAR'S FINANCIAL PERFORMANCE

(before non-underlying items)

Group EBITDA and adjusted EBITDA were ahead of 2014/15 at £448.4 million (by 9.1%) and £508.4 million (by 9.1%) respectively. Profit before tax was broadly in line at £211.3 million. This has been achieved against the backdrop of reduced allowed returns in our water business for the K6 regulatory period (2015-2020), with strong contributions from Viridor's growing portfolio of operational Energy Recovery Facilities (ERFs) and having acquired Bournemouth Water during the year.

Both our water businesses recorded strong performances against their new K6 regulatory contracts, outperforming regulatory assumptions. The water business's profit before tax was marginally down by £2.2 million (1.3%) to £165.7 million, reflecting South West Water's expected revenue reset, largely offset by the additional earnings from Bournemouth Water (acquired in April 2015), good cost control and lower average borrowing rates. With the highest potential returns in the sector for K6, South West Water is outperforming its business plan. Combined with Bournemouth Water outperformance, this results in a water business Return on Regulated Equity (RoRE) of 11.7%.

At Viridor, the portfolio of operational ERFs continues to perform well, with the six most recently delivered ERFs ramping up as Viridor optimises each plant. Peterborough ERF became operational in December 2015, having been delivered on time and on budget, bringing the total number of operational ERFs to eight. As a result, Viridor's adjusted EBITDA increased 30.5% compared to the previous year, driven by the full-year effect of its expanded fleet of ERFs.

Earnings per share were broadly in line with the prior year, down 0.8% to 39.5p. Overall, weighted average shares outstanding increased by c.20 million to 410.9 million, reflecting the placing of c.12 million new shares, which were issued to replenish cash resources following the acquisition of Bournemouth Water.

Dividend per share increased by 5.6% on a sustainable basis to 33.58p.

We continue to maintain a strong liquidity and funding position to support our ongoing capital investment growth programme. We had £1,707 million of cash resources and committed funding (including £226.5 million of restricted funds) as at 31 March 2016, having raised or renewed £470 million of facilities over the year. These funds support the continuing growth in Viridor's ERF business, together with a significant proportion of the water business's 2015-2020 (K6) capital programme.

Capital investment remained significant this year at £316.9 million due to continuing major investment in Viridor's ERFs, which is driving future growth. Over two-thirds of committed ERF capital investment is now complete. The water business capital expenditure in the year was slightly down on 2014/15, reflecting the acceleration last year of certain K6 projects to deliver early outcome benefits to customers and the environment.

We have secured funding at a cost that is efficient and effective. The Group interest rate on average net debt improved to 3.3% (2014/15 3.4%).

REVENUE

Group revenue was broadly in line with last year at £1,352.3 million. Revenue from the water business was up by 4.7% to £547.0 million as a result of the Bournemouth Water acquisition and new customers connecting to our network, offset by the revenue reset and the reduction in revenue as a result of customers switching from unmeasured to metered charges. Viridor's revenue decreased by 3.6% to £806.2 million due to the expected decrease in construction spend on service concession arrangements (as plants come on stream) and lower landfill volumes, partly offset by the full-year contribution of operational ERFs.

ADJUSTED EBITDA (before non-underlying items)

Group adjusted EBITDA, which consists of EBITDA of £448.4 million, IFRIC 12 interest receivable of £16.7 million and our share of joint venture EBITDA of £43.3 million, increased by 9.1% to £508.4 million, with the water business up by 1.2% to £335.2 million and Viridor up by 30.5% to £176.5 million.

Our water business EBITDA was boosted by the acquisition of Bournemouth Water, which contributed £17.4 million, offsetting the reduction in South West Water's allowed returns. While average RPI rose 1.1%, both South West Water's and Bournemouth Water's operating costs in 2015/16 fell compared to the previous year, with significant savings in operational maintenance, as well as targeted efficiencies contributing to cost performance. In addition, South West Water's bad debt charges also fell to 1.5% as a percentage of revenues from 1.7% in 2014/15. At Bournemouth Water, bad debt charges fell to 0.4% from 0.8% in 2014/15, which was driven by a strong collections performance. Total operating costs before depreciation for the water business were £211.8 million for the year (£322.5 million including depreciation).

Viridor's EBITDA was ahead of last year due predominantly to the full-year impact of operational ERFs. Our ERF activities delivered EBITDA of £89.7 million (2014/15 £33.7 million), a significant increase compared to 2014/15. We remain on track to deliver our target of c.£100 million of EBITDA from ERFs by 2016/17 (before IFRIC 12 interest receivable and our share of joint venture EBITDA). Joint venture EBITDA increased to £43.3 million (2014/15 £41.4 million) due to continuing strong EBITDA from Lakeside and higher EBITDA from Runcorn 1, reflecting a full year of operations, despite Lakeside planned maintenance. This resulted in a share of joint venture profit after tax of £3.6 million (2014/15 £4.9 million).

Recycling and resources EBITDA, comprising recycling, collection and contracts and 'other'⁽¹⁾, was broadly in line with last year at £49.6 million (2014/15 £49.0 million), despite lower recycle prices and therefore lower average revenues at £85 per tonne (recyclate sales plus gate fees) (2014/15 £86 per tonne). Average costs fell by £2 per tonne to £77 per tonne (2014/15 £79 per tonne) as a result of self-help measures under the Input Throughput and Output Optimisation (ITOO) programme, and therefore the recycling EBITDA margin increased by £1 per tonne to £8 per tonne (2014/15 £7 per tonne). Although the short-term outlook for recycle prices is relatively stable, we remain cautious about future recycle price growth and are not relying on a near-term recovery. We are instead focusing on self-help measures to drive margin improvement.

Landfill gas power generation EBITDA of £31.5 million (2014/15 £35.8 million) was impacted by the removal of Levy Exemption Certificates and lower volumes. As expected, landfill EBITDA was down to £6.3 million (2014/15 £15.4 million) due to the continuing planned landfill wind-down and after care programme. Three sites were closed to waste arisings during the year and one following the year end.

Through the Group's portfolio management approach to energy hedging, c.90% of energy (generation net of internal usage of electricity) is hedged into 2016/17 and over 50% is hedged out to 2019/20.

NET FINANCE COSTS (before non-underlying items)

We continued our effective management of interest rates in 2015/16 with net finance costs (including capitalised interest, but before pensions interest, discount unwind on provisions, IFRIC 12 finance income and joint venture finance income) net of interest receivable on average net debt equating to 3.3% (2014/15 3.4%) which included lower interest payable on RPI-linked debt and lower rates on interest rate swaps.

Net finance costs of £54.1 million were £13.3 million higher than last year, reflecting a £13.1 million decrease in capitalised interest following a number of ERFs becoming operational towards the end of 2014/15 together with higher borrowings associated with the ongoing ERF capital expenditure programme, partly offset by lower average borrowing rates and £3.2 million higher IFRIC 12 interest receivable.

Interest receivable (before IFRIC 12 finance income and joint venture finance income) totalling £14.7 million (2014/15 £19.1 million) has been achieved from the objective of enhancing returns on the Group's substantial pre-funding of £632 million.

During the year net finance costs (excluding pensions net interest, discount unwind on provisions and IFRIC 12 contract interest receivable) were £59.6 million (2014/15 £41.1 million) covered 4.4 times (2014/15 6.0 times) by Group operating profit.

PROFIT BEFORE TAX

Underlying profit before tax was £211.3 million, an increase of 0.3%. On a statutory basis, profit before tax was £206.3 million, reflecting non-underlying items of £5.0 million.

TAXATION

The Group's underlying UK corporation tax charge for the year was £32.9 million (2014/15 £39.2 million) including a prior-year credit of £1.4 million (2014/15 credit of £5.5 million). The decrease of £6.3 million primarily reflects the reduction in the UK rate of corporation tax and higher ERF capital allowances. The £1.4 million credit relating to prior years includes a charge of £30 million for an uncertain tax item relating to a financial transaction. This is largely offset by an updated assessment of other uncertain tax items following discussions with HM Revenue and Customs (HMRC) on complex tax legislation relating to the deductibility of financial arrangements, relief claims for capital expenditure, and submission of the prior-year tax returns resulting in lower tax being due compared to the assessment made for the 2014/15 charge.

Underlying deferred tax for the year was a charge of £39.2 million (2014/15 £18.2 million). The higher charge this year reflects higher ERF capital allowances.

EARNINGS PER SHARE

(before non-underlying items and deferred tax)

Earnings per ordinary share were broadly comparable with prior year down 0.8% at 39.5p. This reflects the weighted average number of shares in issue during the year increasing to 410.9 million (2014/15 390.9 million) driven by the equity placing of 12.1 million shares at the start of the year and the full year impact of the conversion of 20.9 million shares last year from the £125 million convertible bond. Net assets per share at book value at 31 March 2016 were 361p.

In addition, there is a £33.1 million deferred tax credit relating to the enacted reduction in the UK rate of corporation tax and a £1.0 million tax credit relating to other non-underlying items. This results in a total tax charge for the year of £38.0 million (2014/15 £54.7 million).

(1) Includes £2.4m operating profit on disposal of Whitehead landfill site.

CHIEF FINANCIAL OFFICER'S REPORT CONTINUED

NON-UNDERLYING ITEMS

Net non-underlying items totalling a charge before tax of £5.0 million have been recognised. The net charge includes a £10.2 million charge for restructuring provisions and a £5.2 million credit relating to the non-cash fair value movement on our long-dated derivatives with the commercial hedged position unchanged. In addition, there is a £33.1 million deferred tax credit relating to the enacted reduction in the UK rate of corporation tax and a £1.0 million tax credit relating to non-underlying items noted above.

During the year the Group reviewed the allocation of Viridor's long-lived assets to cash generating units (CGUs) to ensure they remained consistent with Viridor's operations and the waste market it serves. This review concluded the need for updated allocations with assets now considered part of integrated regional CGUs which resulted in a £60.9 million impairment of non-strategic landfill sites and a £60.9 million reversal of previous impairments. Details of the review are set out in note 17 to the financial statements.

The non-underlying items total a credit after tax of £29.1 million. EBITDA after non-underlying items was £438.2 million (2014/15 £421.6 million). Profit after tax and non-underlying items attributable to shareholders was £152.1 million (2014/15 £126.3 million).

DIVIDENDS AND RETAINED EARNINGS

The statutory net profit attributable to ordinary shareholders of £151.9 million has been transferred to reserves.

The Directors recommend the payment of a final dividend of 23.12p per share for the year ended 31 March 2016. With the interim dividend of 10.46p per share paid on 1 April 2016, this gives a total dividend for the year of 33.58p, an increase of 5.6% over 2014/15 (reflecting 4% real growth plus March 2016 RPI of 1.6%).

Proposed dividends totalling £138.5 million are covered 1.1 times by net profit (before non-underlying items and deferred tax) (2014/15 1.2 times). Dividends are charged against retained earnings in the year in which they are paid.

DIVIDEND POLICY

The Group's policy is to increase the dividend each year by 4% above inflation up to the end of 2019/20. The Group is well positioned to continue delivering shareholder value.

OPERATING COSTS (before non-underlying items)

Operating costs for the year totalled £1,090 million. The most significant areas of expenditure were:

Expenditure	£m
Landfill tax	160
Employment costs	180
Depreciation	183
Raw materials and consumables*	79
Transport	57
Power	39
Business rates	37
Abstraction and discharge consents	8

* Excludes transport costs

GROUP CAPITAL INVESTMENT

Group capital investment was £316.9 million in 2015/16 compared to £407.3 million in 2014/15, reflecting lower spend on ERFs as the investment programme moves from construction to operation.

South West Water and Bournemouth Water capital expenditure was £134.1 million compared to £145.1 million for South West Water in 2014/15. The beginning of the new regulatory period reflects a change in the nature and extent of capital activity. South West Water has also delivered efficiency savings through innovative planning and scoping of schemes and maximising benefits during construction and through the supply chain.

South West Water's spending has focused on preparations for the innovative new water treatment works at North Plymouth, schemes to improve water quality and investment in digital infrastructure. Bournemouth Water has focused on continued pressure management and commissioning two ultraviolet treatment plants at Beaulieu and Knapp Mill. Both South West Water and Bournemouth Water have made a good start to delivering their K6 capital programme.

Viridor's capital investment was £182.8 million compared to £262.2 million in 2014/15, predominantly driven by expenditure on ERFs. This reduction reflected reduced capital expenditure on ERFs as eight of the eleven plants in the portfolio are now on stream, and reduced capital investment in recycling as 2014/15 included expenditure on the Scottish Newhouse glass recycling facility in North Lanarkshire, which came on-stream during 2015/16. Before capitalised interest, cumulative ERF expenditure to date is £910 million, excluding the £72 million spent on Peterborough ERF, which was local authority financed. This leaves £295 million left to invest on the ERF programme, around £185 million in 2016/17, around £100 million in 2017/18 and around £10 million in 2018/19. So far, Viridor has realised £22 million of efficiencies across the ERF capital investment programme and is targeting further savings. The Group's capital expenditure on property plant and equipment, including service concession arrangements, remained significant at £316.9 million (2014/15 £407.3 million). The major categories of expenditure were:

ERF	£139m
Water	£59m
Wastewater	£75m
Recycling	£7m
Landfill energy	£12m
Other	£25m

CASH FLOW

The Group had operational cash inflows in 2015/16 of £418 million (2014/15 £412 million). These funds have been put to use in efficiently financing the Group's capital structure and investing in future growth, through our continuing substantial capital investment programme. This investment together with non-cash movements associated with assuming the fair value of Bournemouth Water's debt has resulted in higher Group net debt. In April 2015 Pennon acquired Bournemouth Water for a cash consideration of £100.3 million. An equity placing was undertaken to replenish our cash resources in respect of the acquisition and ensure funding flexibility.

Summarised cash flow	2015/16 £m	2014/15 £m
Cash inflow from operations	418	412
Net interest paid	(64)	(42)
Tax paid	(45)	(22)
Dividends paid (net of scrip)	(123)	(69)
Hybrid periodic return	(20)	(20)
Capital expenditure	(291)	(365)
Dividends and loan repayments received from joint ventures	34	6
Pension contributions	(34)	(28)
Equity placing and other share issues	102	3
Acquisitions (net of cash acquired)	(91)	-
Net cash outflow	(114)	(125)
Fair value of debt acquired from Bournemouth Water	(160)	-
Conversion of share of convertible bond	-	125
Debt indexation/interest accruals	(13)	(3)
Increase in net borrowings	(287)	(3)

Finance leasing	£1,339m
Bank bilateral debt	£403m
Index-linked bond 2057	£413m
European Investment Bank loans	£273m
Private placements	£554m
Bond 2040	£133m

MAJOR COMPONENTS OF THE GROUP'S DEBT FINANCE AT 31 MARCH 2016

LIQUIDITY AND DEBT PROFILE

The Group has a strong liquidity and funding position, with £1,707 million cash and facilities at 31 March 2016. This includes cash and deposits of £632 million (including £227 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £1,075 million. A total of £470 million in new or renewed debt facilities was arranged during the year, being:

- £130 million new European Investment Bank facility
- £100 million new 20-year facility
- £100 million of new finance leases in South West Water
- £140 million of term loans and revolving credit facilities

At 31 March 2016 the Group's loans and finance lease obligations totalled £3,116 million. After the £632 million held in cash, this gives a net debt figure of £2,484 million, an increase of £287 million during the year.

The Group's debt has a maturity of up to 41 years with an average maturity of 22 years. Much of the Group's debt is floating rate and derivatives are used to fix the rate on that debt. The Group has fixed, or put swaps in place to fix, the interest rate on a substantial portion of the existing water business debt for the entire K6 period.

£395.7 million of South West Water's debt is index-linked at an overall real rate of 1.7%. As a result of the aforementioned initiatives, South West Water's cost of finance is among the lowest in the industry. Two thirds of the water business debt is finance leases giving us a long maturity profile. Interest payable benefits from the fixed credit margins, which were secured at the inception of each lease.

The Group's financing structure gives us the scope and flexibility we need to implement our strategic objectives in order to maximise value for our shareholders.

The Group's interest rate on average net debt for the year to 31 March 2016 is 3.3% (after adjusting for capitalised interest of £9.4 million, notional interest items totalling £5.5 million and interest received from shareholder loans to joint ventures of £10.7 million, as detailed in note 8 to the financial statements). For South West Water this figure was 3.1%.

At 31 March 2016 the fair value of the Group's non-current borrowings was £114 million less than its book value (2015 £74 million) as detailed in note 28 to the financial statements. This reflects the benefit of securing interest rates below the current market rate.

CHIEF FINANCIAL OFFICER'S REPORT CONTINUED

CAPITAL STRUCTURE – OVERALL POSITION

The Group's net debt has increased by £287 million to £2,484 million, with the increase in part reflecting the net debt assumed in the acquisition of Bournemouth Water. The Group's gearing ratio at 31 March 2016, being the ratio of net debt to (equity plus net debt), was 62.5% (2015 61.9%).

In March 2013 the Group issued a £300 million hybrid capital security recognised as equity as set out in note 37 to the financial statements.

During the year the Company continued to benefit from offering a scrip dividend alternative. £6.3 million (2014/15 £48.0 million) of potential cash dividend was retained in the business and resulted in the issuance of 760,626 shares.

Group net debt includes £978 million of funding for our wholly owned ERFs (Runcorn II, Oxford, Exeter, Cardiff, Glasgow, Dunbar and South London) and £81 million of funding for our investments in our joint ventures through shareholder loans (which represents 40% of Group net debt). In addition, our joint ventures have net debt from third parties (excluding shareholder loans) of £212 million.

South West Water's Regulatory Capital Value (RCV) including Bournemouth Water's RCV of £152.9 million, rose 7.6% to £315.0 million at 31 March 2016. This resulted in a combined debt to RCV ratio of 59.7% (2015 62.1%) of which South West Water was 59.8% and Bournemouth Water was 56.7%, which compares to Ofwat's K6 target efficient gearing of 62.5%.

REGULATORY CAPITAL VALUE (£m) as at 31 March

2012	2,827
2013	2,916
2014	2,959
2015	2,928
2016	3,150
	+7.6%

TREASURY POLICIES

The role of the Group's treasury function is to ensure we have the funding to meet foreseeable needs, to maintain reasonable headroom for future contingencies and to manage interest rate risk. The Group enters into certain structured financing transactions that have, and are expected to provide, an improved return on surplus funds and overall interest rate performance. It operates only within policies approved by the Board and undertakes no speculative trading activity.

The Board regularly monitors expected financing needs for at least the following 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cash flows.

The Group has considerable financial resources and a broad spread of business activities. The Directors therefore believe that it is well placed to manage its business risks.

INTERNAL BORROWING

South West Water's and Bournemouth Water's funding is treated for regulatory purposes as ring-fenced. This means that funds raised by, or for, either company are not available as long-term funding for other areas of the Group.

TAXATION STRATEGY

Our tax strategy, reaffirmed by the Board in April 2016, is to fulfil our statutory obligations by the application of relevant tax legislation in a reasonable way, engaging in tax planning only when it is aligned with the commercial and economic activity of the Company. This is in line with the principles published by the Confederation of British Industry (CBI) in 2013. The Group engages with HMRC in an open and transparent way, identifying potential areas of uncertainty on a timely basis. Due to the complexity of tax legislation, the Group and tax authorities may sometimes have differing opinions on the treatment of certain tax items. The Group manages this risk and accrues for areas of tax uncertainty in line with accounting standards requirements, where appropriate. The Board is regularly updated on tax matters, and any tax implications of commercial activities are highlighted to the Board with the use of a risk matrix to assess the appropriateness of a proposal.

TAX CONTRIBUTION 2015/16 – COLLECTED/PAID

The Group made a net payment of £45.0 million of UK corporation tax in the year (2014/15 £21.0 million). The main element of the payment was £25.4 million in relation to 2015/16 net of refunds of £0.2 million from prior years. £9.3 million was paid in relation to the 2014/15 quarterly instalments, in addition £10.3 million was paid for earlier years.

The total tax charge for the year (before non-underlying items) of £72.1 million was greater than the charge that would have arisen had the accounting profit before tax and non-underlying items been taxed at the statutory rate of 20%. A reconciliation is provided in note 9 to the financial statements.

The mainstream tax charge for the year (before deferred tax, prior-year and non-underlying items) of £34.3 million results in an effective rate of 16.2%, which is lower than the statutory rate of 20.0% due to capital allowances received on ERF capital expenditure.

Landfill tax	£167m
Employment taxes	£54m
UK corporation tax	£45m
Business rates	£42m
Environmental payments	£11m
Fuel Excise Duty	£8m
VAT	£8m
Carbon Reduction Commitment	£4m
Other	£3m

The Group's total tax contribution extends significantly beyond its UK corporation tax charge. Total taxes amounted to £342 million (2014/15 £329 million) of which a net amount of £62 million (2014/15 £26 million) was collected on behalf of the authorities for employee payroll taxes and Value Added Tax (VAT).

In addition to corporation tax, the most significant taxes involved together with their profit impact, were

- Landfill tax of £167 million includes £166 million (2014/15 £204 million) collected by the Group on behalf of HMRC. This amount includes £11 million (2014/15 £11 million) paid to local environmental bodies via the Landfill Tax Credits Scheme. Landfill tax is an operating cost that is recovered from customers and is recognised in revenue. The Group incurred landfill tax of £1 million (2014/15 £5 million) on the disposal of waste to third parties. The reduction of £4 million compared to 2014/15 reflects the level of waste that is being diverted to ERFs rather than going to landfill. This is an operating cost for the Group and reduces profit before tax. The net amount of landfill tax paid to HMRC by the Group and via third parties represents 17% of the total landfill receipts of HMRC in the year.
- VAT of £8 million paid (2014/15 £9 million recovered) by the Group to HMRC. The movement in VAT from recovered to paid is a result of a reduction in the capital expenditure and the increase in Group operating profit. VAT has no material impact on profit before tax.
- Business rates of £42 million (2014/15 £33 million) paid to local authorities. This is a direct cost to the Group and reduces profit before tax.
- Employment taxes of £54 million (2014/15 £50 million) including employees' Pay As You Earn (PAYE) and total National Insurance contributions (NICs). Employer NICs of £15 million (2014/15 £14 million) were charged approximately 92% to operating costs with 8% capitalised to property, plant and equipment. The total amount of £54 million includes PAYE of £3 million (2014/15 £2 million) on pension payments made by the Group pension schemes.
- Fuel excise duty of £8 million (2014/15 £10 million) related to transport costs. This reduces profit before tax.
- Payments to the Environment Agency and other regulatory bodies totalling £11 million (2014/15 £9 million). This reduces profit before tax.
- Carbon Reduction Commitment payment for the Group of £4 million (2014/15 £4 million). This reduces profit before tax.

The corporation tax rate for 2015/16 used to calculate the current year's tax is 20% and will reduce to 19% for the year ended 2018 and to 18% for the year ended 2021.

PENSIONS

The Group operates defined benefit pension schemes for certain employees of Pennon Group. The main schemes were closed to new entrants on or before 1 April 2008.

At 31 March 2016 the Group's pension schemes showed an aggregate deficit (before deferred tax) of £40.9 million (2014/15 £59.6 million). The decrease primarily reflects an acceleration of deficit recovery payments totalling £22.6 million and the addition of the Bournemouth Water's defined benefit scheme, which is in surplus, offsetting adverse movements in asset market conditions and continuing low bond rates used in the discounting of the schemes' liabilities.

Net liabilities of £33 million (after deferred tax) represented around 1% of the Group's market capitalisation at 31 March 2016.

The last actuarial valuation of the main scheme was as at 31 March 2013. The 31 March 2016 valuation is underway.

INSURANCE

Pennon Group manages its property and third party liability risks through insurance policies that mainly cover property and business interruption, motor, public liability, environmental pollution and employers' liability.

The Group uses three tiers of insurance to cover operating risks:

- self-insurance – Group companies pay a moderate excess on most claims
- cover by the Group's subsidiary (Peninsula Insurance Limited) of the layer of risk between the self-insurance and the cover provided by external insurers
- cover provided by the external insurance market, arranged by our brokers with insurance companies that have good credit ratings

Susan Davy
Chief Financial Officer
Pennon Group Plc

OUR OPERATIONS

WATER AND WASTEWATER

STRATEGY

We are focused on providing water and wastewater services in the most efficient and sustainable way possible. Innovation, new technologies, and the pioneering of a holistic approach to water and wastewater management are playing a key role in delivering service improvements and long-term value.

KEY FACTS

- 2.2 million total population served
- 996,929 customers
- 23 raw water reservoirs
- 18,131km of drinking water mains network
- 688 treatment works with 66 ultraviolet (UV) treatment facilities
- 15,600km wastewater mains network*
- 900 wastewater pumping stations*
- 145 bathing waters and 24 shellfish waters*

* South West Water region only

South West Water has delivered further improvements in line with our Business Plan to 2020, ensuring we are well placed to meet the changing demands of our sector. The integration of Bournemouth Water is progressing well and provides further scope for performance improvement, operational efficiency and sharing best practice.

WASTE RECYCLING AND RECOVERY

STRATEGY

Our purpose is to give the world's resources new life
We remain at the forefront of the resource sector in the UK, transforming waste into energy, high quality recyclates and raw materials

KEY FACTS

- Eight energy recovery facilities in operation and three more under construction across the UK
- Produces enough energy to power over 330 000 homes
- Over 150 local authority and major corporate clients as well as over 32,000 customers across the UK
- Network of 313 recycling, energy recovery and waste management facilities
- Over 7.5 million tonnes of recyclates and resources managed each year of which 1.8 million tonnes are recycled (including organics)
- A fleet of 650 waste collection vehicles

Viridor continues to develop and improve its recycling and recovery and facilities for clients and partners throughout the UK. Driven by a clear purpose and strategy, this year we've seen further investment in our essential recycling and energy recovery infrastructure, and in our people and processes, to deliver future growth, better UK resource efficiency and a quality service for our customers.

OUR OPERATIONS CONTINUED

WATER AND WASTEWATER

OUR PERFORMANCE AGAINST THE K6 REGULATORY CONTRACT (2015-2020)

South West Water has the highest potential rewards in the sector for K6. At 31 March 2016 the combined water business (South West Water and Bournemouth Water) has delivered an 11.7% Return on Regulated Equity (RoRE)⁽¹⁾ arising from base, operational and financing returns.

2015/2016 RoRE

1) Base – 6.0%
2) Totex outperformance – 2.5%
3) ODI outperformance – 0.2%
4) Financing outperformance – 3.0% ⁽²⁾
TOTAL – 11.7%

(1) RoRE reflects the Ofwat regulatory guidance of Base RoRE plus Outperformance. It is calculated using actual results before non-underlying items (deflated into 2012/13 prices) and compared against the Final Determination allowances sourced from Ofwat published models and based on notional gearing and annual average regulatory capital vehicle (RCV).

(2) Interest outperformance is based on the outturn effective interest rate (aligned with Regulatory Accounting Guidelines and adjusted for one-off credits) using the expected K6 RPI of 2.8% aligned with the 2014 Final Determination cost of capital assumptions: notional debt gearing of 62.5% and a notional tax impact of 20%.

(3) £53m from South West Water, £3m from Bournemouth Water including integration synergies already delivered. Phasing of actual expenditure compared to the planned programme has been reflected. Outperformance includes a reduction in the RCV run-off for the RCV element of Totex outperformance calculated based on the Final Determination PAYG. Tax impacts reflect actual effective tax rates.

(4) Financing outperformance is based on comparing average iBoxx rates adjusted by notional Final Determination RPI of 2.8% and compared to the cost of debt assumed of 2.75%. This is applied to an assumed new debt proportion of 25% and adjusted for the tax impact.

TOTEX STRATEGY – SECURING OUTPERFORMANCE

South West Water is striving for ever greater efficiency in K6, building on a strong track record from K5. The company was deemed to be at the frontier of cost efficiency when it was awarded an enhanced Business Plan assessment with the largest element of potential operational outperformance over K6 coming from total expenditure (Totex) savings and efficiencies. Bournemouth Water is one of the top performing water-only companies and was deemed to be mid-table for efficiency. The combined water business is 'front-end-loading' efficiencies and savings to allow early and more certain delivery of outperformance. £56m of Totex savings⁽³⁾ have been delivered in 2015/16, despite costs of delivering growth. These Totex savings reflect changes in the timing of delivery from those planned in the determinations.

ODI REWARDS SECURED

South West Water has 23 outcome delivery incentives (ODIs), including SIM, which have potential financial rewards or penalties. Incentives for performance are recognised in the year of delivery, whether the measure is recovered in period or as a regulatory true-up at the end of the period.

Operational performance for the year which is covered in more detail below, has resulted in an ODI reward. Rewards were secured across bathing water quality, odour complaints and water restrictions. Improved performance is being targeted in areas where penalties were received such as pollution and interruptions to supply. Bournemouth Water has 10 ODIs including the service incentive mechanism (SIM), which have financial rewards and penalties. Rewards were achieved in leakage and reducing large scale interruptions. Combined ODI rewards result in a £2.1m benefit and reflects RoRE outperformance of 0.2%.

WATERSHARE

South West Water has in place a unique WaterShare mechanism to share net benefits with customers through reinvestment options, future bill reductions and service improvements exceeding planned targets.

WaterShare reflects the established mechanism for sharing Totex outperformance but also allows customers to share in financing outperformance⁽⁴⁾ from movements in the market on new debt instruments. In addition specific items are also shared with customers – with differing rates depending on the company delivery.

This WaterShare mechanism has identified c. £3.1m of benefits to customers this year and following discussions with our independent WaterShare panel it has been decided that this would be earmarked for reinvestment, rather than a targeted reduction in customer bills. This equates to a RoRE of 0.3%.

DRINKING WATER QUALITY (mean zonal compliance)

SOUTH WEST WATER

99.97%

BOURNEMOUTH WATER

100%

DRINKING WATER

South West Water continued to deliver high quality drinking water in 2015 achieving 99.97%,⁽¹⁾ a slight improvement on the previous year. Leakage was kept within target levels, water resources were unrestricted for a 19th consecutive year and there was a 14% reduction in customer contacts regarding taste, odour or discolouration issues.

Bournemouth Water achieved a perfect score for drinking water quality, with 100% of compliance tests⁽¹⁾ carried out meeting the required standard and there was a further substantial reduction in the amount of water lost through leaks and bursts. The number of customer contacts regarding taste, odour or discolouration issues was well within the target threshold, and less than 1% of customers experienced an interruption to their water supply lasting three hours or more.

The average duration of supply interruptions per property for South West Water regrettably was up by 2 minutes to 25 minutes in 2015/16. This was largely due to two large trunk main bursts affecting customers' supplies at St Blazey in Cornwall in October 2015 and in Plymouth in December 2015. In each case we took immediate steps to restore supplies as quickly as possible and keep customers informed.

We have further developed our strategies to prevent and mitigate the impact of such occurrences in future. These are being supported by the use of innovative techniques for network pressure management and monitoring, together with investment in advanced repair technologies.

Recognising that customers regard a clean and safe supply of drinking water as their top service priority, key areas of investment and activity during 2015/16 included:

South West Water

- Development expenditure for a new £60 million state-of-the-art North Plymouth water treatment works
- Detailed design of improved water treatment processes such as granular activated carbon (GAC) filtration and UV disinfection at five water treatment works across the region
- Mains rehabilitation and flushing
- Pressure management and network modelling
- Investment in digital infrastructure, including improvements in retail engagement targeting a proactive and positive customer experience

Bournemouth Water

- Mains replacement schemes and new mains development
- Water treatment upgrades including GAC replacement and the addition of UV treatment at three sites
- Improvements to the disinfection process at Alderney water treatment works

Furthermore, improved drinking water quality and drinking water treatment efficiency continue to be targeted through South West Water's award-winning 'Upstream Thinking' programme of catchment management.

Delivered in partnership with a range of stakeholder groups, including wildlife trusts and river authorities, Upstream Thinking's combination of moorland restoration initiatives and agricultural improvement schemes seeks to reduce the level of man-made and natural contaminants in the region's watercourses.

Building on the programme's success in K5 (2010-2015), South West Water is investing around £10 million between 2015 and 2020 to deliver improvements in 11 additional catchment areas. This will include 700 farm improvement schemes and the restoration of c. 1,300 hectares of moorland.

At Bournemouth Water catchment management work has commenced with our partner Natural England and Catchment Sensitive Farming, working with farmers in the River Stour catchment area to educate them about the effects of their activity on raw water quality.

(1) As measured by mean zonal compliance, the recognised industry measure for overall drinking water quality.

OUR OPERATIONS CONTINUED

WATER AND WASTEWATER

WASTEWATER

We aim to ensure the safe and efficient removal and disposal of wastewater while minimising the likelihood of sewer flooding or pollution affecting homes, businesses or the environment

During K5 (2010-2015) South West Water focused on a targeted programme of wastewater treatment improvements while also working to prevent potential failure through increased monitoring. In 2015 the company's score for numeric compliance (the percentage of wastewater treatment works deemed compliant) at 95.8% remained above the K5 average but was slightly below that of the previous year (2014 96.1%). This highlights the need for further enhancements as we strive to achieve 100% compliance by 2020.

Our legacy of major investment to protect bathing waters, in addition to accelerated bathing water quality schemes implemented during 2014/15, was reflected in extremely positive results for the 2015 bathing water season, which was assessed under tougher new EU standards. Of the 145 bathing waters tested in the South West Water region, 141 (97.2%) were classified 'sufficient' or better, with more than 70% classified as 'excellent'.

Four bathing waters were rated as 'poor', however this was not attributed to any failure of South West Water's assets. We recognise that bathing water quality is dependent on a wide range of factors and work continues, alongside partners including local councils, community groups, landowners and conservationists to tackle bathing water quality issues in a holistic and sustainable way.

South West Water had zero 'serious' (Category 1) pollution incidents in 2015 and made a substantial reduction in the number of pollution incidents overall (Categories 1-4). However, there were seven 'significant' (Category 2) incidents compared with three in 2014.

A comprehensive performance review was undertaken that identified blockages on the network as the largest pollution risk. To improve the robustness of the wastewater network and assets, a strategy is being implemented to increase monitoring and maintenance. We also continue to raise customer awareness about sewer misuse.

These improvements will also help to reduce the risk of sewer flooding. While the annual level of rainfall was relatively normal for the year, the number of internal and external sewer floodings was higher than the previous year as a result of extended periods of heavy rainfall in the winter of 2015/16.

In addition to capital maintenance and improvement schemes, we are working to improve our response times to flooding incidents. In the longer term a reduction in sewer flooding is also being targeted through our 'Downstream Thinking' programme of work to improve urban drainage using low-cost sustainable techniques including landscaping and sustainable drainage systems (SuDS). In 2015/16 this included:

- Aveton Gifford, Devon (pictured, below) – tackling sewer flooding in a joint project alongside the parish council, the school, county council and householders to reduce the amount of surface water entering combined sewers
- Exmouth, Devon – locations have been identified where SuDS would be most beneficial. Community engagement and initial designs are planned for 2016/17
- Kingsbridge, Devon – the development of an Integrated Urban Drainage Model in partnership with the Environment Agency and Devon County Council

Furthermore, we continue to work with organisations including the Environment Agency and local councils on flood alleviation projects. In 2015/16 this included the completion of a £2 million scheme to protect homes in the Colebrook area of Plymouth and support for the proposed Environment Agency and Cornwall Council-led £20 million flood alleviation and regeneration scheme around St Austell (for which a funding bid has been submitted to the EU). South West Water is also providing financial support for the Exeter Flood Defence Scheme.

Technology to improve sewer network monitoring

The use of new technologies is a key part of South West Water's approach to improve both efficiency and sustainability. During 2015/16 we trialled the use of SewerBatt – innovative pipe inspection technology that uses sound to assess the condition of sewers. It is hoped that the roll-out of SewerBatt will allow for improved sewer cleansing by identifying blockages and other potential causes of pollution much more quickly than traditional methods.

OUR OPERATIONS CONTINUED

WASTE RECYCLING AND RECOVERY

ENERGY RECOVERY FACILITIES (ERFs)

We are successfully establishing a significant asset base of ERFs, with eight plants, representing more than two-thirds of the committed portfolio capacity, now in operation. Peterborough ERF was completed and became operational in December 2015. The process of ramping up towards operational optimisation continues at the six most recently delivered ERFs.

Around 80% of the committed ERF portfolio is expected to be operational by the end of 2016/17, and is on track to deliver c £100 million of EBITDA in 2016/17. We expect to have c 18% ERF market share by 2020, with a network of strategic facilities driving Vindor's longer-term profit growth.

Currently we have 142 megawatts (MW) of renewable energy capacity from our eight operational ERFs, including our share of joint ventures, and the Greater Manchester and Walpole anaerobic digestion (AD) plants. We, together with our joint venture partners, have a total operational/committed ERF capacity of over 2.8 million tonnes. Approximately 80% of inputs required across the ERF portfolio (operational and those under construction) are now secured under long-term contracts, helping to secure revenue streams and move to a more homogeneous risk profile across the Group.

Of the three ERFs under construction, Dunbar and Beddington ERFs are progressing as planned. The Glasgow gasification plant is expected to enter commissioning in H1 2016/17. All three remain on budget.

ENERGY

Viridor's total energy capacity is changing in scale and across its energy division, currently we have 277MW of operating capacity from ERFs, AD and landfill gas (including joint ventures) and expect to export over one terawatt hour (TWh) of power to the national grid in 2016/17. Once the total committed ERF portfolio is completed in 2018/19, ERFs alone will provide 242MW of energy generation capacity.

We have developed a portfolio management strategy to help realise the full potential of this growth, with a team of experienced energy market professionals to actively manage our market position. We have also implemented framework contracts to enable us to 'hedge out' market risk where appropriate in the longer term. The business now has the ability to hedge its market position for periods up to five years ahead. In addition, the Group has a natural hedging opportunity which represents one third of Viridor's energy generation, as South West Water is a net user of electricity.

During the period, Levy Exemption Certificates (LECs) were discontinued with a modest impact on Viridor. There have also been changes to the Renewable Obligation Certificates (ROCs) regime. However, Viridor's ROC accreditations are unaffected by these changes. Energy generation continues to be a profitable business for us.

Opportunities for decentralised energy and heat utilisation (combined heat and power) at selective ERF and landfill gas power generation sites are being developed.

RECYCLING AND RESOURCES

During the year, our recycling volumes traded increased by 121,000 tonnes (7.3%) to 1.8 million tonnes. Recyclate prices were lower for the year of 2015/16 compared to 2014/15. Prices have now stabilised to some degree for most commodities but remain under pressure, reflecting world economic conditions and competitive markets.

Through the Input, Throughput and Output Optimisation (ITOO) programme, we are targeting improvements in source material quality (involving contract renegotiation where required), restructuring, asset efficiency, productivity and yield, and specific quality control of outputs. A number of contracts have been successfully renegotiated enhancing value and quality of inputs. Where new recycling contracts have been secured, better gate fees reflect the sharing of recyclate price risks with customers and secure a better specified quality of inputs. These self-help measures have resulted in marginal increases compared to the prior year.

We continue to operate the most extensive Material Recycling Facility (MRF) capacity in the UK. Viridor is established as a quality brand in the UK, European and Asian markets including China, where it holds accreditations for export. There are clear long-term regulatory drivers for recycling from the EU and UK Government, alongside expectations from clients, including local authorities, leading corporates and the business community.

OUR OPERATIONS CONTINUED

WASTE RECYCLING AND RECOVERY

LANDFILL GAS POWER GENERATION

Our landfill energy business is being managed to maximise the value of landfill gas power generation, while exploring alternative commercial development opportunities and other energy uses such as photovoltaics (PV) and energy storage at our landfill sites

At present we have 99MW of landfill gas capacity (excluding 3MW capacity at sub-contract sites in Suffolk). Gas volumes reached peak production in 2012/13 and have been reducing gradually, partially offset by improved gas capture efficiency. In 2015/16 the landfill gas power generation output was only marginally down to 562 gigawatt hours (GWh) (2014/15 602GWh), reflecting a continued successful output optimisation programme.

Average revenue per megawatt hour (MWh) was 2.2% lower at £90.72 (2014/15 £92.72) reflecting the withdrawal of LECs. The switch from legacy Non Fossil Fuel Obligation (NFFO) contracts to ROCs continues with 94% of energy now sold under the higher value ROCs. The remaining 6% NFFO component will migrate to ROCs in 2016/17. Average costs increased slightly to £34.76 per MWh (2014/15 £33.19).

At Pilsworth landfill in Greater Manchester, Viridor is hosting an £8 million cryogenic energy storage pilot project, funded by the Department of Energy and Climate Change, which is due to become operational shortly. Landfill sites have very good potential as energy reservoirs as most already have established grid connections, making them valuable for energy generation and storage. Novel energy storage options are being assessed through Viridor's Technology and Innovation Forum.

LANDFILL SITES BEING MANAGED FOR CASH AND ALTERNATIVE USE

We have a strategy in place for landfill that will see the business reduce the number of sites taking new waste inputs from 18 at the end of 2014/15 to a small number of strategic sites by 2020. Three landfills closed during the year with a fourth site closing just after the year end. This is in line with legislative moves and economic drivers to divert waste away from landfill.

While sites are being wound down to closure and aftercare our emphasis remains on maximising the value of electricity generation from landfill gas, reducing costs and developing opportunities for alternative uses for sites or divestment. We completed the divestment of Whitehead landfill and its associated environmental liability, generating an operating profit on disposal of £2.4 million (recorded within asset sales), and continue to promote similar opportunities for other sites with development potential.

The business continues to be cash generative as the wind-down and aftercare programme accelerates. Viridor's average gate fees increased by 1% to £20.14 per tonne. Consented landfill capacity reduced from 51.7 million cubic metres (mcm) at 31 March 2015 to 47.4 mcm, reflecting usage during the period and a disposal. As previously provided for, c. 3.4mcm of Viridor's consented landfill capacity is not expected to be used.

Landfill tax continues to increase in line with inflation and rose to £84.40 per tonne on 1 April 2016.

CONTRACTS AND COLLECTIONS

Performance across our major local authority contracts around the UK (the more significant contracts include Greater Manchester, Glasgow Lancashire, Somerset and West Sussex) and the Thames Water contract remains broadly in line with last year

Our large-scale contract successes in 2015/16 include a 25-year contracted service for Tomorrow's Valley in Wales (where four local authorities have come together to create a £190 million residual waste contract for 90,000 tonnes per annum), a 10-year contract with South Lanarkshire Council (with a potential 5-year extension) for treatment of 80,000 tonnes per annum of residual waste via Dunbar ERF, and Clyde Valley in Scotland (where five local authorities have come together to create a £450 million residual waste contract for 190,000 tonnes per annum over 25 years)

The solid performance of the collection business reflected the benefits of sustained management action. Collection remains a key focus in securing increased input tonnages for the business

JOINT VENTURES

All three of Viridor's joint ventures continue to perform well

Viridor Laing Greater Manchester (VLGM), a joint venture between Viridor and John Laing Infrastructure, is delivering the 25-year Greater Manchester Waste PFI. Now in its eighth year, this remains the UK's largest ever combined waste and energy project. The recycling, recovery and waste management facilities serving the contract, which handle in excess of one million tonnes of material per annum, are operated by Viridor on a sub-contract basis

Solid recovered fuel produced from the residual waste from Greater Manchester is used to generate heat and power at Runcorn 1 ERF (TPSCo, a joint venture between Viridor, John Laing Infrastructure and Inovyn), which has operated well since it came on line in 2015

The third joint venture at Lakeside ERF (a 50/50 joint venture with Grundon Waste Management) is in its sixth year of operation and continues to outperform its original power generation and waste processing targets

CUSTOMERS AND COMMUNITIES

Penon aims to be a good neighbour and consults with its stakeholders in order to understand and respond to their priorities. We aspire to have a positive effect on quality of life, communities and regional economies.

PENNON'S CUSTOMER STRATEGY

Central to our strategy is the management of the Group as a sustainable and successful business for the benefit of all of our stakeholders. We recognise that consultation with our customers, a key stakeholder group, is imperative in order to understand their priorities and deliver the level of service that they require. In turn, this helps us to build a solid reputation for high quality customer service, which contributes to the creation of shareholder value.

South West Water's customer strategy will be realised through delivery of its Business Plan to 2020, which places customer priorities at the heart of all its services and activities, aiming to deal with customer requests, problems and queries quickly and efficiently, and ensuring that the service provided represents value for money for all customers, whether residential or business.

Bournemouth Water's strong customer service ethos and impressive track record of service excellence means it is well placed to support the delivery of Penon's customer strategy through the sharing of best practice.

For Vindor, the focus is on a programme of initiatives to enhance the customer experience across its large and diverse range of large corporate, commercial and local authority clients, while ensuring a consistent and transparent approach.

CUSTOMER SATISFACTION

Penon's water businesses maintained their previous high levels of customer satisfaction during the year. South West Water's overall customer satisfaction remained broadly stable at 89% (2014/15 90%), with satisfaction regarding value for money at 59%, 1% higher than last year. For 16 years Bournemouth Water has retained the biennial Customer Service Excellence Award, which it last received in 2014. This national award recognises service excellence across the measures of timeliness, quality of information, professionalism and employee attitude.

A key indicator of customer service performance for the water businesses is the service incentive mechanism (SIM), which Ofwat uses to compare the performance of water companies. The SIM score is calculated against a qualitative element (based on a customer survey) and a quantitative element that takes into account, among other things, the number of complaints received in writing or by phone. South West Water's SIM score for the year was 78.6 (continuing the improving trend of recent years), and Bournemouth Water's SIM score at 86.2 remains one of the highest in the industry.

Vindor also conducted an extensive customer research survey in 2015, involving over 1,000 customers in sectors including retail, education, food production and construction, as well as our local authority clients. The output of the research will help us to take smarter business decisions in order to meet our customers' needs, deliver customer benefits and drive business growth.

RESPONSIVE TO CUSTOMERS' NEEDS

Household water customers expect to have a choice of communication methods through which queries can be raised, they expect their issues to be resolved on the first contact and as quickly as possible. In order to meet this expectation, our approach is to focus on recruitment, training and employee development, and enhance and promote the services we offer online.

South West Water saw an improvement in first time resolution of contacts from customers during the year, reflecting both operational improvements and ongoing work to improve customer service through the proactive delivery of information, advice and support. This includes the availability of self-service options and real time information through digital platforms such as MyAccount, WaterLive and BeachLive. A revamped web presence is also in development for 2016/17.

Over time, we intend to migrate Bournemouth Water to South West Water's technology and systems to give customers more choice and flexibility. This will include providing an online billing and account management facility, increasing use of electronic communication channels and introducing social media.

Our waste recovery and recycling services have been developed in response to customer demands for 'zero waste' recycling-led services that reflect the waste hierarchy, improve resource efficiency and contribute towards a more circular economy.

Viridor's customers expect to receive a high quality and reliable service, financial integrity and transparency, and the highest standards of compliance. An increasing number of Viridor's customers also want clear auditing and reporting of recycling, resource and carbon management practices, alongside a commitment to continuous improvement and engagement with us as a supply chain partner.

Viridor continues to offer a progressive and collaborative approach to service and sustainability epitomised in the aggregated services model we are developing with our partners in Greater Manchester. This is not only delivering results in terms of increased recycling and landfill diversion but is supporting and contributing to the region's decentralised energy and low carbon ambitions, aiming to attract further inward investment within the broader context of the 'Northern Powerhouse'.

SUPPORT FOR THOSE WHO NEED IT

South West Water has implemented a range of innovative industry-leading schemes to assist those customers with affordability or debt issues, such as its WaterCare+ scheme and initiatives delivered in partnership with Citizens Advice.

We were one of the first water companies to introduce a social tariff to ease financial pressures on very low income customers and to introduce the FreshStart grant scheme to assist those new to debt as a result of a downturn in their personal circumstances, such as a bereavement or long-term illness.

Through partnerships with social housing providers, we are providing affordability help and advice to residents in order to build positive customer relationships and reduce customer debt. During 2015/16 this included targeted work with Teign Housing and North Devon Homes which resulted in a 170% increase in the uptake of affordability schemes, increased metering and significant debt reduction.

Bournemouth Water also offers a range of support and payment options. Specially trained and experienced employees, together with local debt charities, help customers manage their bills in times of financial hardship. With customer support, we are looking to introduce a social tariff later in 2016 to help the most vulnerable in the community.

METERING

South West Water and Bournemouth Water continue to promote the benefits of metering, including water efficiency, the identification of leaks and the savings that can be made. 80% of South West Water's customers are now metered (2014/15 79%) with 6,058 installations carried out over the past year for customers switching to metering. In 2015/16, Bournemouth Water installed 2,553 meters against a target of 1,860. 70% of all Bournemouth Water's customers are now metered.

NON-HOUSEHOLD RETAIL STRATEGY

Preparations are being made to maximise the opportunities presented by the opening of the non-household retail market in 2017 while continuing to improve the services provided to our business and commercial customers.

A separate legal entity has been created, Pennon Water Services, which operates from Bournemouth. This company will provide retail and water management services to our c. 85,000 non-household customers, who will be eligible for the water retail market in 2017, through our existing brands – South West Water Business Services, Source for Business, Avon Valley Water, Bournemouth Water Business Services and Aquacare.

A key part of our non-household strategy will be to capitalise on Viridor's national footprint, focusing on existing customer relationships and exploring the opportunities to provide value-added services.

CUSTOMERS AND COMMUNITIES CONTINUED

PENNON'S COMMUNITY RELATIONS STRATEGY

We aim to ensure that all our business activities have a positive impact on the communities in which we operate. With over 1,000 operating facilities and treatment works, it is important that we maintain the highest operational standards, meet community expectations and deliver clear community benefits in our service areas. We achieve this by:

- undertaking our activities in a way that minimises potential adverse effects on society, the environment and on those living or working in proximity to our sites
- ensuring a positive economic impact on the local economy through the provision of essential services, employment and supply chain opportunities
- conducting open and transparent engagement with local communities and taking into account their needs and priorities
- making community investments that create benefits for both the community and the Group's core businesses
- fostering an environment that encourages employees to engage with communities and provides opportunities for establishing partnerships with community organisations

Both South West Water and Viridor have developed their own strategies to deliver Pennon's community vision. South West Water is focusing on strengthening its profile within the communities it serves, creating opportunities for employee engagement and developing long-term collaborations with charity and sponsorship partners, including the Royal National Lifeboat Institution, the Devon and Cornwall Food Association, the Devon Wildlife Trust and the South West Coast Path Association.

Viridor offers structured and transparent programmes of community investment linked to its core business and guided by its community strategy. Such activities include an annually reviewed programme of targeted charitable giving and sponsorship, education and engagement and employee volunteering opportunities.

In 2016 both Viridor and South West Water received 2.5 stars out of five in the Business in the Community's 2016 Corporate Responsibility (CR) Index. This is a rigorous and robust benchmarking tool which has helped hundreds of companies measure and manage the progress they are making to integrate responsible business practice into their mainstream business at all levels.

Bournemouth Water provides support through community volunteering and the company matches the fundraising of its employees. Employees of both South West Water and Bournemouth Water continue to support WaterAid via regular giving and participating in events and challenges, helping to bring safe water and sanitation to those desperately in need.

During 2015/16 Pennon provided a total of £12.1 million in community support, sponsorship and charitable donations, of which £11.8 million was paid to Viridor Credits⁽¹⁾ for distribution via the Landfill Communities Fund.

COMMUNITY SUPPORT, SPONSORSHIP AND DONATIONS

SOUTH WEST WATER (£)

2011/12	79,858
2012/13	73,301
2013/14	90,921
2014/15	106,188
2015/16	136,250

VIRIDOR* (£m)

2011/12	10.4
2012/13	10.7
2013/14	13.5
2014/15	12.8
2015/16	12.0

* Including amounts paid to Viridor Credits for distribution via the Landfill Communities Fund.

(1) Viridor Credits is an independent not-for-profit organisation that was set up to administer Viridor's contributions to the Landfill Communities Fund.

UPDATE: VIRIDOR STREET TREES – GREATER MANCHESTER

Viridor's innovative urban tree planting project in partnership with Red Rose Forest, an environmental charity, celebrated its fifth year in 2015/16. The partnership seeks to reward key recycling customers by allowing them to give something back to their local communities and contribute to a greener Greater Manchester, by identifying local streets and working with communities to plant and maintain semi-mature street trees.

The partnership has directly engaged 1,092 residents, planted 154 semi-mature trees and improved 3,144 metres of urban roadside.

Via its regional educational programme, Viridor will continue to support Red Rose Forest's new movement – City of Trees – which aims to plant three million trees in the next two decades, one for every man, woman and child in Greater Manchester.

RECREATION AND LEISURE

The recreational opportunities and facilities available at South West Water's reservoirs are managed on its behalf by the South West Lakes Trust. Sailing, fishing, windsurfing, wakeboarding, nature trails and cycling are just a few of the activities the trust helps to facilitate. A highlight for 2015/16 was the achievement of a Green Tourism Gold Award for Wimbleball Lake in December 2015, recognising the trust's work to promote sustainable tourism.

Bournemouth Water owns around three-quarters of Christchurch Harbour, together with the tidal reaches of both the Stour and Avon rivers, and offers fishing in the harbour and the Lower Stour, as well as a range of fishing locations at Longham Lakes. We also manage a wide range of moorings in the harbour which provides easy access to one of the most popular areas for boating on the south coast.

CUSTOMER CAMPAIGNS

We strive to engage, educate and inform residents and businesses about water usage, sewer blockages, waste prevention and best practice in recycling and resource efficiency.

In Greater Manchester an updated communications plan for 2015-2018 has been developed to drive behavioural change and increase recycling in communities that have been identified as mid-performing and hard to reach. Viridor also works with Somerset Waste Partnership and West Sussex County Council to deliver comprehensive educational and behavioural change programmes to a wide range of stakeholders.

In 2015 South West Water launched its 'Love Your Loo' community engagement campaign aimed at reducing sewer blockages and sewer flooding incidences. The campaign began in Falmouth, where the local public toilets received the 'red carpet' treatment in an attempt to engage local residents and visitors to the area.

EMPLOYEE VOLUNTEERING

South West Water has an active volunteering programme that enables staff to take part in agreed community projects including beach cleans and habitat restoration. These are often linked with external groups, such as Keep Britain Tidy and the region's wildlife trusts. In 2015/16 the volunteering programme included tree planting and woodland expansion at Park Lake, a designated County Wildlife Site in North Cornwall.

Viridor employees continued to fundraise for their preferred charities, including Breast Cancer Now, Jeans for Genes, Save the Children and Viridor's main charity partner, the Children's Air Ambulance. A new partnership with Plantlife, an organisation that promotes the protection of wild flowers and plants, was recently confirmed.

Bournemouth Water encourages its employees to spend three days each year working on community initiatives with charitable organisations, schools, wildlife trusts and other community partners. Volunteering resulted in 201.5 employee days being spent in the community during 2015/16.

CUSTOMERS AND COMMUNITIES CONTINUED

SUPPORT FOR EDUCATION

To promote environmental sustainability and increase the level of understanding about the sectors in which we operate, we are actively engaged with schools, colleges and universities. Pennon Group provides educational resources and activities ranging from school talks to work experience placements and site visits.

In 2015/16, Viridor welcomed over 17,000 students and visitors to its 11 educational facilities. The visitor centre at Ardley Energy Recovery Facility (ERF) won the Chartered Institution of Wastes Management's award for Waste and Resource Learning & Development for its work to educate children about the benefits of reducing, reusing and recycling waste, and energy recovery. A new education facility at the Glasgow Recycling and Renewable Energy Centre is planned for 2016/17.

Bournemouth Water has developed a bespoke water efficiency education programme, Waterwise, which is available free to all schools within the company's area of supply.

INSPIRING THE NEXT GENERATION OF ENGINEERS

Viridor's flagship educational partnerships with the Engineering Development Trust's 'Go4SET' programme in Scotland and Business in the Community's 'Business Class' programme are helping establish long-term productive partnerships with secondary schools. These innovative programmes closely align with the science, technology, engineering and mathematics (STEM) curriculum with real world applications in industry and help to inspire and connect students with career opportunities in these important fields.

In Wales, Viridor runs a programme for 'Girls into STEM' that supports the ambition of the Engineering Education Scheme Wales (EESW) to encourage more young women to take up educational and career options in engineering and science.

SKILLS FOR THE FUTURE

South West Water is a leading partner, together with the University of Exeter and South Devon College, in the development of a new University Technical College (UTC) for South Devon, based in Newton Abbot. The college, which opened in October 2015, places a unique focus on engineering, water and the environment and caters for up to 600 young people aged between 14 and 18.

Students will achieve academic and technical qualifications, enabling them to progress to positions as technicians, apprentices and graduate engineers, thereby making a valued and sustainable contribution to the industry and the region.

UNIVERSITY PARTNERSHIPS

Viridor collects the waste and recycling for a number of universities including the universities of Exeter, Kent and Glasgow. Our partnerships with these key customers have shown impressive results. In Exeter we secured a three-year contract with the potential to extend for another two. This will deliver three fundamental objectives: to improve the institution's recycling rate by providing support and education to university staff and students, an upgrade on vehicles that will allow a pay-by-weight solution and the delivery of zero waste to landfill.

Viridor has secured a further three to five-year contract with the University of Kent. This long-established relationship has seen the university achieve a recycling rate of 65%. We continue to support the university's zero waste strategy by helping it to further increase recycling and utilise our ERF for energy generation.

In 2015/16, South West Water supported a successful bid, led by the University of Exeter, to secure £0.7 million from the European Commission's Horizon 2020 programme. The funds will be used to conduct pioneering investigations into how policymakers can develop strategies to meet the climate change challenges facing water, food and energy provision.

Bournemouth Water has maintained its successful partnership with the Students' Union at Bournemouth University and, with its support, continues to run campaigns to engage students with the aim of increasing awareness of the social impact of non-payment of their bills.

REGIONAL ECONOMIC IMPACTS

As an essential service provider and a significant employer and user of third party services, South West Water has a major economic impact on its region. We work with local enterprise partnerships (LEPs) and are actively involved with European Structural Fund and Rural Development Programme Monitoring Committees to support economic growth, resilience and match funding opportunities for delivery partners.

South West Water also works with partners to maximise funding opportunities on behalf of the communities it serves. Alongside Cornwall Council and the Environment Agency, we are part of a bid to secure European Union funding for a £20 million flood defence scheme in South East Cornwall.

Viridor's programme of investment, which includes the UK's largest power plant programme over the last five years, has

- provided 3 700 construction jobs and 470 new, full-time skilled jobs
- supported 90 construction apprentices and 50 construction graduate trainees, along with 230 work placement opportunities
- spent over £190 million with SMEs and other supply chain partners in the communities around our facilities

Our ERF construction projects will continue to add to the already significant community benefits provided. As an example, Viridor and its contractors are firmly committed to realising an ambitious package of community benefits as part of the delivery of the £177 million ERF at Dunbar, East Lothian. Over £3 million of sub-contracts have been awarded to local companies, and a series of 'meet the buyer' and job events have been held with more planned for the coming year.

SUSTAINABLE SUPPLY CHAINS

Supply chain engagement remains an integral element of sustainable business practice and delivers real economic and social benefit.

South West Water annually places approximately £100 million of order value with companies which have a base in the region. Our procurement process sets standards for how individual suppliers approach economic, financial and environmental sustainability and rigorous steps are taken to ensure they meet strict criteria in this regard. The water business operates a 'mixed economy' supply chain model which uses smaller specialist companies alongside larger strategic partners. Following the merger with Bournemouth Water, the existing procurement strategy is being carried forward across both companies.

Viridor continues to strengthen its approach to procurement and supply chain relationships via its procurement team and has a wide range of policies and protocols in this important area. These include a policy on sustainable procurement which utilises whole-life costings and criteria to ensure clear social and environmental responsibility for goods and services procured. This approach helped deliver benefits of over £2.6 million in 2015/16, demonstrating long-term value for us and, in turn, our customers.

Examples of activities supporting Pennon's sustainable procurement objective include the adoption of in-cab technology that monitors driver behaviour and helps to reduce accidents, fuel usage and carbon emissions, the trial of electric and hybrid vehicles as part of a review of the transport fleet, the introduction of limits on CO₂ emissions for company cars, and, at Viridor, a tender for the procurement of new printing and photocopying equipment that will reduce the amount and cost of printing, as well as a move to environmentally friendly office supplies.

OUR ENVIRONMENT

As a business within which the environment is so closely correlated with its core activities, Pennon is acutely aware of its environmental impact and obligations. We understand that the scale of our operations brings responsibilities in how we manage our workforce and operational activities, and we are committed to working in the most environmentally sustainable way possible.

PENNON'S ENVIRONMENT STRATEGY

We are committed to the conservation and enhancement of the natural environment. Our strategy involves applying best practice and targeting innovation to ensure the sustainability of our activities, maximising the efficiency of our use of resources, reducing waste, increasing recycling and fully exploiting opportunities for renewable energy generation.

Across the Group we are focused not only on meeting environmental standards but also the drive to find new ways of working that deliver better environmental outcomes. Our water businesses take rigorous steps to protect the environment during the extraction, treatment and delivery of drinking water and, for South West Water, the removal and safe disposal of wastewater (see 'Our Operations' on pages 28 to 31). Viridor's mission to give the world's resources 'new life' directly contributes to environmental sustainability.

KEY PERFORMANCE INDICATORS

WATER BUSINESS – RECYCLING VOLUMES

(tonnes of dry solids)

2011/12	54,612
2012/13	45,304
2013/14	34,918
2014/15	41,300
2015/16	38,000

WASTE BUSINESS – RECYCLING VOLUMES

TRADED (million tonnes)

2011/12	1.8
2012/13	1.9
2013/14	1.8
2014/15	1.7
2015/16	1.8

GROUP RENEWABLE ENERGY GENERATION

(GWh)

2011/12	775
2012/13	839
2013/14	795
2014/15	949
2015/16	1,496

RENEWABLE ENERGY BREAKDOWN 2015/16

WATER AND WASTEWATER

- 1) Hydro – 12 8GWh
- 2) CHP – 5 1GWh
- 3) Solar PV – 7 3GWh*
- 4) Wind – 0 3GWh

TOTAL – c 25 5GWh

* This includes 5 1GWh of output from two private wire schemes – Polmaugan (Restormel) and Wadebridge Renewable Energy Network (Nanstallon) – and 0 3GWh of Bournemouth Water solar energy generation

WASTE RECYCLING AND RECOVERY

- 1) ERFs – 903GWh
- 2) Anaerobic digestion – 3GWh
- 3) Landfill gas – 562GWh
- 4) Solar PV – 3GWh

TOTAL – 1,471GWh

Looking ahead, South West Water has committed to buying power from Viridor, via its electricity supplier, Total Gas & Power and we are also investigating additional private wire renewable energy opportunities with developers and community groups across the South West region

OUR ENVIRONMENT CONTINUED

GREENHOUSE GAS EMISSIONS

Pennon aspires to leadership in minimising emissions that contribute to climate change and recognises that improved waste recycling and recovery contributes to the associated UK and EU climate change adaptation strategies

CHANGE IN GROUP EMISSIONS

Our overall net emissions increased by 21% between 2014/15 and 2015/16 (see table on page 45) primarily as a result of the addition of new Energy Recovery Facilities (ERFs) that became fully operational during 2014/15. The proportion of Group emissions assigned to such plants has more than doubled in the year as we seek to move our focus away from landfill towards investment in energy recovery

Our emissions intensity measure of tCO₂e/£100,000 revenue also increased from 92 tCO₂e/£100,000 to 112 tCO₂e/£100,000 as a result of the Group's emissions growing at a faster rate than its revenue

South West Water reduced its carbon emissions to 158,891 tonnes of carbon dioxide equivalent (tCO₂e) (2014/15 166,370 tCO₂e). This was in part due to a reduction in the emissions factor applied to usage of imported electricity from the national grid which, as a result of a fall in coal-fired electricity generation, reduced by almost 7% between 2014/15 and 2015/16. Bournemouth Water (which, having been acquired in April 2015, is included in Group reporting for the year 2015/16 only) was responsible for 1% of total Group net emissions in 2015/16 with a carbon footprint of 16,844 tCO₂e

Vindor's overall emissions increased to 1,354,686 tCO₂e (2014/15 1,111,906 tCO₂e) although emissions from landfill operations continued to decrease

CARBON REDUCTION STRATEGY AND TARGETS

Consistent with the overall Group strategy, we are exploring synergies across our businesses with a view to identifying areas of best practice for carbon management and to develop common goals

Our businesses' strategies are based on the optimisation and efficiency of plants and treatment works through a suite of energy management techniques (including performance monitoring and maintenance of assets, such as Bournemouth Water's pump replacement programme), as well as the use of new technologies (such as remote operating systems, cryogenic energy storage, the installation of LED lighting and solar PV), community initiatives to encourage greater water efficiency (which reduces the amount of water to be pumped around the network), measures for the reduction of transport emissions (including a trial of electric and hybrid vehicles) and the promotion of in-house energy efficiency

Our long-term goals are

- To reduce the carbon footprint of our waste management business by 35% by 2020 from a 2011 baseline of 1,231,762 tCO₂e. This is an ambitious target, given the challenges of a landfill wind-down and aftercare programme in the operating landfill business happening in parallel with bringing a fleet of ERFs into operation. In addition, Vindor's aspiration is to become 20% more efficient in terms of the fossil fuel-based energy it uses
- In our water and wastewater business, South West Water's target is to reduce emissions to less than 150,000 tCO₂e by 2019/20. The scope and boundary of this target includes emissions from the regulated business, which includes Scope 1 and 2 emissions and significant Scope 3 emissions (see page 45 for definitions). This will represent a 12% reduction from the 2014/15 baseline

88% of the Group's gross emissions can be attributed to our waste management business. In the short term, our increasing fleet of ERFs will continue to contribute to a significant proportion of our carbon footprint. We anticipate that in the long term, however, our energy recovery activities and their related combined heat and power schemes will help to deliver a step-change improvement over landfill. In addition, although energy intensive for our business, the displacement of virgin materials in manufacturing supply chains with recycled material contributes to significant reductions in embodied carbon across product life cycles (although this offset falls outside greenhouse gas reporting scopes)

INITIATIVES DURING THE YEAR

A number of initiatives relating to renewable energy generation and energy efficiency were implemented or progressed during the year. This includes the Burrator Dam hydro scheme, a 160 kilowatt turbine generating c.250MWh per annum, which South West Water brought on line in April 2015. The water business has also commissioned two solar PV schemes in Cornwall, one of which is a 250kW array generating 270MWh per annum for Camborne Wastewater Treatment Works in Cornwall (approximately 12% of the site's total usage) and the other a 100kW array (pictured) supplying Nanstallon treatment works via a private wire supply and 20-year power purchase agreement with Wadebridge Renewable Energy Network. The promotion of energy efficiency internally has continued through South West Water's 'Powerdown' initiative which focuses on the 20% of the company's energy consumption that comes from process treatment and non-operational activities, for example, ultraviolet disinfection, process control, heating, lighting, cooling and computer usage.

Within the waste recycling and recovery business we have recently installed solar power at seven of our facilities which will generate 841kW of renewable energy and significantly reduce the demand for electricity from the national grid, as well as saving money, boosting energy output from a renewable source and reducing the need for fossil fuels. In addition, our strategic objective of utilising closed landfill sites for alternative energy generation and storage technologies is progressing well (see page 34 for further details)

Vindor, South West Water and Bournemouth Water operate separate energy management systems and each is registered to ISO 50001:2011 by independent external UKAS accredited assessors

PENNON GROUP PLC GREENHOUSE GAS EMISSIONS

	2015/16	2014/15
Scope 1	1 351 192	1 105 242
Scope 2	157 089	148,917
Scope 3	56 764	56 966
Total gross emissions	1,565,044	1,311,125
Green tariff electricity offset	(2 041)	(1 018)
Exported renewable energy reduction (up to total amount of electricity purchased and consumed by organisation)	(155 048)	(147 899)
Total annual net emissions	1,407,955	1,162,208
Biogenic emissions outside of scopes	1,767,878	1,214,455
Intensity measure tCO ₂ e (gross Scope 1+2)/£100 000 revenue	112	92

Scope 1 (direct emissions) Activities owned or controlled by our organisation that release emissions straight into the atmosphere for example the combustion of fuels in company-owned and company-controlled stationary equipment and transportation, emissions from site based processes and site based fugitive emissions

Scope 2 (indirect emissions) Emissions released into the atmosphere associated with our consumption of purchased electricity, heat, steam and cooling. These are indirect emissions that are a consequence of our activities but which occur at sources we do not own or control.

Scope 3 (other indirect emissions) Emissions that are a consequence of our actions which occur at sources that we do not own or control and that are not classed as Scope 2 emissions.

NOTES

METHODOLOGY AND APPROACH

We have retained last year's approach in applying the 'equity share' methodology for Vindor and its subsidiary companies. This means that emissions from joint venture operations can be accurately attributed to the company in proportion to the percentage of Vindor's holding. The remaining companies in the Group continue to use the 'financial control' approach. This is the conventional method for parent companies and subsidiaries within a group that have the ability to direct financial and operating policies and retain the majority of the organisation's risk and rewards.

QUANTIFICATION AND REPORTING

We have followed the Government's guidelines for mandatory greenhouse gas emissions reporting published by the Department for Environment, Food and Rural Affairs (DEFRA) in June 2013 (and updated in October 2013). In calculating our emissions we have used the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised edition) and the web-based conversion factors provided by DEFRA.

We have adopted the revised emissions conversion factors published by DEFRA in 2015, which are based on a higher rate for the global warming potential (GWP) of methane gas⁽¹⁾. Despite this, emissions from our landfill operations have continued to decrease, falling a further 3% between 2014/15 and 2015/16.

Bournemouth Water was acquired by Pennon Group on 15 April 2015 and accordingly Bournemouth Water's emissions have been included in this greenhouse gas report for 2015/16.

ORGANISATIONAL BOUNDARY

The emissions listed here cover the Pennon Group of companies, each of which uses the financial control approach, with the exception of Vindor which uses an equity share approach.

OPERATIONAL SCOPES

We have measured our Scope 1 and 2 emissions and certain Scope 3 emissions where information is available.

INTENSITY MEASUREMENT

We have chosen an intensity measure of Scope 1 and 2 gross emissions in tCO₂e per £100,000 revenue.

EXTERNAL ASSURANCE STATEMENT

Our greenhouse gas emissions data has been independently verified by Strategic Management Consultants who tested the assumptions, methods and procedures that are followed in the development of the reported data and audited that data to ensure for accuracy and consistency.

CARBON OFFSETS

We rely on self-generated renewable energy to reduce our overall Scope 2 emissions. We supplement this with power purchase contracts with third parties for renewable energy through private wire where it is available near our sites.

RENEWABLE ENERGY EXPORT

Pennon Group self-generates more electricity than it uses and much of its renewable electricity generation is exported to the national grid. We account for this exported renewable electricity in our net emissions measure where we subtract 'emissions credits' up to the limit of our gross volume of Scope 2 emissions.

(1) The GWP of methane gas has risen from 21 to 25 times the GWP of carbon dioxide under the Fourth Assessment Report of the Intergovernmental Panel on Climate Change, which is in line with the calculation of emissions for UK GHG Inventory reporting under the Kyoto Protocol.

OUR ENVIRONMENT CONTINUED

BIODIVERSITY

We recognise the importance of environmental stewardship, and the protection and enhancement of natural capital and biodiversity

BIODIVERSITY BENCHMARK SCHEMES

In addition to managing 14 active landfill sites and other substantial landholdings Vindor also continues to care for 31 closed landfills across the UK. Using our expertise in restoration, we can take a number of different approaches to closing a landfill restoring large tracts of land to heathland, grassland, woodland, agriculture, amenity parkland or a combination of these schemes, and Vindor seeks to restore and manage its sites in accordance with clear biodiversity plans.

Some sites are also being restored and managed to attain the Wildlife Trusts' Biodiversity Benchmark Scheme (BBS). The BBS is a national standard which recognises continual biodiversity improvement to restore and manage habitats for existing plants and wildlife, recreate new habitats once alternative land use has ceased, and finally to work towards developing a network of habitats in the local area.

Vindor currently has nine sites that have achieved and retained the Biodiversity Benchmark. These include sites of notable habitat importance such as two heathland restorations (Tatchells and Warmwell in Dorset) and a grassland restoration that has national significance for birdlife (Beddingham in Sussex).

These transformations have been so successful that the sites have become havens for several rare and endangered species. Dormice and bats at Odcombe and sand lizards, adders and woodlarks at Tatchells and Warmwell are all thriving thanks to careful land management and support from partner organisations such as the RSPB.

ECOLOGICAL BASELINE ASSESSMENTS

Good ecological baseline assessment is key to producing good management options for enhancing biodiversity and creating healthy ecosystems. Bournemouth Water has been focusing its work on establishing a baseline for all habitats and species on its properties, many of which are designated as special protection areas, special areas of conservation or sites of special scientific interest, such as the banks of the River Avon at the Knapp Mill site.

SITES OF SPECIAL SCIENTIFIC INTEREST

There are nine sites of special scientific interest (SSSIs) in South West Water's region and six in Bournemouth Water's region. South West Water is the only water and wastewater company to have met the 2010 targets for SSSI land condition, with 95% of the total area classed as 'favourable' or 'recovering'. We are now working to bring all of our land with SSSI designation to 'favourable' status by 2020.

Vindor also actively manages eight SSSIs on five of its sites.

NON-NATIVE INVASIVE SPECIES

In order to protect native biodiversity and ecosystems South West Water and Bournemouth Water monitor, report and assess the extent and potential impact of non-native invasive species on their sites and remove them as appropriate. We also work to protect any known protected species on our sites, for Bournemouth Water, this has included the creation of roosts for its resident bats.

RESTORATION OF PARK LAKE

Park Lake, a former china clay pit on Bodmin Moor, has been transformed by South West Water from a 'moonscape of waste sand and mica' to a designated County Wildlife Site and home to rare plants and animals.

Park Pit was turned into a reservoir by South West Water after we entered into an agreement with the former owners, Imerys, to manage the surrounding land as an exemplar of post-industrial restoration. Planning conditions were met by 2012 but, working in partnership with local environmental groups and volunteers we have continued with an integrated management programme of restoration.

Work has included restoration of wetlands, control of invasive species and the introduction of managed grazing which has led to it being described by local conservationists as one of the best sites on Bodmin Moor for wildlife. It is now home to the second largest colony of the tormentil mining bee in Cornwall, breeding populations of the nationally scarce small red damselfly, 15 species of dragonfly including the keeled skimmer and black darter and the marsh fritillary butterfly, making it a nationally important site for conservation.

CATCHMENT SENSITIVE FARMING

Bournemouth Water works closely with Natural England and Catchment Sensitive Farming to protect the quality of raw water sources through managing the catchment area and visiting farmers in the catchment area with the aim of educating them about the effects of their activities on raw water quality. The key areas of focus are helping farmers find cost-effective, alternative solutions to the use of pesticides and ensuring that livestock is kept away from rivers to reduce the potential for contamination.

OUR PEOPLE

Across Pennon the most important element for the delivery of our strategic objectives is our people. It is our goal to attract, nurture and retain a dedicated, highly trained workforce.

PENNON'S WORKPLACE STRATEGY

Pennon relies on the talent and professionalism of its employees and is committed to their health, safety and wellbeing, which it sees as investment in the Group's long-term human capital and directly related to shareholder value. We aim to develop and motivate employees, treat them fairly and ensure they are fully engaged in all aspects of the Group's objectives. Through this approach, we seek to maintain a pipeline of talent that is well placed to lead and serve our businesses as they grow and adapt.

We are committed to employee engagement, training and development, and equality and diversity and provide ongoing support through a range of workplace policies. These cover areas such as health and safety, equal opportunities, human rights, ethics, employee relations and family-friendly policies such as flexible working and parental leave, and schemes designed to promote the health and wellbeing of employees.

HEALTH AND SAFETY

We strive for the highest standards of health and safety in the workplace so as to minimise accidents, incidents and lost time. Both the water and wastewater businesses and the waste recycling and recovery business are working hard to embed health and safety within the culture of the organisation, reduce risk and achieve zero incidents across the Group.

At South West Water performance in respect of RIDDOR-reportable injuries was maintained at the same level during the calendar year 2015 as in 2014, with a total of seven reportable injuries (an incidence rate of 520 per 100,000 employees), none of which involved a serious injury (2014: 7 incidents, 552 per 100,000 employees). Bournemouth Water had one RIDDOR-reportable injury (a rate of 490 per 100,000 employees).

During the same period Vindor experienced 47 RIDDORs of which 34 involved employees (an incidence rate of 1,063 per 100,000 employees). In addition, there were nine incidents involving agency colleagues, three involving contractors and one involving a member of the public. Disappointingly, this was an increase from 30 incidents the previous year (28 employees and two agency workers) and the 2014 incidence rate of 889 per 100,000 employees.

Vindor has committed to delivering a new Safety, Health, Environment, Quality and Sustainability (SHEQS) strategy centred on the vision of 'no harm to people and environment'.

Building on our world-class safety record within our ERF and capital investment programme, we have adopted a 'beyond a million' approach with employees and contracting partners which targets over a million safe working hours on each project. During 2015/16 this was exemplified at the Glasgow Recycling and Renewable Energy Centre, which achieved the milestone one million safe hours worked with no RIDDORs during construction.

Following a major review of its operational sites during 2014/15, South West Water undertook a number of activities in 2015/16 to further reduce health and safety risks. This included the roll-out of a Dynamic Risk Assessment training package, designed to help front-line operational personnel undertake advanced risk assessment.

South West Water made progress with its Lone Worker project to further safeguard staff working alone. This has seen the introduction of wearable hardware known as TWIG™, which can monitor body movement and raise alerts if patterns of movement synonymous with injury (trips or falls) are detected. We explored the use of remote technologies including aerial drones to provide improved risk assessment and physiotherapy to provide employees with timely treatment, reduce the risk of longer-term injury and thereby minimise lost working time due to absence. Health, safety and wellbeing also continued to be promoted through a variety of internal campaigns including 'TAP' ('Think, Act, Prevent') and 'Hang on a Sec' which was focused on raising awareness within wastewater operations.

RIDDOR INCIDENTS⁽¹⁾

2011	59 ⁽²⁾
2012	52
2013	40
2014	35
2015	42 ⁽³⁾

(1) Incidents involving employees under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations

(2) Since 2012 reportable incidents have been reported on seven days' absence; in previous years they were reported on three days' absence.

(3) Bournemouth Water incidents included for 2015 only.

Bournemouth Water's strong safety record is underpinned by a comprehensive programme of training, audit and inspection. Senior managers are required to accompany compliance personnel in conducting regular audits to ensure that they are familiar with the requirements, can interrogate processes and bring fresh perspectives to bear.

EMPLOYEE DEVELOPMENT

South West Water's 'People Strategy' continues to foster a culture of support and motivation for staff. Various programmes are in place to encourage career development, and we continue to review and expand these to ensure we have the right balance of skills for the years ahead.

In 2015/16 South West Water's employee development programme included:

- continuing with the programme of skills-based training for operational staff (started in 2014/15)
- supporting over 120 first-line, middle and senior managers through three tiers of management development programmes (Managing for Success (M4S), STEP and LEAD)
- continuing to grow and expand our award-winning apprenticeship programme (85 apprentices have been recruited to the apprenticeship programme since it started in 2011)

Bournemouth Water has retained the Gold standard of the Investors in People accreditation and South West Water has retained its Silver status.

Viridor believes strongly in helping all colleagues to reach their full potential and has structured training programmes to develop and nurture employees at all levels of the business.

As well as its range of employment benefits, Viridor offers popular training opportunities for employees who wish to progress within the company. Last year, colleagues across the waste business were provided with over 6,500 training days. Viridor's pioneering management degree programme, developed in partnership with Edge Hill University, will give its future leaders the skills necessary to build on their existing knowledge and expertise. So far 40 supervisors and managers have completed the degree, which was launched in 2012 and seeks to bridge the gap between technical expertise and managerial knowledge. The latest round of students began their studies in April 2015 with a further 30 currently on the programme and due to graduate in 2017.

In addition, Viridor has a graduate management training scheme that aims to develop the next generation of managers and technical experts to support the changing nature of its business. This programme is open to internal and external applicants with a degree or equivalent qualification.

The two-stage development starts by providing a thorough understanding of Viridor's operations and services, framed within the wider context of the recycling and waste industry. This sees candidates participating in a rotating programme around core areas of the business.

The second year involves an extended, and possibly permanent placement with clear objectives backed up with regular reviews.

In 2015 we recruited three graduates onto Viridor's training scheme and of the 12 past attendees of the scheme, currently 10 are in permanent positions across the business.

APPRENTICESHIPS

Apprenticeships provide a legacy for the skills and knowledge that are integral to the Group's core businesses.

In 2015/16 the water business recruited 24 new apprentices which brings the current total to 89 apprentices recruited since 2011, including four at Bournemouth Water. South West Water received a number of accolades during the year including Large Employer of the Year (South West) at the National Apprenticeship Awards and the retention of our Top 100 Apprenticeship Employer status.

Viridor offers a wide range of apprenticeship programmes in different areas of its business, from Engineering Technician to Business Administration Assistant.

Over 23 apprenticeships are currently registered across our waste management business. All employees are offered a wide range of training and career progression opportunities.

Viridor is currently working alongside Energy & Utility Skills and other organisations in its industry and beyond to develop and deliver a series of trailblazing apprenticeships in waste recycling and recovery.

OUR PEOPLE CONTINUED

EMPLOYEE ENGAGEMENT

Engaged staff are critical to our success. Employees who are more engaged feel safer and are involved in fewer accidents at work, take fewer days off sick and receive more positive feedback from customers. Put simply, working to improve engagement is a key part of working to improve overall performance and sustainability.

South West Water, Bournemouth Water and Viridor undertake employee surveys at regular intervals.

Viridor's most recent survey, which utilised the Gallup Q12 methodology, showed an impressive 77% response rate, up from 39% in 2014/15. We also saw an increase in the overall engagement score with nearly one-third of employees ranking as actively engaged in our purpose and values, well above the UK average of Gallup's users. Resultant areas of focus for 2016/17 include management development, more emphasis on recognising and rewarding effort and a more structured approach to performance management and career progression.

South West Water's 2015 employee survey, which was carried out by Ixia, also showed a 77% response rate, up 4% on the prior year. The Engagement Index remained at 74% (against Ixia's benchmark of 70%), with areas of focus including more communication on company changes, more recognition of effort and the sharing of rationales for decision-making.

CONSULTATION AND SUPPORT

At South West Water, director-led briefing sessions and a formal consultation regarding the integration of Bournemouth Water commenced in January 2016. A comprehensive employee support programme was made available for those affected.

In February 2015 Viridor announced a new operating model to meet the needs of current and future market conditions and to provide a platform for growth in line with its business strategy. The plans, which were subject to consultation with affected employees, include proposals to close a small number of sites and merge the company's South West and South East operating regions. Affected employees were offered full support and, where appropriate, assistance with finding alternative opportunities outside the Group.

WORKPLACE DIVERSITY

We are committed to providing equal opportunities and improving diversity within our workforce.

Viridor has established a new 'Diversity in Action' group whose specific aim is to promote and encourage a culture of inclusion where all colleagues are treated fairly and are given every opportunity to learn, grow and excel in their careers with us. The group's initial focus is on improving gender diversity. The majority of Viridor's employees are male (83.8%), reflecting a traditionally male-dominated industry. The ratio is similar across senior management with 16.2% female. This is just short of our goal of increasing the number of women to at least 20% by the end of the 2015/16 financial year.

In South West Water over 25% of the workforce is female, although in the craft and industrial group female ratios are very low at less than 1%. We are focusing on this as an area for improvement, in particular in operational and technical roles.

GENDER DIVERSITY as at 31 March (%)

Employees	924	19.4
2015	3,836	80.6
Employees	1,054	20.4
2016	4,105	79.6
Senior management	11	16.4
2015	56	83.6
Senior management	21	21.9
2016	75	78.1
Board	2	25.0
2015	6	75.0
Board	2	28.6
2016	5	71.4
	Women	Men

RISK REPORT

The Group faces a number of risks which, if they arise, could affect its ability to achieve its strategic objectives. The Board is responsible for identifying principal risks and ensuring appropriate risk mitigation is in place to manage them effectively.

RISK MANAGEMENT FRAMEWORK

Successful management of existing and emerging risks is essential to the long term success of the Group and the achievement of its strategic objectives. Pennon has established a fully embedded Group risk management framework, to identify significant risks and determine whether they are being appropriately managed and mitigated.

With Pennon's strategic decision to move towards a more homogeneous Group risk profile, the risk management framework has evolved to ensure risks are being managed in line with the Group's agreed risk appetite. To support this transition, a Group Risk Forum has been established to provide a 'top down' assessment of Group risks, to supplement the 'bottom up' risk assessments by each subsidiary. The key stages of the risk process are:

- Identification of significant risks by core business functions, utilising agreed risk criteria based on a combination of likelihood over a five-year period, and impact based on financial, reputational, management effort and impact on stakeholders and customers,
- Principal and other business risks are captured in risk registers which are examined and challenged as part of a robust assessment of the risks and key mitigations, controls and assurance activities that have been defined by risk owners. The assessment considers gross risk, net risk after mitigation, and risk appetite, as well as the direction of travel of the risk level,
- Quarterly risk and assurance forums are held to review principal risks, with management justifying their bottom-up risk assessments through formal reports and presentations, and
- Principal risks faced by each subsidiary are reviewed and confirmed on a quarterly basis by the subsidiary executive management boards, following which the Group Risk Forum completes a comprehensive top-down evaluation of risks that could impact on the delivery of Group strategic objectives. The Forum consists of senior executives and its role is to debate, challenge, agree and prioritise the principal risks faced by the Group, based on the risk appetite set by the Board. The risk assessment is then subjected to a thorough appraisal by the Audit Committee before formal presentation to the Board for approval.

RISK APPETITE

Risk appetite is defined as the level of risk it is considered appropriate to accept in achieving Group strategic objectives. The appropriateness of the mitigation applied to each principal risk is considered by the Board in the context of the effectiveness of the overall control environment in ensuring compliance with risk appetite.

ROBUST RISK ASSESSMENT

The Directors confirm that they have carried out a robust assessment of risks facing the Group. The following table describes the principal risks and how they are being managed or mitigated in line with the Board's risk appetite. These principal risks have been considered in preparing the viability statement on page 55.

RISK REPORT CONTINUED

Key	Risk Level		
	Low	Medium	High
The low medium and high risk level is our estimate of the net risk to the Group after mitigation. It is important to note that risk is difficult to estimate with accuracy and therefore may be more or less than indicated.	●	●	○
	Increasing	Unchanged	Decreasing
Current assessment of direction of travel of risk level	↑	↔	↓

LAW, REGULATION AND FINANCE

Principal Risks	Mitigation	Net Risk	Direction	Risk Appetite
Compliance with law, regulation or decisions by Government and regulators, including water industry reform	Robust regulatory framework ensures compliance with Ofwat, Environment Agency and other requirements. Full engagement in consultations on reform of policy and legislation, helps influence change through effective stakeholder relationships. Good progress has been made in preparing for regulatory reform. We are fully engaged in the Water 2020 programme including upstream regulatory reform. External reviews support the assurance letters required by the Market Operator.	●	↑	High standards of compliance are sought with no appetite for legal and regulatory breaches. As regulatory reform is progressing, we aim to minimise the impact by targeting changes which are NPV neutral over the longer term, to protect shareholder value and customer affordability.
Maintaining sufficient finance and funding to meet ongoing commitments	Clear treasury and funding policies and an effective Group Treasury team. Funding in place at effective average interest rates below many in its sector, with prefunding and headroom including revolving credit facilities, to meet future funding requirements.	●	↔	Ensure funding requirements are fully met by maintaining prudent headroom.
Non-compliance or occurrence of avoidable health and safety incident	Rigorous health and safety compliance systems, policies and procedures are in place across the Group, supported by a programme of capital investment to further reduce risk.	●	↑	High standards of compliance are sought with no appetite for compliance breaches within the Group and third party operations.
Uncertainty arising from open tax computations where liabilities remain to be agreed	Professionally qualified and experienced in-house tax team, supported by external specialists. A dedicated team is working with HMRC to expediate the agreement of outstanding tax items.	●	↑	Full compliance with HMRC requirements. Residual risk is higher on some historic arrangements.

MARKET AND ECONOMIC CONDITIONS

Principal Risks	Mitigation	Net Risk	Direction	Risk Appetite
Non-recovery of customer debt	<p>Water business debt collection strategies kept under review with new initiatives regularly implemented</p> <ul style="list-style-type: none"> targeting previous occupier debt after customer moves specific case management and use of court claims, and use of charging orders <p>Affordability tariffs (e.g. Restart, WaterCare, Fresh Start) help to reduce bad debt exposure for customers struggling to pay</p> <p>Vindor's debt collection risk is lower due to the high proportion of public sector accounts</p>	●	↔	Minimise non-recoverable debt. We recognise customer affordability challenges and that given the inability to disconnect domestic customers, some risk of uncollectable debt remains.
Macro-economic risks arising from the global and UK economic downturn impacting commodity and power prices	<p>Vindor is well positioned across the waste hierarchy, with long-term contracts supporting the ERF segment. The ITOO (Input, Throughput and Output Optimisation) programme helps focus on recycling performance in mitigating the impact of global economic conditions on commodity prices.</p> <p>Energy risk management at a Group level acts as a natural hedge between SWW and Vindor, offsetting the drop in power prices. Existing investments that qualified for Renewable Obligation Certificates are protected by the 'grandfathering' procedure.</p>	●	↑	Taking well-judged risks and having response plans in place to mitigate external macro-economic risk factors down to an acceptable level.

RISK REPORT CONTINUED

OPERATING PERFORMANCE

Principal Risks	Mitigation	Net Risk	Direction	Risk Appetite
Poor operating performance due to extreme weather or climate change	<p>Contingency plans, emergency resources and investment through a planned capital programme mitigates the risks of extreme weather incidents</p> <p>We prepare a Water Resources Management Plan every five years and review it annually for a range of climate change and demand scenarios with various schemes promoted to maintain water resources (e.g. pumped storage for reservoirs), conservation and customer water efficiency measures</p> <p>Vindor has in place a regional adverse weather management strategy, aimed at reducing disruption to site operations and transport logistics</p>	●	↔	Reduce both the likelihood and impact through long term planning and ensuring sufficient measures are in place to mitigate risk
Poor customer service/ increased competition leading to loss of customer base	<p>Targeted improvements made to improve customer service and SWW's relative industry standing during the K6 period</p> <p>Vindor's strategy to diversify into energy recovery has offset the decline in landfill and current challenges in recycling</p> <p>Vindor is exploring alternative uses for its landfill assets</p>	●	↑	<p>Good customer service is at the heart of everything we do. Continually seek to increase customer satisfaction</p> <p>Minimise the impact of market reform by defending the existing customer base whilst developing further markets</p>
Business interruption or significant operational failures/ incidents	<p>Detailed contingency plans and incident management procedures</p> <p>Equipment failure is managed through sophisticated planned preventative maintenance regimes. Any disruption is alleviated by good liaison and communication</p>	●	↑	Effective business continuity and contingency plans in place to mitigate the risk and accelerate the recovery from an incident with residual risk covered by insurance
Difficulty in recruitment, retention and development of appropriate skills, which are required to deliver the Group's strategy	<p>Succession plans are in place. The recent Group restructure, Vindor transformation and integration of Bournemouth Water has strengthened the executive team but in turn have the potential to impact morale</p>	●	↔	Appropriate skills and experience in place, with good succession plans to mitigate impact on strategic plan

BUSINESS SYSTEMS AND CAPITAL INVESTMENT

Principal Risks	Mitigation	Net Risk	Direction	Risk Appetite
Failure or increased cost of capital projects/exposure to contract failures	Skilled project management resource and oversight boards provide rigour to the delivery of major projects. Due diligence on suppliers, technologies and acquisitions. Back-to-back agreements and supplier guarantees provide protection. Regular reporting of performance on major contracts and post project appraisals.	●	↔	Pennon's investment activities are based on taking well-judged risks for appropriate returns.
Failure of information technology systems, management and protection including cyber risks	Major systems implementation is supported by a formal programme governance framework, supplemented by specialist consultants. Cyber risks are mitigated by a strong information security framework, cyber security awareness campaigns, plus internal and external testing and formal ISO accreditation.	●	↑	Robust systems in place to support business activity, with strong cyber protection to minimise a growing risk.

VIABILITY STATEMENT

The Board has assessed the Group's financial viability and confirms that it has a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over a five-year period. The assessment has been made with reference to the Group's current position and prospects, its longer-term strategy, the Board's risk appetite and the Group's principal risks and how these are managed, as detailed on pages 51 to 54 of the risk report.

The Group's strategic business plan and associated principal risks are a foundation of the scenario testing. This assessment has considered the potential impact of these risks arising on the business model, future performance, solvency and liquidity over the period in question. In making their assessment, the Directors reviewed the principal risks and considered which risks might threaten viability. It was determined that none of the individual risks would in isolation compromise the Group's viability, so a number of plausible risk combinations were considered to stress test the plan, primarily by reducing revenues, increasing costs and impacting cash flows. The Board considered the monetary impact of these scenarios over a five-year period, to ensure that they did not adversely impact the Group's viability.

In making the assessment, the Directors have taken account of the Group's robust solvency position, its ability to raise new finance and a key potential mitigating action of restricting any non-contractual payments.

In assessing the prospects of the Group, the Directors note that, as the Group operates in a regulatory industry which

potentially can be subject to non-market influences, such as assessment is subject to uncertainty, the level of which depends on the proximity of the time horizon, and accordingly the future outcomes cannot be guaranteed or predicted with certainty.

As set out in the Audit Committee's report on page 68, the Directors reviewed and discussed the process undertaken by management, and also reviewed the results of the stress testing performed.

FORWARD-LOOKING STATEMENTS

This strategic report, consisting of pages 4 to 51, 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 Pennon Group and its subsidiaries, wherever they occur in this strategic report, 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 the light of relevant factors, including those set out in this section on principal risks and uncertainties.

The strategic report consisting of pages 4 to 55 was approved by the Board on 24 May 2016.

By Order of the Board

Helen Barrett-Hague

Helen Barrett-Hague
Group Company Secretary
24 May 2016

GOVERNANCE AND REMUNERATION

GOVERNANCE AND REMUNERATION

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COMMITTED TO OPERATING
TO THE HIGHEST STANDARDS
OF CORPORATE GOVERNANCE

RESPONSIBLE AND
SUSTAINABLE BUSINESS
BENEFITING CUSTOMERS
AND SHAREHOLDERS

WELL PLACED TO
DELIVER SOLID GROWTH
AND EFFICIENCY

CHAIRMAN'S LETTER TO SHAREHOLDERS

DEAR SHAREHOLDER

In my first corporate governance report on behalf of the Board, I am pleased to confirm that it was evident to me on my appointment that the three essential pillars of a successful board were in evidence in the Pennon boardroom, namely having strong financial control, sound administration and good governance. I place great importance on all these facets but maintaining good governance is central to the successful management of every board and to the creation of shareholder value as set out in our business model on pages 10 and 11.

I am committed to ensuring that Pennon Group continues to operate to the highest standards of corporate governance and in my first few months as Chairman I have reviewed in consultation with the Non-executive Directors the Board governance structure. The result is a more streamlined structure as described in this report on page 62 whilst ensuring that the water business remains ring-fenced in accordance with Ofwat regulatory requirements.

The annual report is the principal method of reporting to our shareholders on the Board's governance policies and the practical application of the principles of good corporate governance set out in the UK Corporate Governance Code (the UK Code). The UK Code is published on the Financial Reporting Council (FRC) website, www.frc.org.uk. In accordance with the FRC's requirements, we have reported against the latest version of the Code, which is effective for reporting periods commencing on or after 1 October 2014.

ROLE OF THE BOARD AND ITS EFFECTIVENESS

My primary role as Chairman is to provide leadership to the Board and to provide the right environment to enable the Directors and the Board as a whole to perform effectively to promote the success of the Company for the benefit of its shareholders. In doing so we take account of the interests of our customers, employees, suppliers, the communities in which we operate and other interested stakeholders including Ofwat, the Drinking Water Inspectorate, the UK environment agencies and other regulatory bodies in the UK.

I believe our revised Board structure reinforces the good governance that was in place before I became Chairman and will enable us to continue to operate effectively and cohesively as a Board. It is my responsibility each year to lead a detailed performance evaluation of the Board and each of the Committees. The aim is to identify further areas for improvement and ensure that our knowledge, skills and processes remain relevant as the Group's businesses develop and grow. Further details of the review, which was facilitated by an external governance consultancy, are set out later in this report.

The revised Board structure also assists in ensuring that all Board members continue to have appropriate up-to-date knowledge and understanding of our businesses as we pursue our refreshed strategy described in the strategic report.

SHAREHOLDER ENGAGEMENT

We maintain appropriate and regular dialogue with our shareholders to ensure that there is a good understanding of our rationale for our strategy and our performance actions. It also allows shareholders to provide feedback on the matters they consider to be important and any issues which require addressing.

We have a comprehensive investor relations programme. During the year some 85 meetings and conference calls were held and Pennon attended six City conferences and salesforce briefings hosted by investment banks. This engagement covered both current and prospective shareholders, the majority of which are institutional, with the remainder being a selection of large private client investment managers.

Over the year we also held a series of analyst and investor briefings focused on particular industry themes and key areas of our business. These included a Viridor Waste Market Briefing, a South West Water Briefing on delivering and outperforming the K6 business plan and an analyst and investor day in Manchester including site visits to Viridor's Runcorn Energy Recovery Facility and Longley Lane Materials Recycling Facility. In addition to these events Pennon held its inaugural Capital Markets Event in February, focusing on recent Board and management changes and Group strategy.

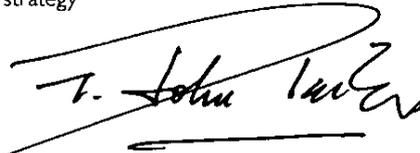
The Chief Financial Officer continues to report to the Board regularly on major shareholders' views about the Group, and every six months the Company's brokers present to the Board on equity market developments and shareholder perceptions. This ensures that the Board is fully briefed on the views and aspirations of shareholders.

I will actively encourage the participation of our shareholders at our AGMs and will welcome questions on any business issues affecting the Group. As usual, at our 2016 AGM on 1 July all our Directors intend to be present together with a number of other senior executives of our businesses to meet with shareholders to further explain the developments in the Group.

COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE AND OTHER REQUIREMENTS

I am pleased to report that throughout the year the Company complied with the provisions and applied the main principles set out in the UK Code with no exceptions to report.

My introduction to this corporate governance report and the following sections are made in compliance with the UK Code, Financial Conduct Authority (FCA) Listing Rule 9.8.6 and FCA Disclosure and Transparency Rules 7.1 and 7.2 and cover the work of our Board and its Committees, our internal control systems and procedures including risk management, our corporate governance statements relating to share capital and control, our confirmation of the Company as a going concern and Directors' responsibility statements. Finally, in accordance with reporting requirements, on page 101 the Board confirms to shareholders that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary to assess the Company's performance, business model and strategy.



Sir John Parker
Chairman
Pennon Group Plc
24 May 2016

BOARD OF DIRECTORS

The Board considers each of its Non-executive Directors to be independent in accordance with the UK Corporate Governance Code

The Board believes its Directors have an appropriate range of experience to oversee the business of the Group

COMPOSITION as at 31 March		(%)			(%)
2015	Executive	37.5	2015	Male	75.0
2015	Non-executive (inc. chairman)	62.5	2015	Female	25.0
2016	Executive	43.0	2016	Male	71.4
2016	Non-executive (inc. chairman)	57.0	2016	Female	28.6

EXPERIENCE as at 31 March		(%)	TENURE as at 31 March		(%)
2015	Industry	37.5	2015	0-3 years	50.0
2015	Finance	50.0	2015	4-6 years	12.5
2015	Governance	12.5	2015	7-10+ years	37.5
2016	Industry	43.0	2016	0-3 years	57.0
2016	Finance	43.0	2016	4-6 years	14.0
2016	Governance	14.0	2016	7-10+ years	29.0

The Board's target to achieve 25% female representation was achieved early, before the 2014/15 year end. However, during a period of transition on the Board, the female representation fell to 22% between April and July 2015 but then increased to 28.6% following the 2015 AGM.

CHAIRMAN

Sir John Parker

GBE FREng, DSc (Eng), ScD (Hon), DSc (Hon), DUniv (Hon), FRINA

Sir John was appointed to the Board as Deputy Chairman on 1 April 2015 and became Chairman on 1 August 2015. He is also chairman of the Nomination Committee.

Sir John is recognised as a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He was previously the chairman of National Grid Plc, senior non-executive director and chair of the Court of the Bank of England, deputy chairman of DP World, joint chair of Mondi and chair of BVT and P&O Plc.

External appointments

Sir John is the chairman of Anglo American Plc. He is also a non-executive director of Carnival Corporation and Airbus Group. Sir John is a Visiting Fellow of the University of Oxford and was president of the Royal Academy of Engineering from 2011 to 2014.

Sir John's significant commitments in the year have reduced with his stepping down as deputy chairman of DP World in July 2015.

GROUP CHIEF EXECUTIVE OFFICER

Christopher Loughlin

BSc Hons, MICE, CEng, MBA

Chris was appointed to the Board on 1 August 2006 upon joining Pennon Group as Chief Executive of South West Water. He became the Group Chief Executive on 1 January 2016. Chris is chairman of the Pennon Executive Management Board and a member of the Sustainability Committee.

Chris was previously chief operating officer with Lloyds Register and earlier in his career was an executive director of British Nuclear Fuels Plc and executive chairman of Magnox Electric Plc. He was also a senior diplomat in the British Embassy, Tokyo. Chris started his career as a chartered engineer working in both the consulting and contracting sectors and subsequently held a number of senior positions with British Nuclear Fuels. Between April 2008 and March 2012 he was chairman of Water UK.

External appointments

Currently Chris is vice chairman of the Cornwall Local Enterprise Partnership and a trustee and member of the audit committee of WaterAid. He is a board member (and past president) of the Institute of Water.

DIRECTORS

Martin Angle

BSc Hons, FCA, MCSI

Independent Non-executive Director

Martin was appointed to the Board on 1 December 2008. He is chairman of the Remuneration Committee and a member of the Audit, Nomination and Sustainability Committees.

Formerly, Martin had senior positions with Terra Firma Capital Partners and various of its portfolio companies, including the executive chairmanship of Waste Recycling Group Limited. Before that he was the group finance director of TI Group Plc having previously held a number of senior investment banking positions with SG Warburg & Co Ltd, Morgan Stanley and Dresdner Kleinwort Benson.

During the year, having completed his full terms of office, he retired from the boards of OAO Severstal, Shuaa Capital psc and the National Exhibition Group where he was chairman.

External appointments

Martin is currently the senior independent director at Savills Plc, the vice chairman and non-executive director of the FIA Foundation and the adviser to the board of the Commercial Bank of Dubai.

Ian McAulay

BEng, CEng, MICE, MCIWEM

Chief Executive, Viridor

Ian was appointed to the Board on 9 September 2013. He is chairman of the Viridor Executive Management Board and a member of the Pennon Executive Management Board and the Sustainability Committee.

Ian was previously chief of global strategy and corporate development with MWH Global based in the US and before that he was the managing director capital programmes, at United Utilities Plc. Ian started his career as a consulting civil engineer and held a number of positions with Crouch & Hogg in Glasgow and subsequently Montgomery Watson which merged in 2001 with Harza to form MWH Global.

External appointments

Ian is a member of the board of the Environmental Services Association, the Greater Manchester Low Carbon Hub board and the Scottish Government's 2020 Climate Group.

Neil Cooper

BSc Hons, FCMA

Independent Non-executive Director

Neil joined the Board on 1 September 2014. He is chairman of the Audit Committee and is currently a member of the Remuneration and Nomination Committees.

Neil was previously group finance director of William Hill Plc and before that he was group finance director of Bovis Homes Group Plc. He also held senior finance roles with Whitbread Plc, worked for PricewaterhouseCoopers as a management consultant and held a number of roles with Reckitt & Colman Plc.

External appointments

Neil is currently the chief financial officer of Barratt Developments Plc.

Susan Davy

BSc Hons, ACA

Chief Financial Officer

Susan joined the Board on 1 February 2015. She is a member of the Pennon Executive Management Board. Susan is a graduate qualified chartered accountant with 20 years' experience in the utility sector.

Susan was previously finance and regulatory director of South West Water, a position to which she was appointed in August 2007. Prior to joining Pennon Group she held a number of senior posts with Yorkshire Water including head of regulation and head of finance in its Waste Water Unit and was head of finance for Brey Utilities, a joint venture company owned by Yorkshire Water and Earthtech Engineering Limited.

External appointments

Susan is a council member of CBI South West.

Gill Rider

CB, PhD, CCIIPD

Senior Independent Director

Gill was appointed to the Board on 1 September 2012. She is chairman of the Sustainability Committee and a member of the Audit, Remuneration and Nomination Committees.

Formerly, Gill was head of the Civil Service Capability Group in the Cabinet Office reporting to the Cabinet Secretary and prior to that held a number of senior positions with Accenture LLP culminating in the post of chief leadership officer for the global firm. She was previously president of the Chartered Institute of Personnel and Development and a non-executive director of De La Rue Plc.

External appointments

Gill currently holds non-executive directorships with Charles Taylor Plc, where she is senior independent director and Intertek Group Plc. She is chairman of both their remuneration committees. She is also chair of the council (board) of the University of Southampton.

GROUP COMPANY SECRETARY

Helen Barrett-Hague

Solicitor, LLB Hons

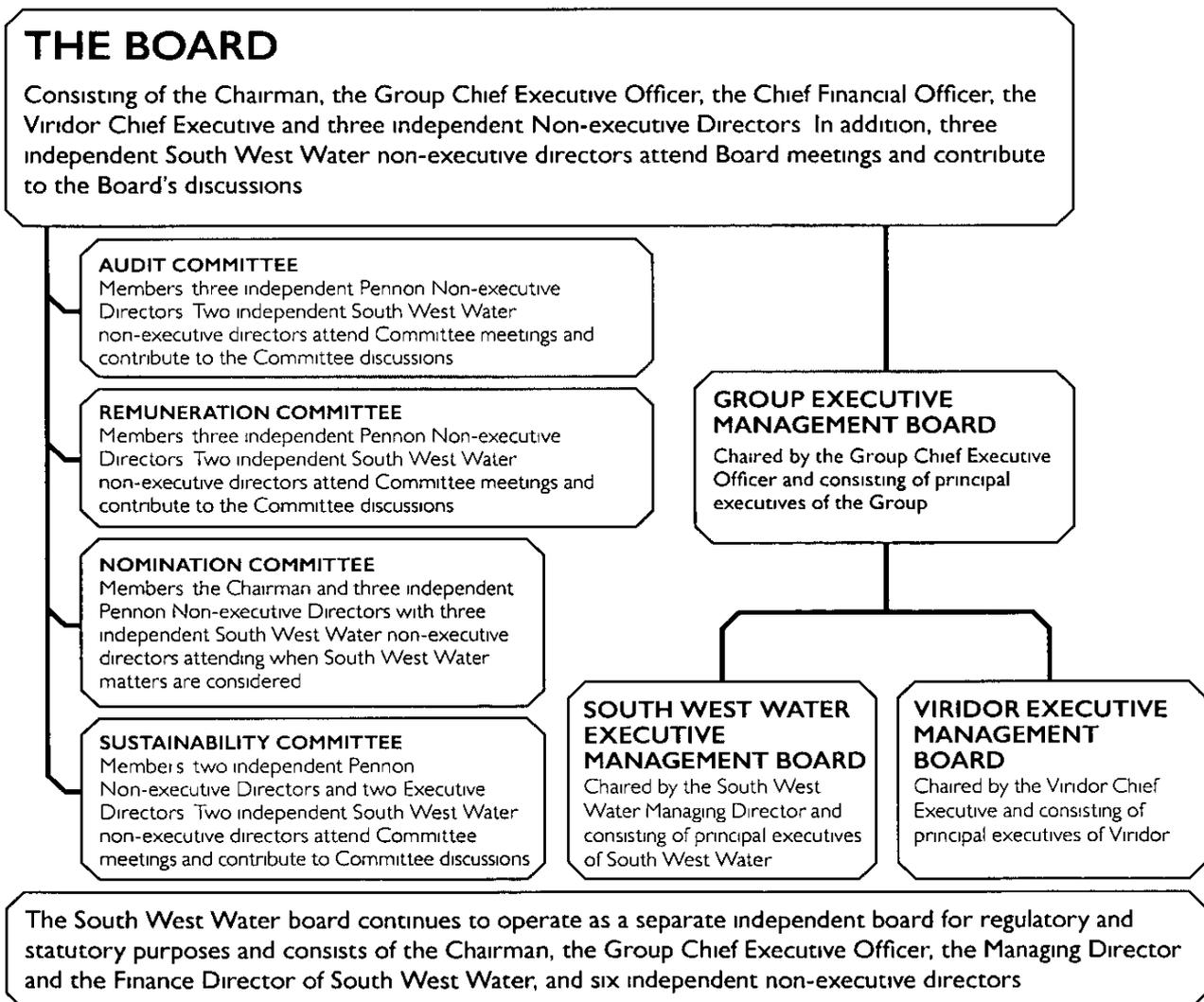
Group General Counsel & Company Secretary

Helen joined Pennon Group as Group General Counsel & Company Secretary to the Board in March 2016.

She began her career in private practice before moving in-house in 1999. Helen subsequently held positions of increasing responsibility with the Generics Group AG, Aveva Group Plc and Alent Plc. She has worked both in the UK and overseas and has extensive corporate experience including capital raisings, initial public offerings, corporate restructuring, mergers and acquisitions. She has previously held a number of non-executive directorships.

THE BOARD AND ITS GOVERNANCE FRAMEWORK

The Board and its new governance framework introduced in April 2016, which incorporates a 'plenary' style of operation, is set out below. The Board has a 'matters reserved' schedule setting out its responsibilities, and each Committee has a detailed terms of reference setting out its responsibilities, accountabilities and reporting obligations to the Board. Further details of the responsibilities of the Pennon Group Board Committees are set out in the report of each Committee on pages 66 to 76. These, together with the risk management and internal control frameworks described on pages 51 and 65, form an effective and robust governance structure designed to manage and develop the Group in accordance with the Group's strategy to maintain and grow shareholder value.



BOARD COMPOSITION AND INDEPENDENCE

At the end of the year the Board of Directors comprised the Chairman, three Executive Directors and three Non-executive Directors. All of the Non-executive Directors were considered by the Board to be independent throughout the year. None of the relationships or circumstances set out in provision B 1.1 of the UK Corporate Governance Code (the UK Code) applied to the Directors listed on the next page other than in respect of Gerard Connell who retired on 31 July 2015. While Gerard had served on the Board for more than nine years since his first election, he was determined by the Board to be independent, and the Board was satisfied that he demonstrated independence of character and judgement in the performance of his role on the Board up to the date of his retirement.

Sir John Parker, who was appointed to the Board on 1 April 2015 as Deputy Chairman, succeeded Ken Harvey as Chairman following the 2015 Annual General Meeting. Sir John met the independence criteria set out in provision B 1.1 of the UK Code on his appointment as Chairman and there have been no significant changes to his external commitments since his appointment.

Following the acquisition of Bournemouth Water in April 2015, Chris Loughlin and Gerard Connell were appointed as non-executive directors on the Bournemouth Water board. That board, following the merger of South West Water and Bournemouth Water on 31 March 2016, ceased to operate and was disbanded.

All Directors are subject to re-election each year in accordance with provision B 7.1 of the UK Code.

DIRECTORS' SKILLS AND ROLES

All of the Non-executive Directors are considered to have the appropriate skills, experience in their respective disciplines and personality to bring independent and objective judgement to the Board's deliberations. Their biographies and the experience chart on pages 60 and 61 demonstrate collectively a broad range of business, financial and other relevant experience.

Neil Cooper is chairman of the Audit Committee and in accordance with the UK Code and FCA Disclosure and Transparency Rule 7.1.1 he has recent and relevant financial experience (as set out in his biography on page 61). Martin Angle is also a member of the Audit Committee and he has relevant financial experience as set out in his biography on page 61.

There is a clear separation of responsibilities between the Chairman and the Group Chief Executive, divided between managing the Board and the business, while they of course maintain a close working relationship.

All the Directors are equally accountable for the proper stewardship of the Group's affairs but they do have specific roles, which include those set out below.

Position	Director	Role
Chairman	Sir John Parker	<ul style="list-style-type: none"> Leading the Board and setting its agenda Promoting the highest standards of integrity and probity and ensuring good and effective governance Managing Board composition, performance and succession planning Providing advice, support and guidance to the Group Chief Executive Representing the Group and being available to shareholders Discussing separately with the Non-executive Directors performance and strategic issues
Group Chief Executive Officer	Chris Loughlin	<ul style="list-style-type: none"> Managing the Group and providing executive leadership Developing and proposing Group strategy Leading the operation of the Group in accordance with the decisions of the Board Co-ordinating with the Chairman on important and strategic issues of the Group and providing input to the Board's agenda Contributing to succession planning and implementing the organisational structure Leading on acquisitions, disposals, business development and exploring Group synergies Managing shareholder relations
Senior Independent Director	Gill Rider	<ul style="list-style-type: none"> Assisting the Chairman with shareholder communications and being available as an additional point of contact for shareholders Being available to other Non-executive Directors if they have any concerns that are not satisfactorily resolved by the Chairman Leading the annual evaluation of performance of the Chairman with the other Non-executive Directors
Executive Directors	Susan Davy Ian McAulay	<ul style="list-style-type: none"> Supporting the Group Chief Executive Officer in providing executive leadership and developing Group strategy Reporting to the Board on performance and developments within their business areas Implementing decisions of the Board Managing their own specific business responsibilities
Non-executive Directors	Martin Angle Neil Cooper Gill Rider	<ul style="list-style-type: none"> Critically reviewing the strategies proposed for the Group Critically examining the operational and financial performance of the Group Evaluating proposals from management and constructively challenging management's recommendations Contributing to corporate accountability through being active members of the Committees of the Board

THE BOARD AND ITS GOVERNANCE FRAMEWORK

CONTINUED

BOARD ATTENDANCE, OPERATION AND ACTIVITIES

The Directors and their attendance at the 10 scheduled meetings of the Board during 2015/16 are shown below

Members	Appointment date	Attendance
Kenneth Harvey (Chairman until 31 July 2015)	March 1997	4/4
Sir John Parker (Deputy Chairman and Non-executive Director until 31 July 2015 and Chairman thereafter)	April 2015	9/10
Non-executive Directors		
Martin Angle	December 2008	10/10
Gerard Connell	October 2003	4/4
Neil Cooper	September 2014	9/10
Gill Rider	September 2012	10/10
Executive Directors		
Susan Davy	February 2015	10/10
Christopher Loughlin	August 2006	10/10
Ian McAulay	September 2013	10/10

Sir John Parker and Neil Cooper were each unable to attend a Board meeting on one occasion due to a prior commitment that was scheduled before their appointment to the Board

In accordance with the governance framework set out on page 62, the Board has a schedule of matters reserved for its decision. The Board delegates more detailed consideration of certain matters to Board Committees, to the Executive Directors and to the Group General Counsel & Company Secretary, as appropriate. The matters reserved to the Board include

- approval of the full-year and half-year results announcements
- the approval of the Annual Report and Accounts (including the financial statements)
- all acquisitions and disposals
- major items of capital expenditure
- authority levels for other expenditure
- risk management process and monitoring of risks
- approval of the strategic plan and annual operating budgets
- Group policies, procedures and delegations
- appointments to the Board and its Committees

The Pennon Group Board now operates as a plenary board covering Group and Viridor matters and separately, when appropriate, as the board of South West Water. This is to ensure governance of South West Water in compliance with Ofwat's principles on board leadership, transparency and governance

The Board operates by receiving written reports circulated usually in advance of the meetings from the Executive Directors and the Group General Counsel & Company Secretary on matters within their respective business areas of the Group. When appropriate, the Board also receives presentations on key areas of the business and undertakes site visits to gain a better understanding of the operation of business initiatives.

Under the guidance of the Chairman, all matters before the Board are discussed openly. Presentations and advice are received frequently from other senior executives within the Group and from external advisers to facilitate the decision-making of the Board.

BOARD SUPPORT AND TRAINING

Directors have access to the advice and services of the Group General Counsel & Company Secretary and the Board has an established procedure whereby Directors, in order to fulfil their duties, may seek independent professional advice at the Company's expense.

Newly appointed Directors receive a formal induction which includes an explanation of the Group structure, regulatory and legal issues, the Group governance framework and policies, the Group's approach to risk management and its principal risks (financial and non-financial) duties and obligations (including protocols around conflicts of interest and dealing in shares), and the current activities of the Board and its Committees. Directors also visit operating facilities across the Group and have meetings with staff to receive briefings on key processes and systems.

The training needs of Directors are reviewed as part of the Board's performance evaluation process each year. Training consists of attendance at external courses organised by professional advisers and also internal presentations from senior management.

PERFORMANCE EVALUATION

The Board has well-developed internal procedures to evaluate the performance of the whole Board, each Committee, the Chairman, each individual Director and the Group General Counsel & Company Secretary.

The evaluation of the performance of the Board and its Committees was facilitated by an external governance consultancy, Lintstock. All participants' views were sought via an online questionnaire on a range of questions that were designed by Lintstock following consultation with the Chairman and the Group General Counsel & Company Secretary to ensure objective evaluation of performance. Responses were then analysed and summarised by Lintstock for the Board and each Committee to consider and determine possible improvement areas. Apart from providing services relating to pension scheme board and committees' performance evaluations and an insider list governance system, Lintstock has no other connection with the Company.

The Board considered the 2015/16 performance evaluation which it concluded was a thorough and valuable assessment of Board performance although it was recognised that the new governance structure had only just been introduced and therefore there was a need to allow it to 'bed in' before further review. Nevertheless some actions were considered desirable to improve performance which related to a further drive to achieve more succinct reporting by executives and careful time management by the Board to ensure critical matters and strategic issues were fully considered. The Board has agreed a performance action plan against which the Group Company Secretary will monitor developments during the year and ensure, in conjunction with the Chairman and Executive Directors that the agreed actions are implemented.

The main area for action that had been identified as a result of the 2014/15 performance evaluation (namely a focus on strategy at a time of transition with the new Chairman) has been followed up during the year and has resulted in a refreshed strategy as outlined on page 8 and described in more detail on pages 14 to 17.

The Chairman's performance was evaluated separately by the Non-executive Directors, led by the Senior Independent Director.

BOARD COMMITTEES' TERMS OF REFERENCE

In accordance with Group policies, a range of key matters are delegated to the Board's Committees as set out on pages 66 to 76 of this governance report.

The terms of reference of each of the Board's Committees are set out on the Company's website www.pennon-group.co.uk or available upon request to the Group Company Secretary.

DEALING WITH DIRECTORS' CONFLICTS OF INTEREST

In accordance with the directors' interest provision of the Companies Act 2006 and the Company's Articles of Association, the Board has in place a procedure for the consideration and authorisation of Directors' conflicts or possible conflicts with the Company's interests.

RISK MANAGEMENT AND THE GROUP'S SYSTEM OF INTERNAL CONTROL

The Board is responsible for maintaining the Group's system of internal control to safeguard shareholders' investment and the Group's assets 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 2015/16 and up to the date of the approval of this Annual Report and Accounts.

The Group's system of internal control has been further reviewed to take account of the FRC's new 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' (FRC Internal Control Guidance) which is applicable to reporting periods beginning on or after 1 October 2014.

The Board confirms that it applies procedures in accordance with the UK Code and the FRC Internal Control Guidance which brings together elements of best practice for risk management and internal control by companies. The Board's risk framework described on page 51 in the strategic report provides for the identification of key risks including environmental, social and governance (ESG) risks in relation to the achievement of the business objectives of the Group, monitoring of such risks and ongoing and annual evaluation of the overall process.

As part of the review of the effectiveness of the system of risk management and internal control under the Group risk management policy, all Executive Directors and senior managers are required to certify on an annual basis that they have effective controls in place to manage risks and to operate in compliance with legislation and Group procedures.

The Group also has policies covering suspected fraud, anti-bribery and whistleblowing. Allegations of misconduct and irregularity are thoroughly investigated and follow-up action in respect of the Group's control environment is taken when appropriate. In the normal course of business investigations into irregularities may be ongoing as of the date of the approval of the financial statements.

The Group's processes and policies serve to ensure that a culture of effective control and risk management is embedded throughout the Group 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 strategic report on pages 52 to 54.

BOARD COMMITTEES' REPORTS

THE AUDIT COMMITTEE REPORT

Dear Shareholder

I am pleased to introduce the Audit Committee's report in my first full year as chairman of the Committee

The principal responsibilities of the Committee are focused firstly on the appropriateness of the Group's financial reporting, including the accounting judgements made in preparing reporting secondly the ongoing effectiveness of the internal control environment and thirdly the risk management processes across the Group, including challenging and testing the Group's risk appetite. Monitoring and reviewing the effectiveness of the external auditor and the internal audit function is an important element of the Committee's assurance activities. These responsibilities are discharged throughout the year in accordance with the calendar of business of the Committee, which is designed to allow sufficient time for their consideration whilst also permitting time to be spent on related key financial matters.

New significant matters considered during the year included a review of the Group's delegated authorities and financial procedures which, following the appointment of a Group Chief Executive Officer for the first time, were refreshed to ensure ongoing alignment with Group requirements and the risk profiles of the businesses, and a review of the long-lived asset cash generating units (CGUs) within Viridor, which were realigned to ensure they remained consistent with the evolving operational and management focus of the business.

The Committee has also reviewed progress on Viridor Enterprise (business transformation and systems integration) solution, which is progressing on a multi-year timescale, to ensure assurance protocols are in place, and the internal controls and audit systems in place in Bournemouth Water which was acquired in April 2015. It was pleasing to note that they were determined to be robust and appropriate to the size of the business.

We are mindful of the revisions to the UK Corporate Governance Code (the UK Code) and supporting FRC guidance on risk reporting. As a result, we have further reviewed the risk management processes in place across the Group and have endorsed the establishment of a new Group executive risk management forum to assess risk appetite and monitor key risks and their mitigation. More detail on our risk management processes, principal risks and their mitigation can be found on pages 51 to 55. Aligned with this we have also assessed the Company's viability over a period of five years, which we consider to be aligned with key business cycle periods in the water business and the longer-term nature of Viridor's ERF assets as well as being reasonable in terms of our ability to look forward with some certainty in the business and regulatory environment in which the Company operates. Our viability statement is reported on page 55.

As part of the half-year and year-end reporting review process, we reviewed and challenged the key judgements of management as set out on page 68. Significant matters considered by the Committee both during the year and in relation to the year-end financial statements are explained in this report.

Neil Cooper
Audit Committee Chairman

AUDIT COMMITTEE COMPOSITION AND MEETINGS

The membership of the Committee together with appointment dates and attendance at meetings during 2015/16, is set out below.

Members	Appointment date	Attendance
Neil Cooper (Committee chairman)	September 2014	7/7
Gerard Connell*	October 2003	2/2
Martin Angle	December 2008	7/7
Gill Rider	September 2012	7/7

* Retired on 31 July 2015

Other regular attendees to our meetings during the year included

- Group Chief Executive (following appointment on 1 January 2016)
- Group Director of Finance (now retitled Chief Financial Officer)
- Chief Executive, South West Water (until 31 December 2015)
- Chief Executive, Viridor
- Group General Counsel & Company Secretary
- Managing Director South West Water (following appointment on 1 January 2016)
- Finance Director, South West Water
- Finance Director, Viridor
- Group Financial Controller
- Group Audit Manager
- External auditor

In preparation for the revised governance structure (detailed on page 62) two South West Water non-executive directors, Martin Hagen and Lord Matthew Taylor, also attended the last two meetings of the Committee in the year.

In addition, the Chairman of the Group, Ken Harvey until 31 July 2015 and Sir John Parker as his successor from this date, has had an open invitation to attend the Committee meetings. In the last year the Chairman has attended those meetings where the Committee has reviewed the half-year and full-year financial results of the Group.

In accordance with the UK Code, the Board is satisfied that Neil Cooper and Martin Angle have recent and relevant financial experience and also, in accordance with FCA Rule Disclosure and Transparency Rule 7.1 IR, have competence in accounting and/or auditing. Details of each Director's significant current and prior appointments are set out on pages 60 and 61.

All of the Committee members are also members of the Remuneration Committee which allows them to provide input into both Committees on any Group performance matters and on the management of any risk factors relevant to remuneration matters.

SIGNIFICANT MATTERS CONSIDERED BY THE COMMITTEE

The calendar of business of the Committee provides a framework for ensuring that it manages its affairs efficiently and effectively throughout the year and is able to concentrate on the key matters that affect the Group

The most significant matters that the Committee considered and made decisions on during the year and, where appropriate, since the year end, are set out below

Financial reporting	<ul style="list-style-type: none"> Monitored the integrity of the financial statements of the Group and the half-year and full-year results announcements relating to the Group's financial performance including reviewing and discussing significant financial reporting judgements contained in the statements After a detailed review in accordance with its established process advised the Board that the Annual Report and Accounts is fair, balanced and understandable in accordance with reporting requirements and recommended their approval for publication
Internal control and compliance	<ul style="list-style-type: none"> Quarterly review of internal audit reports on core systems and processes across the Group, including Group treasury credit management, reactive operational maintenance, payroll, procurement practices, energy recovery facility control environment, information security and IT risks, water leakage management, customer facing processes including billing and collection, and business continuity management Reviewed internal control framework for the Group Monitored performance on specific matters including Vindor's Project Enterprise (business transformation project)
External auditor	<ul style="list-style-type: none"> Considered auditor's report on its review of the annual results focusing on key findings Assessed external auditor and its effectiveness in respect of the previous year's external audit process Recommended to the Board reappointment of the external auditor for approval at the Annual General Meeting with the Committee being authorised to agree the external auditor's remuneration Considered and approved the audit plan and audit fee proposal for the external auditor Monitored the provision of non-audit services
Risk management	<ul style="list-style-type: none"> Reviewed the risk management framework and compliance with that framework during the year and after the year-end up until the publication of the Company's annual report Reviewed the assessment of the risks by the Executive Directors and considered risk appetite Reviewed the Group risk register and considered appropriate areas of focus and prioritisation for the audit work programme for the year Received as part of the risk management review the annual report on any whistleblowing Introduced regular deep dives at Committee meetings on specific areas
Governance	<ul style="list-style-type: none"> Discussed the annual evaluation exercise of the Committee and agreed action plans to further improve the Committee's performance Reviewed new annual report disclosure requirements including the audit report Considered and approved Group accounting policies used in the preparation of the financial statements Reviewed a number of updated Group policies covering financial delegations, foreign exchange, whistleblowing and suspected fraud, anti-bribery and other irregularities Confirmed compliance with the UK Code Regularly held separate meetings with the external auditor and the Group Internal Audit Manager without members of management being present

BOARD COMMITTEES' REPORTS CONTINUED

THE AUDIT COMMITTEE REPORT CONTINUED

In respect of the monitoring of the integrity of the financial statements, which is a key responsibility of the Committee identified in the UK Code, the significant areas of judgement considered in relation to the financial statements for the year ended 31 March 2016 are set out in the following table, together with details of how each matter was addressed by the Committee. At the Committee's meetings throughout the year the Committee and the external auditor have discussed the

significant matters arising in respect of financial reporting during the year and the areas of particular audit focus, as reported on in the independent auditor's report on pages 104 to 113. In addition to the significant matters set out in the table below, the Committee considered a range of other areas including presentational issues in particular relating to non-underlying disclosure and changes to asset lives following external expert review.

Area of focus by the Committee	How the matter was addressed by the Committee
Revenue recognition	Once again there were a number of judgement areas in respect of revenue recognition relating to income from measured water services, estimates of timing of receipt of unmeasured revenue accounting for revenue from long-term service concession arrangements under IFRIC 12 and calculation of accrued income on waste management contracts and powergen. The Committee relied on South West Water's track record of assessing an appropriate level of accrual at previous year ends given actual outturns and Viridor's internal processes for analysing complex long-term contracts. The Committee also considered the work in respect of these areas at year end by the external auditor who was satisfied with the approach taken in each business.
Non-current asset impairment review and provisions	Recognising that the value of certain non-current assets and long-term environmental provisions within Viridor is sensitive to changes in assumptions over future discount rates and cash flow projections which require judgement, the Committee pays careful attention to asset impairment and provisions and the review of goodwill. In addition in the year management reviewed the evolving structure of the cash generating units (CGUs) with the objective of ensuring the determination of CGUs remained consistent with both the waste market and Viridor's operating model. The change in CGU determination resulted in impairment reversals and charges being recognised in the year. This key area was also reviewed as part of the year-end audit by the external auditor. Following a detailed review of the analysis undertaken, and consideration of management assumptions in relation to the revised structure of the CGUs, the Committee was satisfied that a robust and consistent approach had been followed and that the management's assertion that goodwill and intangible assets were not impaired was reasonable and therefore the Committee were able to approve the disclosures in the financial statements.
South West Water and Viridor bad and doubtful debts	Regular updates on progress against debt collection targets and other contractual payments due are received by the Board. Performance is monitored regularly against South West Water's historical collection record and the track record of other companies in the sector. At the year end the external auditor reported on the work it had performed which together with the detailed analysis reported on to the Committee enabled the Committee to conclude that the management's assessment of the year-end position was reasonable.
Provisions for uncertain tax positions	It has been and remains the general policy of the Group to take a balanced view of its tax position and only release tax provisions when matters under discussion are expected to be cleared by HM Revenue & Customs. At the year end the Chief Financial Officer provided an update to the Board on progress in resolving a number of tax positions the background to which had been considered in detail by the Committee on a regular basis as part of progress reports from the Chief Financial Officer. It was noted that where appropriate expert external legal advice and other specialist taxation advice had been sought which assisted the Committee in forming a view on the appropriateness of the provisions for uncertain tax positions and related tax disclosures in the financial statements.
Going concern basis for the preparation of the financial statements and viability statement	A monthly report from the Chief Financial Officer on the financial performance of the Group including forward-looking assessments of covenant compliance and funding levels under differing scenarios is provided to the Board. Rolling five-year strategy projections and the resultant headroom relative to borrowings is also regularly reviewed by the Board. At each half-year end the Chief Financial Officer prepares for consideration by the Committee a report focusing on the Group's liquidity over the 12-month period from the date of signing either the annual report or half-year results. This year the Committee has also considered a report from the Chief Financial Officer on the Group's financial viability over an appropriate period, which the Board considers to be five years in connection with the new UK Corporate Governance Code requirement for a viability statement to be given by the Board. Consideration of these reports and constructive challenge on the findings of the reports including the scenario testing carried out by management has enabled the Committee to form its assessment and satisfy itself that it remains appropriate for the Group to continue to adopt the going concern basis of accounting in the preparation of the financial statements and in addition advise the Board on providing the viability statement set out on page 55.

EFFECTIVENESS OF THE EXTERNAL AUDIT PROCESS

Receiving high quality and effective audit services is of paramount importance to the Committee. We continue to monitor carefully the effectiveness of our external auditor as well as its independence, bearing in mind that it is recognised there is a need to use our external auditor's firm for certain non-audit services. We have full regard to the Auditing Practices Board's Ethical Standards and ensure that our procedures and safeguards meet these standards.

The current external auditor was appointed following a comprehensive audit tender process and approval by shareholders at the Company's 2014 AGM. Their reappointment was approved at the 2015 AGM.

The external auditor produced a detailed audit planning report in preparation for the year-end financial statements, which has assisted the auditor in delivering the timely audit of the Group's annual report and financial statements.

The effectiveness review of the external auditor is undertaken as part of the Committee's annual performance evaluation. The review demonstrated that there was satisfaction with the performance of the external auditor. Accordingly, the Committee considered that it is appropriate that the external auditor be re-appointed and has made this recommendation to the Board.

The Committee chairman has also met privately with the external auditor.

AUDITOR INDEPENDENCE

The Committee carefully reviews on an ongoing basis the relationship with the external auditor to ensure that the auditor's independence and objectivity is fully safeguarded.

The external auditor reported on their independence in the year and since the year end and confirmed to the Committee that they have complied with the Auditing Practices Board's Ethical Standards and, based on their assessment, that they were independent of the Group.

PROVISION OF NON-AUDIT SERVICES

The Committee has a restrictive policy for the engagement of the external auditor's firm for non-audit work. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work. Where fees for non-audit work exceed 50% of the annual audit fees (but are less than 70%) the Committee must be notified of the assignment with a summary report on the background and the reasons for using the auditor for the work. In exceptional circumstances, where there is good rationale for the auditor's non-audit fees to exceed 70%, the Chief Financial Officer is required to set out in a report to the Committee the reasons why the auditor's firm should be appointed for any such work. The Committee would carefully review whether it was necessary for the auditor's firm to carry out such work and would only grant approval for the firm's appointment if it was satisfied that the auditor's independence and objectivity would be fully safeguarded. If there was another accounting firm that could provide the required level of experience and expertise in respect of the non-audit services, then such firm would be chosen in preference to the external auditor.

The level of non-audit fees payable to the external auditor for the past year is 15.74% of the audit fee, which is well within the Group's 70% non-audit fee limit.

The Chief Financial Officer regularly reports to the Committee on the extent of services provided to the Company by the external auditor and the level of fees paid. The fees paid to the external auditor's firm for non-audit services and for audit services are set out in note 7 to the financial statements on page 132.

INTERNAL AUDIT

The internal audit activities of the Group are a key part of the internal control and risk management framework of the Group. At Group level there is a long-standing and effective centralised internal audit service led by an experienced head of function who makes a significant contribution to the ability of the Committee to deliver its responsibilities.

A Group internal audit plan is approved usually in September each year. It takes account of the principal risks, the activities to be undertaken by the external auditor, and also the Group's annual and ongoing risk management reviews. This approach seeks to ensure that there is a programme of internal and external audit reviews focused on identified key risk areas throughout the Group.

The Group Internal Audit Manager reports quarterly to the Committee on audit reviews undertaken and their findings, and there are regular discussions, correspondence and private meetings between the Group Internal Audit Manager and the Committee chairman.

FAIR, BALANCED AND UNDERSTANDABLE ASSESSMENT

To enable the Committee to advise the Board in making its statement that it considered that the Company's Annual Report and Accounts is fair, balanced and understandable (FBU) on page 101, the Committee has applied a detailed FBU review framework that takes account of the Group's well-documented verification process undertaken in conjunction with the preparation of the Annual Report and Accounts. This is in addition to the formal process carried out by the external auditor to enable the preparation of the independent auditor's report, which is set out on pages 104 to 113.

In preparing and finalising the 2016 Annual Report and Accounts, the Committee considered a report on the actions taken by management in accordance with the FBU process and an FBU assessment undertaken by each Group executive management board. This assisted the Committee in carrying out its own assessment and being able to advise the Board that it considered that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

STATEMENT OF COMPLIANCE WITH CMA ORDER

Having undertaken a competitive audit tender process in 2014, the Company is in compliance with the Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order 2014.

BOARD COMMITTEES' REPORTS CONTINUED

THE SUSTAINABILITY COMMITTEE REPORT

Dear Shareholder

I am pleased to introduce the Sustainability Committee's report on its annual activities. Sustainability remains an integral part of Pennon's strategy, and the Group continues to take this responsibility very seriously in all its business and operational practices. Our investment and our commitment to high levels of service and performance will contribute to meeting our communities' long-term needs – for water, energy and waste management.

The role of the Sustainability Committee is to bring together and review initiatives that drive sustainability, to approve targets and to monitor the progress made in achieving Pennon's strategic sustainability objectives. Those objectives are set out on page 72.

The implementation of the new governance structure (as explained on page 62) was introduced formally on 1 April 2016 and we have been pleased to welcome two South West Water non-executive directors to the Committee. Neil Cooper stood down from the Committee on 1 April 2016.

We continue to apply the best practice framework published by Business in the Community (BitC), a leading business-led charity that promotes responsible business, and use the structure provided through BitC's key areas of sustainability (marketplace, workplace, community and environment) for reviewing our programmes and the performance of both South West Water and Viridor as they work to achieve the highest standards of corporate responsibility.

On pages 10 and 11 we show how a thorough approach to sustainability helps us to draw together the needs of society with the delivery of commercial success. This theme is expanded upon by Chris Loughlin in his Group Chief Executive's review, which explains how the Group's strategy of investment for growth allows us to deliver for the benefit of our customers, the environment and the communities we serve, as well as build shareholder value. Details and examples of how South West Water and Viridor are implementing this strategy are provided in the sections on Customers and Communities and Our Environment. We are pleased to note the results in both businesses which confirm sustainability is indeed integrated in all we do.

Gill Rider
Sustainability Committee Chairman

SUSTAINABILITY COMMITTEE COMPOSITION AND MEETINGS

Members	Appointment date	Attendance
Gill Rider (chairman)	September 2012	6/6
Martin Angle	December 2008	6/6
Gerard Connell*	November 2006	3/3
Neil Cooper	September 2014	5/6
Christopher Loughlin	November 2006	6/6
Ian McAulay	September 2013	6/6

* Retired on 31 July 2015

Two South West Water independent non-executive directors, Steve Johnson and Lord Matthew Taylor, were invited to attend the last two Committee meetings of the year in preparation for the revised governance structure (detailed on page 62)

During the year the Sustainability Committee worked with the South West Water sustainability committee and the Viridor board which, prior to the new Group governance framework coming into effect, directed sustainability activities for their respective organisations, to ensure that the Group's sustainability objectives are met. The subsidiaries develop a range of targets as part of their business planning processes and monitor and report progress throughout the year.

As at 31 March 2016 South West Water had achieved eight of its 12 targets for the year and Viridor had completed nine out of 13 of its targets. Further details will be provided in Viridor's sustainability report and South West Water's company annual performance report, to be published in May 2016 and July 2016 respectively.

The Sustainability Committee operates in the context of the requirement for companies to conduct their business in a responsible manner (in relation to environmental, social and governance (ESG) matters) while at the same time delivering strong financial performance and lasting value for shareholders and other stakeholders. The Sustainability Committee reviews and approves as appropriate the strategies, policies, management initiatives, targets and performance of the Pennon Group companies in the areas of occupational health and safety and security environment, workplace policies, responsible and ethical business practice, customer service and engagement, and the role of the Group in society.

During the year the Committee considered a wide range of matters in accordance with its terms of reference, including

- the Group's health and safety performance and plans
- pollution and compliance performance
- performance in respect of customer service and engagement, in particular South West Water's approach to affordability and social tariffs
- the Group's approach to community engagement and investment
- performance against the Group's workplace policy, including review of the results of employee engagement surveys conducted by Pennon, South West Water and Viridor
- sustainable procurement and practices within the supply chain
- sustainability reporting for 2015 for the Group, South West Water and Viridor; and the associated verifier's reports and his recommendations for the 2015/16 reports
- progress against the sustainability targets for 2015/16 and sustainability targets for 2016/17
- the coverage and appropriateness of Group policies

In addition, the Committee considered

- the Committee's performance evaluation results
- modifications to the Committee's terms of reference

BOARD COMMITTEES' REPORTS CONTINUED

THE SUSTAINABILITY COMMITTEE REPORT CONTINUED

STRATEGIC SUSTAINABILITY OBJECTIVES

The Sustainability Committee has defined the following strategic objectives, which inform the sustainability targets set by South West Water and Viridor. Further details are available throughout the strategic report – page references are provided.

MANAGE PENNON GROUP AS A SUSTAINABLE AND SUCCESSFUL BUSINESS FOR THE BENEFIT OF SHAREHOLDERS AND OTHER STAKEHOLDERS

As a well-managed and responsible Group, with sustainability at the core of our business strategy and our operations, we aim to deliver strong performance and lasting value for all our stakeholders. Our services and methods of operation are designed to provide clear community benefits and to protect and enhance the environment.

The key performance indicators by which we measure shareholder value and wider stakeholder benefit are set out on pages 5 and 7.

AIM TO ENSURE THAT ALL OUR BUSINESS ACTIVITIES HAVE A POSITIVE ECONOMIC, SOCIAL AND ENVIRONMENTAL IMPACT ON THE COMMUNITIES IN WHICH WE OPERATE

Pennon recognises it has a responsibility to contribute positively towards communities affected by its operations.

Details of the Group's economic, social and environmental impact can be found on pages 38 to 47.

ENGAGE WITH ALL STAKEHOLDERS AND FOSTER GOOD RELATIONSHIPS WITH THEM

Pennon aims to be a good neighbour, and consults with its stakeholders in order to understand and respond to their priorities.

Details of the Group's approach to stakeholder engagement and customer satisfaction can be found on pages 36 to 41.

STRIVE FOR THE HIGHEST STANDARDS OF HEALTH AND SAFETY IN THE WORKPLACE SO AS TO MINIMISE ACCIDENTS, INCIDENTS AND LOST TIME

The Group remains committed to achieving and maintaining improvements in health and safety. Both South West Water and Viridor continue to endeavour to embed health and safety within each organisation's culture.

Details of South West Water's and Viridor's health and safety performance and their future plans are provided on page 48.

DEVELOP AND MOTIVATE OUR EMPLOYEES, TREAT THEM FAIRLY AND ENSURE THAT THEY ARE FULLY ENGAGED IN ALL ASPECTS OF THE PENNON GROUP'S OBJECTIVES

Pennon's success is fundamentally down to its employees. We recruit talented and committed people and provide training packages to equip them with the skills they need to deliver the Group's objectives.

Details of the Group's strategies and performance around employee engagement can be found on pages 49 and 50.

ASPIRE TO LEADERSHIP IN MINIMISING EMISSIONS THAT CONTRIBUTE TO CLIMATE CHANGE, AND DEVELOP CLIMATE CHANGE ADAPTION STRATEGIES

Pennon continues to strive for a reduction in emissions and encourages its businesses to adopt initiatives for renewable energy generation.

Details of the Group's greenhouse gas emissions and climate change strategies are provided on pages 44 and 45.

ASPIRE TO LEADERSHIP IN ALL ASPECTS OF WASTE PREVENTION AND RESOURCE EFFICIENCY

Pennon is delivering solutions for society to address the environmental challenge of depleting natural resources by maximising the value of residual materials, transforming waste and improving energy efficiency.

Details can be found throughout the strategic report, including on pages 32 to 35 and 39 to 44.

REPORTING AND VERIFICATION

In reporting on sustainability, the Company has sought to comply with the Guidelines on Responsible Investment Disclosure issued by the Association of British Insurers and now maintained by The Investment Association

Pennon's sustainability performance and reporting has been audited by Strategic Management Consultants Limited (SMC), an independent management consultancy specialising in technical assurance in the utility sector. Pennon considers that SMC's method of verification – which includes testing the assumptions, methods and procedures that are followed in the development of data and auditing that data to ensure accuracy and consistency – complements the best practice insight gained through South West Water's and Viridor's membership of Business in the Community Disclosures within this annual report in respect of Bournemouth Water's sustainability performance have been verified by SMC against the output of an independent audit of Bournemouth Water's sustainability disclosures conducted by Halcrow Management Sciences Limited

BENCHMARKING

Pennon is pleased to have retained its place on the FTSE4Good Index, having been independently assessed against the FTSE4Good criteria and satisfying the necessary requirements

Created by the global index provider FTSE Russell (the trading name of FTSE International Limited and Frank Russell Company) FTSE4Good is an equity index series that is designed to facilitate investment in companies that meet globally recognised corporate responsibility standards. Companies in the FTSE4Good Index Series have met stringent environmental, social and governance criteria, and are positioned to capitalise on the benefits of responsible business practice

PENNON SUSTAINABILITY REPORT

Pennon's sustainability reporting is integrated throughout the strategic report and specifically in the following sections

- Group Chief Executive Officer's overview (page 16)
- Our operations (pages 30 to 31)
- Customers and communities (pages 36 to 41)
- Our environment (pages 42 to 47)
- Our people (pages 48 to 50)

SOUTH WEST WATER AND VIRIDOR SUSTAINABILITY REPORTS

The full sustainability report for Viridor will be published in May 2016 and this year South West Water will incorporate its sustainability reporting in its company annual performance report and regulatory accounts, which will be published in July 2016. Both documents will be available to view at www.pennon-group.co.uk and also on the subsidiaries websites. Full details of the sustainability targets for South West Water and Viridor for 2015/16 and their performance against them, are given in their respective reports

BOARD COMMITTEES' REPORTS CONTINUED

THE NOMINATION COMMITTEE REPORT

The Nomination Committee meets in accordance with an annual calendar to consider succession planning, equality and diversity reports and periodically as necessary to manage the Board appointment process and recommend to the Board suitable candidates for Board appointments in the Group

It is the practice of the Committee led by the Chairman, to appoint an external search consultancy to assist in Board appointments to ensure that an extensive and robust search can be made for suitable candidates

During the year the Committee met to consider

- the Group Chief Executive Officer, the South West Water Managing Director and the Group General Counsel & Company Secretary appointments
- the Group's diversity and equality policies and practice

Following the year end the Committee also considered its performance evaluation for the year and concluded that for the forthcoming year there would be a sharper focus on succession planning having regard to the new corporate structure recently introduced

External search consultants were not engaged to assist with the recruitment of the Group Chief Executive Officer or the South West Water Managing Director due to exceptionally able internal candidates being available for consideration by the Committee

The appointment of the Group General Counsel & Company Secretary was undertaken with the assistance of an external search consultant

Members	Appointment date	Attendance
Kenneth Harvey* (Committee chairman until 31 July 2015)	March 1997	2/2
Martin Angle	December 2008	4/4
Gerard Connell	October 2003	2/2
Neil Cooper	September 2014	4/4
Gill Rider	September 2012	4/4
Sir John Parker (Committee chairman from 1 August 2015)	April 2015	4/4

*Retired on 31 July 2015

In accordance with the revised governance structure (detailed on page 62) with effect from 1 April 2016 the South West Water independent non-executive directors will also contribute to Committee discussions when matters within the Committee's remit relevant to South West Water are to be considered

DIVERSITY POLICY

The Committee is required by the Board to review and monitor compliance with the Board's diversity policy and report on the targets, achievement against those targets and overall compliance in the annual report each year

The Board's diversity policy confirms that the Board is committed to

- the search for Board candidates being conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of gender and ethnic diversity on the Board
- satisfying itself that plans are in place for orderly succession of appointments to the Board and to senior management to maintain an appropriate balance of skills and experience within the Group and on the Board and to ensure progressive refreshing of the Board. In addition, within the spirit of Principle B 2 of the UK Code, the Board endeavours to achieve and maintain
 - a minimum of 25% female representation on the Board
 - a minimum of 25% female representation on the Group's senior management team

The Committee is pleased to report that as at 31 March 2016 and, as disclosed with the Directors' biographies on page 60, the Group had exceeded 25% female representation at Board level. While circumstances on occasion will result in changes in Board composition the Committee and the Board remain committed to maintaining at least the 25% level.

In respect of the Group's senior management team, progress is being made with 21.9% being female compared to the reported 16.4% at 31 March 2015. Action is being taken to improve diversity across the workforce which will assist in increasing female representation at senior management level as described on page 50.

The Committee and the Board will continue to monitor and promote diversity across the Group with the aim of achieving a minimum of 25% female representation on the senior management team by the end of 2017.

As well as its diversity policy, the Group has a number of policies in place embracing workplace matters, including non-discrimination and equal opportunities policies which are reported on separately on page 48 together with information regarding the gender breakdown of the workforce on page 50.

THE REMUNERATION COMMITTEE REPORT

The Committee meets in accordance with an annual calendar to consider remuneration matters in respect of the Group and in particular is responsible for

- ensuring remuneration is aligned with and supports the Group's strategy, reflects our values as a Group and optimises performance
- maintaining and reviewing the remuneration policy to ensure it remains appropriate to attract and retain high calibre people who are able to contribute to the success of the Group
- advising the Board on the framework of executive remuneration for the Group
- determining the remuneration and terms of engagement of the Chairman, the Executive Directors and senior management of the Group

Members	Appointment date	Attendance
Martin Angle (Committee chairman)	December 2008	6/6
Gerard Connell*	October 2003	4/4
Neil Cooper	September 2014	6/6
Gill Rider	September 2012	6/6

* Retired on 31 July 2015

Two South West Water independent non-executive directors, Martin Hagen and Steve Johnson, attended the last two Committee meetings of the year in preparation for the revised governance structure (detailed on page 62)

The current remuneration policy was approved by shareholders at the Company's 2014 AGM and no changes are proposed to the policy at this year's AGM

OUR REMUNERATION POLICY IS DESIGNED TO SUPPORT OUR GROUP STRATEGY AND PROVIDE STRETCHING INCENTIVES FOR OUR MANAGEMENT TO PERFORM IN THE INTERESTS OF MAXIMISING SHAREHOLDER VALUE WHILST ENSURING THE LONG-TERM SUSTAINABILITY OF THE GROUP

THE COMMITTEE'S ACTIVITIES DURING THE FINANCIAL YEAR

- annual review of the pay and benefits policies and practices for the staff below Board level in the Group
- annual executive salary review
- determining performance targets in respect of the Annual Incentive Bonus Plan for 2015/16
- reviewing drafts of the Directors' remuneration report for 2014/15 and recommending it to the Board for approval for inclusion in the 2015 annual report, and reviewing early drafts of the Directors' remuneration report for 2015/16
- determining bonuses, deferred bonus awards and executive share options pursuant to the Company's Annual Incentive Bonus Plan in respect of the year 2014/15
- approving the Performance and Co-investment Plan awards for the year
- reviewing the annual performance evaluation results of the Committee
- approving the remuneration arrangements for the new Group Chief Executive Officer, the South West Water Managing Director and the Group General Counsel & Company Secretary
- approving the release of the 2012 deferred bonus share awards and the vesting of executive share options pursuant to the Annual Incentive Bonus Plan
- determining the outcome of the 2012 Performance and Co-investment Plan awards

THE COMMITTEE'S FOCUS FOR 2016/17

- monitor the alignment of executive pay and benefits with the strategic direction of the Group
- following the acquisition of Bournemouth Water and the bringing on stream of the ERFs, ensure incentive criteria is properly aligned with the Group's objectives
- review the remuneration policy in preparation for its submission for approval to shareholders at the 2017 AGM (after the conclusion of the three-year approval period of the current policy) to ensure it is aligned with the Group's strategy going forward

BOARD COMMITTEES' REPORTS CONTINUED

THE REMUNERATION COMMITTEE REPORT CONTINUED

GOVERNANCE

The Committee's terms of reference setting out full details of the role and responsibilities of the Committee in accordance with the principles of the UK Corporate Governance Code is available on our website www.pennon-group.co.uk

In accordance with the Code, all of the Committee members are independent Non-executive Directors, and the Committee is advised by Deloitte, an independent remuneration consultant, to ensure remuneration is determined impartially. The Chairman of the Board is a regular attendee but not a member of the Committee and, following his appointment, the Group Chief Executive Officer is invited to attend meetings except for such part of a meeting when matters concerning his own remuneration are to be discussed.

For 2016/17 two South West Water independent non-executive directors will attend meetings of the Committee and contribute to discussions. They will contribute to the setting of the remuneration policy for the whole Group whilst being responsible for leading on remuneration matters concerning South West Water.

This Directors' remuneration report has been prepared in accordance with the provisions of the Companies Act 2006 and the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013. It also complies with the requirements of the Financial Conduct Authority's Listing Rules and the Disclosure and Transparency Rules. The UK Corporate Governance Code also sets out principles of good governance relating to directors' remuneration, and this report describes how these principles are applied in practice. The Committee confirms that throughout the financial year the Company has complied with these governance rules and best practice provisions.

The above regulations also require the external auditor to report to shareholders on the audited information within the annual report on remuneration which is part of the Directors remuneration report. The external auditor is obliged to state whether, in its opinion, the relevant sections have been prepared in accordance with the Companies Act 2006. The external auditor's opinion is set out on page 112 and the audited sections of the annual report on remuneration are identified in this report.

DIRECTORS' REMUNERATION REPORT

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DIRECTORS' REMUNERATION REPORT CONTINUED

ANNUAL STATEMENT FROM THE CHAIRMAN OF THE REMUNERATION COMMITTEE

Dear Shareholder

INTRODUCTION

Our current remuneration policy was approved by shareholders at our 2014 AGM and last year we set out a summary of the policy for information. We are providing a summary again this year on pages 79 to 83 as we are once again not proposing any changes to the policy at this year's AGM.

On pages 84 to 98 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2015/16 including the single remuneration figure table providing a value for each element of remuneration for each Director together with the details of the link between Company performance and remuneration during the year (pages 87 to 89). It also provides details of how our policy will be applied for 2016/17. This section of the report together with this letter is subject to an advisory shareholder vote at this year's AGM.

Last year the Remuneration Committee was pleased to note that 98% of shareholders who voted approved the annual report on remuneration. The Committee appreciates the continuing support of its shareholders.

REMUNERATION DECISIONS

For 2016/17 the salary of the Group Chief Executive Officer was not increased due to Chris Loughlin being appointed to the position towards the end of the 2015/16 year. The salary for the Chief Executive, Vinidor, was increased by 1.5%, reflecting market rates and performance in the year. Susan Davy was promoted to the position of Chief Financial Officer on 1 February 2015. The Committee initially set her salary at £325,000, a level below market rates, with the intention of providing flexibility to make higher than usual increases to reflect performance and experience in the role. The Committee's assessment is that she is now fully effective in the role, and performing at a level which exceeds the expectations set out on her appointment. The Committee's view was therefore that it was appropriate to make an adjustment to her salary for 2015/16 and her salary was increased to £390,000 from 1 April 2016, the first salary increase since her appointment. Following this adjustment, which is believed to be in line with market rates and commensurate with her predecessor's salary, it is not anticipated that there will be any further increases of this nature for Susan Davy and future increases are not expected to be materially different from general employee increases.

The bonus outturns for the Executive Directors for 2015/16 reflect the achievements of the Group businesses in the year, the Company's performance against corporate financial targets and the Executive Directors' performance against individual targets. Half of the bonus is deferred into shares. Further details of targets, measures and performance are set out on pages 87 and 88.

As regards the Company's long-term incentive plan, the overall estimated outturn for awards vesting at the end of the three year period ended 31 March 2016 is 34.5% of the maximum 100%. This reflects that the Company's total shareholder return is estimated to be 0.52% above the comparator index performance and is expected to have a percentile rank of 52% within the FTSE 250 group.

BOARD CHANGES

Sir John Parker became the Chairman on 1 August 2015 and his fee in the role was set at the same level as that of his predecessor. His fee for 2016/17 will be £266,350.

On 1 January 2016 Chris Loughlin became the Group Chief Executive Officer. As this was a new position for the Group, his salary was set after receiving advice from the Committee's remuneration consultant and reflected the fact that he was an experienced Director with the Pennon Group, having been promoted from being the Chief Executive of South West Water. Accordingly his pre-existing awards and contractual commitments will continue in accordance with their established terms. This is in accordance with the approved remuneration policy.

LOOKING FORWARD

We will continue to review performance measures annually to ensure they are aligned with our strategy. For the financial year 2016/17 they have been adjusted as set out on page 84 to reflect the drive for synergies across the businesses and the changing structure of the businesses as the ERFs become operational and as South West Water prepares for industry change.

We will also review our overall remuneration policy with our external independent remuneration consultant in readiness for submission for shareholder approval at our AGM in 2017 at the end of the approval period of our current policy.

In conclusion, I hope you find our report this year informative and that we can rely on your vote in favour of the annual report on remuneration.

Martin D Angle

Remuneration Committee Chairman

DIRECTORS' REMUNERATION POLICY

INTRODUCTION

The current Directors' remuneration policy was approved by shareholders at the Company's AGM on 31 July 2014.

The Committee's intention is to seek approval for the remuneration policy at the end of the normal three year cycle in line with the remuneration reporting requirements. We are therefore not seeking approval for our remuneration policy at the 2016 AGM. The Committee will undertake a review of the policy during 2016/17 which will then be submitted for shareholder approval at the 2017 AGM.

The remuneration policy tables for Executive and Non-executive Directors are set out below for shareholder information. They have been reproduced as approved at the 2014 AGM with the exception of updating to reflect Director changes, additional wording on malus, clawback and the holding period introduced in 2015 in the Group's Performance and Co-investment Plan, and minor and inconsequential changes.

The Directors' remuneration policy is displayed on the Company's website www.pennon-group.co.uk/about-us/directors-remuneration-policy and is available upon request from the Group Company Secretary.

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS

The table below sets out the elements of the total remuneration package for the Executive Directors which are comprised in this Directors' remuneration policy.

How the component supports the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
BASE SALARY			
Set at a competitive level to attract appropriate candidates to meet Company's strategic objectives and to aid retention.	Salaries are generally reviewed annually and any changes are normally effective from 1 April each year. In normal circumstances salary increases will not be materially different to general employee pay increases but there may be exceptions such as where there has been the recruitment of a new Executive Director at an initially lower salary.	When reviewing salaries the Committee has regard to the following factors: <ul style="list-style-type: none"> • salary increases generally for all employees in the Company and the Group • market rates • performance of the individual and the Company • other factors it considers relevant There is no overall maximum.	None, although individual and Company performance are factors considered when reviewing salaries.
BENEFITS			
Benefits are provided that are consistent with the market and level of seniority and which aid retention of key skills to assist in meeting strategic objectives.	Benefits currently include the provision of a company vehicle, fuel, health insurance and life assurance. Other benefits may be provided if the Committee considers it appropriate. In the event that an Executive Director is required to relocate relocation benefits may be provided.	The cost of insurance benefits may vary from year to year depending on the individual's circumstances. There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remains proportionate.	None.

DIRECTORS' REMUNERATION REPORT CONTINUED

DIRECTORS' REMUNERATION POLICY CONTINUED

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS CONTINUED

How the component supports the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
ANNUAL BONUS			
Linked to achievement of key performance objectives aligned to the strategy of the Company	<p>Annual bonuses are paid following finalisation of the financial results for the year to which they relate and paid usually three months after the end of the financial year</p> <p>A portion of any bonus is deferred into shares in the Company which are normally released after three years. Normally 50% is deferred. Any dividends on the shares during this period are paid to the Directors.</p> <p>The deferred bonus plan is operated in conjunction with the Company's HMRC approved executive share option scheme (ESOS) on the basis that the pre-tax value of awards under both are the same as if the deferred bonus plan had operated alone.</p> <p>For bonuses awarded from the 2014/15 financial year malus and clawback provisions apply. These provisions permit net cash bonuses and/or deferred bonus shares to be forfeited, repaid or made subject to further conditions where the Committee considers it appropriate in the event of any significant adverse circumstances including (but not limited to) a material failure of risk management, serious reputational damage, a financial misstatement or misconduct. Clawback may be applied for the period of three years following determination of the cash bonus.</p>	The maximum bonus potential for each Director is 100% of base salary	<p>Performance targets relate to corporate and personal objectives which are reviewed each year. Normally at least 70% relates to financial targets or quantitative measures.</p> <p>The measures, weighting and threshold levels may be adjusted for future performance years.</p> <p>Following the financial year-end the Committee, with advice from the Chairman of the Board and the Group Chief Executive Officer, except with regard to his own performance, and following consideration of the outturn against target by the chairman of the Audit Committee, assesses to what extent the targets are met and determines bonus levels accordingly. In doing so the Committee takes into account overall Company performance and may adjust the bonus upwards or downwards for any specific factors such as exceptional outperformance or underperformance.</p>

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS CONTINUED

How the component supports the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
LONG-TERM INCENTIVE PLAN (PERFORMANCE AND CO-INVESTMENT PLAN)			
Provide alignment to shareholders and to longer-term Company performance	<p>Annual grant of conditional shares (or equivalent) Share awards vest dependent upon the achievement of specific performance conditions measured over a performance period of no less than three years</p> <p>A grant is only made if the Director has acquired or is due to acquire co-investment shares equivalent to one-fifth of the value of the award</p> <p>Dividend equivalents (including dividend reinvestment) may be paid on vested awards</p> <p>An 'underpin' applies which allows the Committee to reduce or withhold vesting if the Committee is not satisfied with the underlying operational and economic performance of the Company</p> <p><i>Introduced for 2015/16 onwards</i></p> <p>For grants made from 2015 onwards malus and clawback provisions apply which permit shares to be forfeited repaid or made subject to further conditions where the Committee considers it appropriate in certain circumstances The circumstances in which malus may be applied include (but are not limited to) material misstatement serious reputational damage or the participant's misconduct</p> <p>The circumstances in which clawback may be applied are material misstatement or serious misconduct</p> <p>In addition a further two year holding period will apply in respect of any shares which vest at the end of the three year performance period</p> <p>Malus may be applied during the three year performance period and clawback may be applied up until the end of the holding period</p>	The maximum annual award is 100% of base salary	<p>The current performance conditions are based on total shareholder return (TSR) with 50% based on TSR against the peer group index (chosen because these companies are regarded as the Company's key listed comparators) and 50% based on TSR against constituents of the FTSE 250 index (excluding investment trusts) (chosen because this is the FTSE index to which the Company belongs currently)</p> <p>No more than 30% of maximum vests for minimum (threshold) performance as described on page 89 in respect of the current forecast outcome for 2015/16</p> <p>The 'underpin' evaluation includes consideration of environmental social and governance (ESG) factors and safety performance as well as financial performance</p> <p>The Committee will keep the performance measures under review and may change a performance condition for future awards if it was considered to be aligned with the Company's interests and strategic objectives</p> <p>However the Committee would consult with major shareholders in advance of any proposed material change in performance measures</p>

DIRECTORS' REMUNERATION REPORT CONTINUED

DIRECTORS' REMUNERATION POLICY CONTINUED

FUTURE POLICY TABLE – EXECUTIVE DIRECTORS CONTINUED

How the component supports the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
PENSION			
Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives	Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements have been available to new staff since 2008. A cash allowance may be provided as an alternative and/or in addition where pension limits have been reached.	The maximum annual pension contribution or cash allowance is 20% of salary. For Executive Directors who commenced employment prior to April 2013 the maximum annual pension contribution or cash allowance is 30% of salary. Legacy defined benefit pension arrangements will continue to be honoured.	None
ALL-EMPLOYEE SHARE PLANS			
To align interests of all employees with Company share performance	Executive Directors may participate in HMRC approved all-employee plans on the same basis as employees.	The maximum is as prescribed under the relevant HMRC legislation governing the plans.	None

FUTURE POLICY TABLE – NON-EXECUTIVE DIRECTORS

The table below sets out the Company's policy in respect of the setting of fees for Non-executive Directors

How the component supports the strategic objectives of the Company	How the component operates	Maximum potential value of the component
FEES		
Set at a market level to attract Non-executive Directors who have appropriate experience and skills to assist in determining the Group's strategy	<p>Fees are set by the Board with the Chairman's fee being set by the Committee. The relevant Directors are not present at the meetings when their fees are being determined.</p> <p>Non-executive Directors normally receive a basic fee and an additional fee for any specific Board responsibility such as membership or chairmanship of a Committee or occupying the role of Senior Independent Director.</p> <p>In reviewing the fees the Board or Committee as appropriate considers the level of fees payable to Non-executive Directors in other companies of similar scale and complexity.</p>	Total fees paid to the Chairman and Non-executive Directors will remain within the limits stated in the Articles of Association
BENEFITS		
Benefits for the Chairman are provided which are consistent with the market and level of seniority	<p>Expenses incurred in the performance of non-executive duties for the Company may be reimbursed or paid for directly by the Company (including any tax due on the expenses).</p> <p>The Chairman is entitled to expenses on the same basis as for other Non-executive Directors and when appropriate for the efficient carrying out of his duties, is provided with a driver and vehicle.</p>	None

DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

The policy for Executive Directors' service contracts is to provide for 12 months' notice from either side. The policy for Non-executive Directors' letters of appointment is to contain three months' notice from either side. The policy for the Chairman's letter of appointment is to contain a six month notice period from either side.

DIRECTORS' REMUNERATION REPORT

CONTINUED

ANNUAL REPORT ON REMUNERATION

INTRODUCTION

This section sets out how the Company has applied its remuneration policy in the year, and details how the policy will be implemented for the year 2016/17. In accordance with section 439 of the Companies Act, this section will be put to an advisory vote at the Company's AGM which is scheduled to be held on 1 July 2016.

OPERATION OF THE REMUNERATION POLICY FOR 2016/17

A summary of the specific remuneration arrangements for Executive Directors in 2016/17 is described below.

Base salary	<p>2016/17 salaries are</p> <ul style="list-style-type: none"> • Chris Loughlin £510,000 • Ian McAulay £406,000 • Susan Davy £390,000 <p>Susan Davy was promoted to the position of Chief Financial Officer on 1 February 2015. The Committee initially set her salary at £325,000, a level below market rates, with the intention of providing flexibility to make higher than usual increases to reflect performance and experience in the role. This approach of setting a lower salary with the potential for higher increases following appointment is in line with the Committee's normal policy. The Committee's assessment during the review was that she is now fully effective in the role and is performing at a level which exceeds the expectations set out on her appointment. The Committee was therefore of the view that it was appropriate to make an adjustment to her salary for 2015/16 and her salary was increased to £390,000 from 1 April 2016, the first salary increase since her appointment. Following this adjustment, which is believed to be in line with market rates and commensurate with her predecessor's salary, it is not anticipated that there will be any further increases of this nature for Susan Davy. Accordingly, future increases are not expected to be materially different from general employee increases.</p>
Pension and benefits	<p>No changes. Salary supplement cash allowance of between 20% and 30% from which is deducted the employer's contribution to the defined benefit or defined contribution pension schemes for the Directors.</p> <p>Chris Loughlin, appointed on 1 January 2016 and having been promoted from within the Group, already received a pension benefit equivalent to 30% of salary, in respect of which there has been no change.</p>
Annual bonus	<p>No change to maximum opportunity of 100% of salary. No change to operation of deferral: 50% of the bonus is delivered as deferred shares. No changes to the overall performance measurement framework for the annual bonus for 2016/17 although there is some adjustment to the component make-up of the financial performance measures and the role-specific measures affecting the Group Chief Executive Officer and the Chief Financial Officer to reflect goals for the year, as set out below:</p> <ul style="list-style-type: none"> • 30% EPS (before deferred tax and non-underlying items) performance • 30% personal strategic objectives • 40% measures which are specific to the role including, in South West Water: net debt, operating profit, RoRE (Return on Regulated Equity), Totex (total expenditure) performance and service improvements and, in Viridor: operating profit, net debt and Adjusted EBITDA (earnings before interest, tax, depreciation, amortisation and non-underlying items plus joint ventures EBITDA and IFRIC interest receivable). <p>More detail on the measures and weightings is provided on the following page. The objective was to ensure alignment to measures identified as key for each role with an appropriate balance between hard financial measures and objectives aligned to the strategic success of the business.</p> <p>For bonuses from 2014/15 both malus and clawback apply as described in the summary of the remuneration policy report.</p>
Performance and Co-investment Plan (PCP)	<p>No change to maximum performance opportunity of 100% of base salary, awards being subject to co-investment of 20% of the award, and performance measures:</p> <ul style="list-style-type: none"> • 50% TSR vs FTSE 250 (excluding investment trusts) • 50% TSR vs a peer group index <p>'Underpin' relating to overall Group performance including consideration of environmental, social and governance factors and safety performance, as well as financial performance.</p> <p>For awards from 2015/16 both malus and clawback apply and a holding period applies in respect of any shares which vest at the end of the three year performance period, as described in the summary of the remuneration policy report.</p>
Shareholding guideline	<p>No change: 100% of salary to be built up in the first five years of joining.</p>

FORWARD-LOOKING PERFORMANCE TARGETS

Details of the annual bonus framework that will apply for each Executive Director for 2016/17 are set out in the table below

Group Chief Executive Officer, Chris Loughlin		
30%	EPS*	
20%	Average of South West Water directors performance including	
	(i) Operating profit	(iii) Net debt (v) Service improvements performance
	(ii) RoRE* performance	(iv) Totex* outperformance
20%	Average of Viridor directors performance including	
	(i) Operating profit	(iii) Adjusted EBITDA
30%	Personal strategic and delivery objectives	
Chief Executive, Viridor, Ian McAulay		
30%	EPS*	
40%	Average of Viridor directors performance including	
	(i) Operating profit	(ii) Net debt (iii) Adjusted EBITDA
30%	Personal strategic and delivery objectives	
Chief Financial Officer, Susan Davy		
30%	EPS*	
20%	Average of South West Water directors performance including	
	(i) Operating profit	(iii) Net debt (v) Service improvements performance
	(ii) RoRE* performance	(iv) Totex* outperformance
20%	Average of Viridor directors performance including	
	(i) Operating profit	(ii) Net debt (iii) Adjusted EBITDA
30%	Personal strategic and delivery objectives	

* EPS is before deferred tax and non underlying items + RoRE is Return on Regulated Equity # Totex is total capital and revenue expenditure

The specific bonus targets are considered to be commercially sensitive. However, the Committee intends to disclose details of the targets set retrospectively to the extent they are not considered commercially sensitive.

For the PCP (long-term incentive plan) the targets are set out below

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)
Comparator index (50% of award)	Equal to index	15% above the index
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile

The comparator index will comprise

- Shanks Group
- National Grid
- United Utilities
- Suez Environnement
- Severn Trent
- Seche Environnement
- Veolia Environnement

NON-EXECUTIVE DIRECTOR FEES

Non-executive Director fees for 2016/17 are set out below. They include increases per Non-executive Director ranging from 0.6% to 7.3% approved by the Board, effective from 1 April 2016, to reflect principally changed responsibilities and additional commitments arising from the revised Board governance structure. The Chairman's increase approved by the Committee was 1.5%.

Role	Fees £
Chairman	266,350
Basic Non-executive Director fee	46,500
Additional fees	
Senior Independent Director fee	5,000
Additional fee for chairman of the Audit Committee	14,000
Additional fee for chairman of the Remuneration Committee	10,000
Additional fee for chairman of the Sustainability Committee	10,000
Committee fee	5,000

DIRECTORS' REMUNERATION REPORT

CONTINUED

SINGLE TOTAL FIGURE OF REMUNERATION TABLES (AUDITED INFORMATION)

	Base salary/fees (£000)		Benefits (including Sharesave) (£000)		Annual bonus (cash and deferred shares) (£000)		Performance and Co-investment Plan (£000)		Pension (£000)		Total remuneration (£000)	
	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15	2015/16 ⁽ⁱ⁾	2014/15	2015/16	2014/15	2015/16	2014/15
Executive Directors												
Susan Davy Chief Financial Officer (appointed 1 February 2015)	325	54	18	2	238	51	66	–	91 ⁽ⁱⁱ⁾	33 ⁽ⁱⁱ⁾	738	140
Chris Loughlin, Group Chief Executive Officer (appointed 1 January 2016 – previously Executive Director and Chief Executive South West Water) ^(iv)	427	387	29	27	356	303	179	–	128	116	1,119	833
Ian McAulay Chief Executive Vindor	400	355	21	34 ⁽ⁱⁱⁱ⁾	238	202	–	–	80	71	739	662
Non-executive Directors												
Ken Harvey Chairman (retired 31 July 2015)	87	262	8	24	–	–	–	–	–	–	95	286
Sir John Parker Chairman (appointed 1 August 2015 – previously Deputy Chairman from 1 April 2015)	219	–	–	–	–	–	–	–	–	–	219	–
Gerard Connell (retired 31 July 2015)	23	63	–	–	–	–	–	–	–	–	23	63
Neil Cooper	65	37	–	–	–	–	–	–	–	–	65	37
Martin Angle	62	60	–	–	–	–	–	–	–	–	62	60
Gill Rider	65	60	–	–	–	–	–	–	–	–	65	60

(i) Based on an estimated 34.5% vesting as referred to on page 89 and based on the Company's share price of 796.5p as at 19 May 2016 together with an estimate of the accrued dividends payable on the vesting shares

(ii) Includes legacy pension benefit accrued in the year

(iii) Remuneration is aggregate total in the year in respect of both positions

(iv) Benefits included a reimbursement of relocation costs (including income tax) of £15,000

ANNUAL BONUS OUTTURN FOR 2015/16

The performance targets set and the performance achieved in respect of the annual bonus for 2015/16 for each Executive Director is set out below. In line with the Committee's policy 50% of any bonus is payable in shares.

SUSAN DAVY

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS	30%	31.6p	35.1p	40.4p	39.5p	24.38%
SWW operating profit	5%	£198.8m	£209.3m	£219.8m	£215.0m	3.85%
SWW Return on Regulated Equity	5%	8.5%	9%	10%	11.7%	5.00%
Viridor operating profit	10%	£40.3m	£42.4m	£44.5m	£41.0m	2.16%
Net debt	20%	No payout for below target. Maximum payout for net debt of 2.5% below target.*			£1.788m	9.84%
Personal strategic objectives	30%	Relating to key finance business objectives for the Group including progressing the Group's funding strategy, driving the Group strategic review, developing the Group financial framework and delivering on objectives relating to subsidiary financial targets.*			–	28.00%
Total outturn						73.23%

* Some objectives and the detailed targets continue to be commercially confidential.

IAN McAULAY

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS	30%	31.6p	35.1p	40.4p	39.5p	24.38%
Average Viridor directors performance	40%	The average of the bonus earned by the other executive directors of Viridor including targets that related to				10.13%
		<ul style="list-style-type: none"> operating profit – the operating profit targets were £38.2m(threshold) £42.4m(target) and £46.6m(maximum) actual outturn was £40.9m net debt* Adjusted EBITDA.* 				
		The average also took into account collective strategic objectives relating to profitable revenue growth, forecasting process improvements, comparative health and safety performance and implementation of organisational design.*				
Personal strategic objectives	30%	Implementing Viridor strategy and projects including profitable sales of landfill sites and objectives in relation to the implementation of the ERF programme.*			–	25.00%
Total outturn						59.51%

* Some objectives and the detailed targets continue to be commercially confidential.

DIRECTORS' REMUNERATION REPORT

CONTINUED

ANNUAL BONUS OUTTURN FOR 2015/16 CONTINUED

CHRIS LOUGHLIN

Chris Loughlin became Group Chief Executive Officer from 1 January 2016 and therefore different objectives applied to the last three months of the year as set out below

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Targets applicable for the period 1 April 2015 to 31 December 2015						
EPS	22.5%	31.6p	35.1p	40.4p	39.5p	18.28%
Average South West Water directors' performance	30%	The average of the bonus earned by the other executive directors of South West Water in respect of targets which related to				26.00%
		<ul style="list-style-type: none"> operating profit – the operating profit targets were £198.8m (threshold) £209.3m (target) and £219.8m (maximum), actual outturn was £215m net debt* the position the company achieves in the Service Incentive Mechanism of water and wastewater companies established by Ofwat* the achievement of a range of service standards set for the company by Ofwat* 				
Personal strategic objectives	22.5%	Implementing South West Water's new strategies and projects including the achievement of the transition milestones and synergies related to Bournemouth Water acquisition and the delivery of opex/capex efficiency targets*				21.00%
Total outturn						65.28%
Targets applicable for the period 1 January 2016 to 31 March 2016						
EPS	7.5%	31.6p	35.1p	40.4p	39.5p	6.10%
Average South West Water directors' performance	5%	The average of the bonus earned by the other executive directors of South West Water in respect of targets which related to				4.33%
		<ul style="list-style-type: none"> operating profit – the operating profit targets were £198.8m (threshold) £209.3m (target) and £219.8m (maximum) actual outturn was £215m net debt* the position the company achieves in the Service Incentive Mechanism of water and wastewater companies established by Ofwat* the achievement of a range of service standards set for the company by Ofwat* 				
Average Vindor directors' performance	5%	The average of the bonus earned by the other executive directors of Vindor including targets that related to				1.27%
		<ul style="list-style-type: none"> operating profit – the operating profit targets were £38.2m (threshold), £42.4m (target) and £46.6m (maximum) actual outturn was £40.9m net debt* Adjusted EBITDA* <p>The average also took into account collective strategic objectives relating to profitable revenue growth, forecasting process improvements, comparative health and safety performance and implementation of organisational design*</p>				
Personal strategic objectives	7.5%	Development of new role as Group Chief Executive Officer, completing the integration of Bournemouth Water and pursuing synergies across the Group*				7.00%
Total outturn						18.70%
Overall total outturn						83.98%

* Some objectives and the detailed targets continue to be commercially confidential

PERFORMANCE AND CO-INVESTMENT PLAN OUTTURN FOR 2015/16

The PCP awards made on 2 July 2013, which are due to vest on 2 July 2016, are the awards included in the single figure table, and currently it is estimated that the outturn will result in a 34.5% vesting as set out in the table below

50% of the awards vest subject to the Company's TSR performance measured against an index made up of the following six listed comparator companies. These companies were considered to be the Company's key listed comparators

- National Grid Plc
- Seche Environnement
- Severn Trent
- Shanks Group
- Suez Environnement
- United Utilities

The remaining 50% of the awards vest subject to the Company's ranked TSR performance against the constituents of the FTSE 250 (excluding investment trusts)

The calculation of TSR performance over the three year performance period (being 1 April 2013 to 1 April 2016) for the PCP awards was undertaken by Deloitte LLP for the Committee

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)	Achievement in the period to 1 April 2016*	Vesting outturn*
Comparator index (50% of award)	Equal to index	15% above the index	105% above the index	18.3%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	52.0%	16.2%
TOTAL				34.5%
Straight-line vesting between points				
For below threshold performance: 0% vests				

* As the calculation requires averaging TSR performance over the first three months of the performance period and comparing it to the average over the three months following the end of the performance period (1 April 2016 to 30 June 2016) the achievement and the outturn is an estimate at the date of calculation (20 May 2016)

Vesting of an award is also subject to the 'underpin' described on page 81 which the Committee has determined to the date of this report would be satisfied

TOTAL PENSION ENTITLEMENTS (AUDITED INFORMATION)

	Defined benefit pension accrued at 31 March 2016 ⁽ⁱ⁾ £000 p.a.	Normal retirement age (for pension purposes)	Description of additional benefits available to the Director on early retirement
Susan Davy	16	65	None

(i) The accrued pension for Susan Davy is based on service to the year end and final pensionable salary at that date

Susan Davy receives an overall pension benefit from the Company equivalent to 25% of her salary. She is a member of Pennon Group's defined benefit pension arrangements and is entitled to normal retirement pension payable from age 65 of broadly 1/80th of pensionable remuneration for each year of pensionable service completed

The employer's contribution to the pension for Susan Davy is deducted from the overall pension allowance

Pensions in payment are guaranteed to increase at a rate of 5% p.a. or RPI if lower for service accrued in the period up to 30 June 2014 and at a rate of 2.5% p.a. or CPI if lower for service accrued in the period after this date. If a Director dies within five years of retiring, a lump sum equal to the balance of five years' pension payments is paid plus a spouse's pension of one half of the member's pension. Pensions may also be payable to dependants and children

Ian McAulay is a member of Pennon Group's defined contribution arrangement and received an overall pension benefit from the Company equivalent to 20% of his salary. Chris Loughlin is not a member of any of the Pennon Group's pension schemes and receives a sum in lieu of pension entitlement equivalent to 30% of salary

No additional benefits will become receivable by a Director in the event that the Director retires early. Chris Loughlin's normal retirement age is 67, which will be reached on 20 August 2019. Ian McAulay's normal retirement age is 65, which will be reached on 25 April 2030. Susan Davy's normal retirement age for pension purposes is 65, which will be reached on 17 May 2034

DIRECTORS' REMUNERATION REPORT CONTINUED

DATES OF DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

The dates of Directors' service contracts and letters of appointment and details of the outstanding term are shown below

Executive Directors	Date of service contract	Expiry date of service contract
Susan Davy*	1 February 2015	At age 67 (17 May 2036)
Chris Loughlin*	1 January 2016	At age 67 (20 August 2019)
Ian McAulay*	2 August 2013	At age 65 (25 April 2030)

* Each of the Executive Directors' service contracts is subject to 12 months' notice on either side

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
Sir John Parker	19 March 2015	Ongoing – subject to six months notice
Ken Harvey	1 April 2005	31 July 2015 (retired on this date)
Martin Angle	28 November 2008	30 November 2017
Gerard Connell	30 September 2003	31 July 2015 (retired on this date)
Neil Cooper	17 July 2014	30 August 2017
Gill Rider	22 June 2012	30 August 2018

The policy for Executive Directors' service contracts is to provide for 12 months' notice from either side

Non-executive Directors' letters of appointment contain three months' notice from either side and the Chairman's letter of appointment contains a six month notice period from either side

OUTSIDE APPOINTMENTS

Executive Directors may accept one board appointment in another company. Board approval must be sought before accepting an appointment. Fees may be retained by the Director. Currently no Executive Directors hold outside company appointments other than with industry bodies or governmental or quasi-governmental agencies

DIRECTOR CHANGES – ADDITIONAL INFORMATION

RETIREMENT OF MR K G HARVEY AND MR G CONNELL

Both Mr Harvey (Chairman) and Mr Connell retired from office on 31 July 2015. Neither Director received any compensation for loss of office.

Following his retirement Mr Harvey continued in office as the non-executive chairman of the board of Vinidor Limited. This appointment ceased on 31 March 2016 following the implementation of the new Group Board structure. Mr Harvey received fees amounting to £56,667 and benefits of £2,830 in respect of the Vinidor chairman role for the remaining eight months of the year.

Mr Connell, following his retirement, continued in office as a non-executive director on the board of Bournemouth Water until that board was disbanded on 31 March 2016 consequent upon the merger of Bournemouth Water and South West Water. Mr Connell received fees amounting to £13,333 in respect of this role.

SIR JOHN PARKER

Sir John Parker was appointed as a Non-executive Director and as Deputy Chairman of the Board on 1 April 2015.

His fee was determined to be 50% of that of the then Chairman's fee and was increased to the same level as that of his predecessor upon his taking up the appointment as Chairman on 1 August 2015. When appropriate for the efficient carrying out of his duties, he is provided with a driver and vehicle. He is entitled to expenses on the same basis as for other Non-executive Directors.

ALL EMPLOYEE, PERFORMANCE AND OTHER CONTEXTUAL INFORMATION

HISTORICAL TSR

The graph below shows the value, over the seven year period ended on 31 March 2016, of £100 invested in Pennon Group on 1 April 2009 compared with the value of £100 invested in the FTSE 250 Index. This index is considered appropriate as it is a broad equity market index of which the Company is a constituent.

Date	Pennon	FTSE 250
Apr-09	100	100
Apr-10	134	162
Apr-11	167	189
Apr-12	195	191
Apr-13	177	238
Apr-14	219	287
Apr-15	252	308
Apr-16	255	311

EQUIVALENT CHIEF EXECUTIVE OFFICER REMUNERATION

As the Company did not have a Group Chief Executive Officer until 31 January 2016, the Committee has provided historic single figure information in the form of the average remuneration of the Executive Directors for years up to and including 2014/15. Their remuneration was considered to be the most appropriate to use as they were the most senior executives in the Company.

For 2015/16 the Committee has provided the average remuneration for the Executive Directors (excluding the Group Chief Executive Officer) and the Group Chief Executive Officer's remuneration for the year, as explained in footnotes (i) and (ii) below.

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16 ⁽ⁱ⁾	2015/16 ⁽ⁱⁱ⁾
Average Executive Director single figure of remuneration (£000)	916	1,091	1,221	894	962	762	738	1,119
Annual bonus payout (% of maximum)	91.79	94.69	72.87	47.00	67.56	68.20	66.37	83.98
LTIP vesting (% of maximum) ⁽ⁱⁱⁱ⁾	67.30	50.00	79.30	50.00	30.20	0.00	34.50	34.50

(i) The average of the Executive Directors excluding the Group Chief Executive Officer.

(ii) Group Chief Executive Officer for the year including remuneration received between 1 April 2015 and 31 December 2015 when in position as Chief Executive, South West Water.

(iii) The long-term incentive plan (LTIP) vesting percentage is an estimate as at 19 May 2016 and excludes accrued dividends which are added on vesting.

DIRECTORS' REMUNERATION REPORT

CONTINUED

COMPARISON OF EXECUTIVE DIRECTOR REMUNERATION TO EMPLOYEE REMUNERATION

The table below shows the percentage change between 2014/15 and 2015/16 in base salary, benefits and annual bonus for the average of the Executive Directors (including the Group Chief Executive Officer from his appointment on 1 January 2016 and in his previous role as Chief Executive, South West Water) and all employees. To enable comparison, the remuneration of the previous Chief Financial Officer (previously titled Group Director of Finance) for 2014/15 has been included in the calculation of the percentage changes.

The percentage increase in average remuneration for employees is calculated using wages and salaries (excluding share-based payments) of £158.0 million (2014/15: £143.9 million) analysed into the three components in the table and the average number of employees of 4,987 (2014/15: 4,558) both as detailed in note 13 to the Group financial statements. To ensure a consistent calculation of year-on-year movements, Bournemouth Water's costs and employee numbers have been excluded.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
Average Executive Director remuneration	+2.95%	-20.01% ⁽ⁱ⁾	+8.63%
All employees	+0.5%	-0.9%	+9.6%

(i) This figure includes relocation costs for Ian McAulay. Without these benefits the change would have been -2.89%.

RELATIVE IMPORTANCE OF SPEND ON PAY

	2015/16 (£ million)	2014/15 (£ million)	Percentage change
Overall expenditure on pay ⁽ⁱ⁾	180.0	165.4	+8.8%
Distributions to ordinary shareholders	129.5	117.0	+10.7%
Distributions to perpetual capital security holders	20.3	20.3	–
Purchase of property, plant and equipment (cash flow)	283.7	298.1	-7.3%

(i) Excludes non-underlying items. 2015/16 includes Bournemouth Water expenditure on pay.

The above table illustrates the relative importance of spend on pay compared with distributions to equity holders. The purchase of property, plant and equipment (cash flow) has also been included as this was the most significant outgoing for the Company in the last financial year.

SHARE AWARD AND SHAREHOLDING DISCLOSURES (AUDITED INFORMATION)

SHARE AWARDS GRANTED DURING 2015/16

The table below sets out details of share awards made in the year to Executive Directors.

Executive Director	Type of interest	Basis of award	Face value £000	Percentage vesting at threshold performance	Performance period end date
Ian McAulay	PCP	100% of salary	400	30% of maximum	31 March 2018
Chris Loughlin			400		
Susan Davy			325		
Ian McAulay	Deferred bonus	50% of bonus awarded	101	n/a	26 July 2018
Chris Loughlin			151		
Susan Davy			78 ⁽ⁱ⁾		

Sharesave (SAYE) awards were also made as detailed on page 97.

(i) A proportion of the award made to Susan Davy related to her performance in her previous position with the Group as finance and regulatory director, South West Water.

PCP awards were calculated using the share price at the date of grant (1 July 2015) which was £8.105 per share. Deferred bonus awards were calculated using the share price at the date of grant (27 July 2015) which was £7.91.

DIRECTORS' SHAREHOLDING AND INTEREST IN SHARES

The Remuneration Committee believes that the interests of Executive Directors and senior management should be closely aligned with the interests of shareholders

To support this the Committee operates shareholding guidelines. The Executive Directors are expected to build up a shareholding in the Company in accordance with the Company's shareholding guideline which amounts to a shareholding interest equivalent to 100% of salary to be built up within the first five years of joining the Company at the rate of at least 20% per year by the end of each year.

This level of shareholding is then expected to be maintained by each Director and is revalued each year in accordance with the then prevailing share price and the Executive Director's salary.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of the Company as at 31 March 2016 (or date of cessation, if earlier) and 31 March 2015 together with their shareholding guideline obligation and interest are shown in the table below.

	Share interests (including connected parties) at 31 March 2016	Share interests (including connected parties) at 31 March 2015	Shareholding guideline (100% to be accrued over five years)	Shareholding guideline met?	Unvested awards				
					Performance shares (subject to performance conditions)	SAYE	Deferred bonus shares	ESOS	Buyout award
Susan Davy ⁽ⁱ⁾	44,197	38,557	40%	Yes	79,338	2,635	24,907	4,329	–
Chris Loughlin	247,745	225,045	100%	Yes	155,627	4,984	55,654	4,329	–
Ian McAulay	18,748	–	40%	Yes ⁽ⁱⁱ⁾	93,810	–	20,554	3,651	16,091

(i) Susan Davy's unvested awards include those she received in her previous position as finance and regulatory director, South West Water, which she retains an interest in following her appointment as Chief Financial Officer on 1 February 2015.

(ii) Due to salary increase timing and share price movement there is currently a small shortfall due to be made up in connection with the 2016/17 Performance and Co-investment Plan award to Ian McAulay.

Since 31 March 2016 3,618 additional ordinary shares in the Company have been acquired by Chris Loughlin as a result of participation in the Company's scrip dividend alternative and the Company's Share Incentive Plan, and 45 additional ordinary shares in the Company have been acquired by Susan Davy as a result of participation in the Company's Share Incentive Plan. There have been no other changes in the beneficial interests or the non-beneficial interests of the above Directors in the ordinary shares of the Company between 1 April 2016 and 20 May 2016.

DIRECTORS' REMUNERATION REPORT

CONTINUED

NON-EXECUTIVE DIRECTORS' SHAREHOLDING

The beneficial interests of the Non-executive Directors, including the beneficial interests of their spouses, civil partners, children and stepchildren, in the ordinary shares (40.7p) of the Company are shown in the table below

Director	Shares held at 31 March 2016	Shares held at 31 March 2015
Sir John Parker	10,000	–
Ken Harvey (retired 31 July 2015)	26,209	26,209
Martin Angle	–	–
Gerard Connell (retired 31 July 2015)	4,495	4,444
Neil Cooper	–	–
Gill Rider	2,500	2,500

There have been no changes in the beneficial interests or the non-beneficial interests of the above Directors in the ordinary shares of the Company between 1 April 2016 and 20 May 2016

There is no formal shareholding guideline for the Non-executive Directors, however, they are encouraged to purchase shares in the Company

SHAREHOLDER DILUTION

The Company can satisfy awards under its share plans with new issue shares or shares issued from treasury up to a maximum of 10% of its issued share capital in a rolling 10 year period to employees under its share plans. Within this 10% limit the Company can only issue (as newly issued shares or from treasury) 5% of its issued share capital to satisfy awards under discretionary or executive plans. The percentage of shares awarded within these guidelines and the headroom remaining available as at 17 May 2016 is as set out below

	Awarded	Headroom	Total
Discretionary schemes	1.48%	3.52%	5%
All schemes	4.18%	5.82%	10%

DETAILS OF SHARE AWARDS

(a) Performance and Co-investment 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 ordinary shares (40.7p each) of the Company shown below, representing the maximum number of shares to which they would become entitled under the plan should the relevant criteria be met in full

Director and date of award	Conditional awards held at 1 April 2015	Conditional awards made in year	Market price upon award in year	Vesting in year ⁽ⁱ⁾	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2016	Date of end of period for qualifying conditions to be fulfilled
Susan Davy⁽ⁱⁱ⁾							
3/7/12	17,696	–	768.50p	–	–	–	2/7/15
2/7/13	21,347	–	653.00p	–	–	21,347	1/7/16
14/7/14	17,893	–	798.50p	–	–	17,893	13/7/17
1/7/15	–	40,098	810.50p	–	–	40,098	30/6/18
Chris Loughlin							
3/7/12	48,145	–	768.50p	–	–	–	2/7/15
2/7/13	57,810	–	653.00p	–	–	57,810	1/7/16
14/7/14	48,465	–	798.50p	–	–	48,465	13/7/17
1/7/15	–	49,352	810.50p	–	–	49,352	30/6/18
Ian McAulay							
14/7/14	44,458	–	798.50p	–	–	44,458	13/7/17
1/7/15	–	49,352	810.50p	–	–	49,352	30/6/18

(i) None of the July 2012 award shares vested on 2 July 2015 due to the performance criteria not being met. Therefore all of the award lapsed

(ii) A portion of Susan Davy's share awards are those she received in her previous position as finance and regulatory director South West Water up to 31 January 2015 in which she retains an interest in her role as Chief Financial Officer

DIRECTORS' REMUNERATION REPORT

CONTINUED

DETAILS OF SHARE AWARDS CONTINUED

(b) Annual Incentive Bonus Plan – deferred bonus shares (long-term incentive element)

The following Directors had or have a contingent interest in the number of ordinary shares (40 7p each) of the Company shown below, representing the total number of shares to which they have or would become entitled under the deferred bonus element of the Annual Incentive Bonus Plan (the bonus plan) at the end of the relevant qualifying period

Director and date of award	Conditional awards held at 1 April 2015	Conditional awards made in year	Market price of each share upon award in year	Vesting in year	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2016	Date of end of period for qualifying conditions to be fulfilled
Susan Davy⁽ⁱ⁾							
27/7/12	7,263	–	754 50p	7,263 ⁽ⁱⁱ⁾	57	–	26/7/15
5/8/13 ⁽ⁱⁱⁱ⁾	7,555	–	693 00p	–	–	7,555	4/8/16
27/8/14	7,543	–	821 50p	–	–	7,543	26/8/17
27/7/15	–	9,809	791 00p	–	–	9,809	26/7/18
Chris Loughlin							
27/7/12	20,650	–	754 50p	20,650 ^(iv)	163	–	26/7/15
5/8/13 ⁽ⁱⁱⁱ⁾	16,978	–	693 00p	–	–	16,978	4/8/16
27/8/14	19,552	–	821 50p	–	–	19,552	26/8/17
27/7/15	–	19,124	791 00p	–	–	19,124	26/7/18
Ian McAulay							
30/9/13 ^(iv)	16,091	–	696 00p	–	–	16,091	29/9/16
27/8/14 ^(iv)	7,775	–	821 50p	–	–	7,775	26/8/17
27/7/15	–	12,779	791 00p	–	–	12,779	26/7/18

(i) A portion of Susan Davy's share awards are those she received in her previous position as finance and regulatory director South West Water up to 31 January 2015 in which she retains an interest in her position as Chief Financial Officer

(ii) These shares vested on 18 August 2015 at 791 10p per share

(iii) In connection with the awards made on 5 August 2013 (and 27 August 2014 to Ian McAulay) the Directors received options pursuant to the Company's executive share option scheme (ESOS) details of which are set out on page 97 These awards were made in conjunction with the operation of the bonus plan details of which are set out on page 80

(iv) This was a buyout award

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows

Susan Davy £9,251, Chris Loughlin £22,356*

* Chris Loughlin received his dividend in the form of ordinary shares (40 7p each) in the Company as a result of participation in the Company's scrip dividend alternative and these shares are included in the figure given for the additional ordinary shares (40 7p each) in the Company that he acquired since 31 March 2016 given on page 93

(c) Executive Share Option Scheme (ESOS)

The following Directors had a contingent interest in the number of options shown in the ordinary shares (40.7p each) of the Company pursuant to the Company's ESOS. Further details relating to the operation of the scheme are set out on page 80.

Date of award	Options held at 1 April 2015	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2016	Options held at 31 March 2016	Maturity date
Susan Davy⁽ⁱ⁾								
5/8/13	4,329	–	–	693.00p	–	811.00p	4,329	5/8/16
Chris Loughlin								
5/8/13	4,329	–	–	693.00p	–	811.00p	4,329	5/8/16
Ian McAulay								
27/8/14	3,651	–	–	821.50p	–	811.00p	3,651	27/8/17

(i) Susan Davy's share options are those she received in her previous position as finance and regulatory director, South West Water, up to 31 January 2015, in which she retains an interest in her position as Chief Financial Officer.

(d) Sharesave scheme

Details of options to subscribe for ordinary shares (40.7p each) of the Company under the all-employee Sharesave scheme were:

Date of award	Options held at 1 April 2015	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2016	Options held at 31 March 2016	Exercise period/maturity date
Susan Davy⁽ⁱ⁾								
29/6/12	1,530	–	1,530	588.00p	748.00p	–	–	1/9/15 – 28/2/16
24/6/15	–	2,635	–	683.00p	–	811.00p	2,635	1/9/18 – 28/2/19
Chris Loughlin								
3/7/13	2,788	–	–	538.00p	–	811.00p	2,788	1/9/18 – 28/2/19
24/6/15	–	2,196	–	683.00p	–	811.00p	2,196	1/9/20 – 28/2/21

(i) Susan Davy's share options are those she received in her previous position as finance and regulatory director, South West Water, up to 31 January 2015, in which she retains an interest in her position as Chief Financial Officer.

DIRECTORS' REMUNERATION REPORT CONTINUED

ADVISERS TO THE REMUNERATION COMMITTEE

During the year the Committee received advice or services which materially assisted the Committee in the consideration of remuneration matters from Ken Harvey, Chairman of the Company (until 31 July 2015), from Ken Woodier, Group General Counsel & Company Secretary (until 24 March 2016), from Chris Loughlin, Group Chief Executive Officer following his appointment on 1 January 2016, and from the following adviser who was appointed directly by the Committee

- Deloitte LLP on calculating the Company's total shareholder return compared with two comparator groups for the Company's long-term incentive plan on remuneration trends and on the fee level for the Group Chief Executive Officer and the Chief Financial Officer. Subsequent to the year end Deloitte LLP provided advice to the Committee on the form of the Directors' remuneration. Deloitte LLP's fees in respect of advice which materially assisted the Committee during 2015/16 were £28,740 (arrived at from an hourly rate basis of charging). Deloitte LLP also provided tax and share scheme advice to the Group, consulting, corporate finance and assurance advisory services to Vindor and assurance advisory services to South West Water. Deloitte LLP is a member of the Remuneration Consultants Group and as such voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. The Committee is satisfied that the advice it has received from Deloitte LLP has been objective and independent on the basis that it is an independent professional firm and complies with the code of conduct of the Remuneration Consultants Group referred to above.

STATEMENT OF VOTING AT GENERAL MEETING

The table below sets out the voting by the Company's shareholders on the resolution to approve the Directors' remuneration report at the Annual General Meeting held on 31 July 2015, including votes for, against and withheld.

Remuneration report	
For % (including votes at the Chairman's discretion)	98.26
Against %	1.74
Withheld number	3,072

A vote withheld is not counted in the calculation of the proportion of votes for and against a resolution.

The Remuneration Committee is pleased to note that over 98% of shareholders who voted approved the 2014/15 Directors' remuneration report. The Committee appreciates the continuing support of its shareholders.

On behalf of the Board



Martin D Angle
Chairman of the Remuneration Committee
24 May 2016

DIRECTORS' REPORT – OTHER STATUTORY DISCLOSURES

INTRODUCTION

This Directors' report is prepared in accordance with the provisions of the Companies Act 2006 and regulations made thereunder. It comprises pages 58 to 76 and 99 to 101 as well as the following matters which the Board considers are of strategic importance and, as permitted by legislation, has chosen to include in the strategic report rather than the Directors' report:

- risk management systems (page 51 of the strategic report)
- likely future developments of the Company (page 17 of the strategic report)
- important post-balance sheet events (note 45 of the notes to the financial statements)
- all matters relating to sustainability, which include details of the Group's carbon emissions (page 45 of the strategic report) and information relating to employee involvement (page 50) of the strategic report, as well as the disclosure below

In addition, the Directors' report includes the following disclosures (and any other disclosures) which are incorporated by reference:

- financial risk management (note 3 of the notes to the financial statements)
- financial instruments (notes 2(o) and 18 of the notes to the financial statements)

BOARD OF DIRECTORS

The Directors in office as at the date of this report (all of whom served during the year) are named on pages 60 and 61. In addition, Ken Harvey, the previous Chairman, and Gerard Connell, the previous Senior Independent Director, served during the year until their retirement from the Board on 31 July 2015.

FINANCIAL RESULTS AND DIVIDEND

The Directors recommend a final dividend of 23.12p per ordinary share to be paid on 2 September 2016 to shareholders on the register on 8 July 2016, making a total dividend for the year of 33.58p, the cost of which will be £138.5 million, resulting in a transfer to reserves of £13.6 million. The strategic report on pages 18 to 25 analyses the Group's financial results in more detail and sets out other financial information.

DIRECTORS' INSURANCE AND INDEMNITIES

The Directors have the benefit of the indemnity provisions contained in the Company's Articles of Association ('Articles') and the Company has maintained throughout the year Directors' and officers' liability insurance for the benefit of the Company, the Directors and its officers. The Company has entered into qualifying third party indemnity arrangements for the benefit of all its Directors in a form and scope which comply with the requirements of the Companies Act 2006 and which were in force throughout the year and remain in force.

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 persons with disabilities, and special arrangements and adjustments as necessary are made to ensure that 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. Information regarding the Group's workplace policies is provided on page 48.

The Board has a diversity policy and encourages gender diversity in particular. Further details of the Board's diversity policy are set out in the report of the Nomination Committee on page 74, and information regarding the diversity of the workforce is provided on page 50.

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 business performance of their employer and the financial and economic factors affecting the performance of the Group. The Group also cascades information monthly to all employees to provide them with important and up to date information about key events and to obtain feedback from them. Further information about employment matters relating to the Group is set out on pages 48 to 50 of the strategic report.

The Group encourages share ownership among its employees by operating an HM Revenue & Customs approved Sharesave scheme and Share Incentive Plan. Following shareholder approval at the 2014 AGM, these were amended to provide for the increased savings limits approved by government. At 31 March 2016 around 44% of the Group's employees were participating in these plans.

HUMAN RIGHTS AND ANTI-SLAVERY

The Group is fully supportive of the principles set out in the UN Declaration of Human Rights, and the Group Ethics Policy outlines the high standards of employment practice with which everyone in Pennon Group is expected to comply. The Group also supports the International Labour Organization's core conventions for the protection and safety of workforces wherever they may be throughout the Group.

The Group's commitment to ensuring the human rights of its employees are not infringed extends to those of its suppliers. Supplier codes of conduct are in place to ensure that people are treated fairly and with respect and dignity.

DIRECTORS' REPORT – OTHER STATUTORY DISCLOSURES CONTINUED

In addition following appropriate due diligence we have put in place policies and procedures to assess, monitor and reduce the risk of modern slavery and human trafficking occurring in our businesses and supply chains. Risk assessments of any high risk supply partners have been completed by Viridor, South West Water and Bournemouth Water to ensure compliance with the Modern Slavery Act across the Group and we are in the process of drafting our anti-slavery and human trafficking web-based statement for the financial year 2016/17. This will be available at www.pennon-group.co.uk in due course.

RESEARCH AND DEVELOPMENT

Research and development within the Group involving water and waste treatment processes amounted to £0.1 million during the year (2014/15 £0.1 million).

OVERSEAS BRANCHES

The Company has no overseas branches.

PENNON GROUP DONATIONS

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2014/15 nil).

PURCHASE OF OWN ORDINARY SHARES

The Company has authority from shareholders to purchase up to 10% of its own ordinary shares (as renewed at the Annual General Meeting in 2015), which was valid as at 31 March 2016 and remains currently valid. No purchases were made during the year. As at 1 April 2015, 389,515 shares were held in treasury with a nominal value of £158,533 and representing 0.1% of issued share capital. 379,159 treasury shares representing 0.09% of issued share capital as at 1 April 2015 were reissued during the year under the Company's employee share schemes for proceeds of £2.5 million.

DISCLOSURES REQUIRED BY PUBLICLY TRADED COMPANIES

The following disclosures are made pursuant to Part 6 of Schedule 7 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and Rule 7.2.6 R of the UK Listing Authority's Disclosure and Transparency Rules (DTR).

As at 31 March 2016

- a) Details of the Company's issued share capital, which consists of ordinary shares of nominal value 40.7 pence each, are set out in note 33 to the financial statements on page 160. All of the Company's issued shares are fully paid up, rank equally in all respects and are listed on the Official List and traded on the London Stock Exchange. The rights and obligations attaching to the Company's shares, in addition to those conferred on their holders by law, are set out in the Company's Articles, copies of which can be obtained from Companies House in the UK or by writing to the Group Company Secretary at the Company's registered office.
- b) There are no restrictions on the transfer of issued shares of the Company or on the exercise of voting rights attached to them, except where the Company has exercised its right to suspend their voting rights or to prohibit their transfer following the omission of their holder or any person interested in them to provide the Company with information requested by it in accordance with Part 22 of the Companies Act 2006 or where their holder is precluded from exercising voting rights by the Financial Conduct Authority's Listing Rules or the City Code on Takeovers and Mergers. There are no persons with special rights regarding control of the Company. No shares issued under the employee share schemes have rights with regard to control of the Company that are not exercisable directly by the employees.
- c) Details of significant direct or indirect holdings of securities of the Company are set out in the shareholder analysis on page 174. The Company is not aware of any agreements between shareholders which may result in restrictions on the transfer of securities or on voting rights.
- d) The Company's rules about the appointment and replacement of Directors are contained in the Articles and accord with usual English company law provisions. The powers of Directors are determined by UK legislation and the Articles in force from time to time. Changes to the Articles must be approved by the Company's shareholders by passing a special resolution.
- e) The Directors have the power to make purchases of the Company's own shares in issue as set out above. The Directors also have the authority to allot shares up to an aggregate nominal value of (i) £55,765,009 (such amount to be reduced by any shares allotted or rights granted under (ii) below in excess of £55,765,009), and (ii) £111,530,018 by way of a rights issue (such amount to be reduced by any shares allotted or rights granted from (i) above), which was approved by shareholders at the 2015 Annual General Meeting (AGM). In addition, shareholders approved a resolution giving the Directors a limited authority to allot shares for cash other than pro rata to existing shareholders. These resolutions remain valid until the conclusion of this year's AGM. Similar resolutions will be proposed at this year's AGM. The Directors have no present intention to issue ordinary shares other than pursuant to the Company's employee share schemes and the scrip dividend alternative.
- f) There are a number of agreements which take effect, alter or terminate upon a change of control of the Company following a takeover bid, such as bank loan agreements, eurobond documentation, hybrid capital securities documentation, private placement debt and employees' share plans. This may result in certain funding agreements being altered or repaid early. The impact on employees' share plans is not considered significant, and
- g) There are no agreements between the Company and its Directors or employees providing for compensation for loss of office or employment that occurs because of a takeover bid.

GOING CONCERN

Having considered the Group's funding position and financial projections the Directors have a reasonable expectation that the Group has adequate resource 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.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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 (IFRSs) as adopted by the European Union.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the 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 accounting estimates which are reasonable and prudent
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements

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

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Group and the Company, and enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the International Accounting Standards (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.

Each of the Directors, whose names and functions are listed on pages 60 and 61, confirms that, to the best of his or her knowledge

- i) The financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union give a true and fair view of the assets, liabilities, financial position and profit of the Group and of the Company.
- ii) The strategic report (pages 4 to 55) and the Directors' report (pages 99 to 101) include a fair review of the development and performance of the business during the year and the position of the Company and the Group at the year end together with a description of the principal risks and uncertainties they face.
- iii) Following receipt of advice from the Audit Committee, that the annual report, taken as a whole is fair, balanced and understandable, and provides the information necessary for the shareholders to assess the Group's performance, business model and strategy.

The Directors are responsible for the maintenance and integrity of the Company's website www.pennon-group.co.uk. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

STATEMENT AS TO DISCLOSURE OF INFORMATION TO THE AUDITOR

- i) So far as each of the Directors in office at the date of the signing of the report is aware, there is no relevant audit information of which the Company's auditor is unaware, and
- ii) each of the Directors has taken all the steps each Director ought to have taken individually as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

The Directors' report consisting of pages 58 to 76 and 99 to 101 was approved by the Board on 24 May 2016.

By Order of the Board



Helen Barrett-Hague
Group Company Secretary
24 May 2016

FINANCIAL STATEMENTS AND SHAREHOLDER INFORMATION

FINANCIAL STATEMENTS AND SHAREHOLDER INFORMATION

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**STRONG CASH INFLOW
FROM OPERATIONS**

**CONTINUING
INVESTMENT
FOR GROWTH**

**SOLID FINANCIAL
POSITION
UNDERPINNING
CAPITAL INVESTMENT**

INDEPENDENT AUDITOR'S REPORT

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF PENNON GROUP PLC

OPINION ON FINANCIAL STATEMENTS

In our opinion

- Pennon Group Plc's Group financial statements and Parent Company financial statements (the financial statements) give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2016 and of the Group's profit for the year then ended,
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006, and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and as regards the Group financial statements, Article 4 of the IAS Regulation

WHAT WE HAVE AUDITED

Pennon Group Plc's financial statements comprise

Group	Parent Company
Consolidated income statement for the year then ended	
Consolidated statement of comprehensive income for the year then ended	
Consolidated balance sheet as at 31 March 2016	Balance sheet as at 31 March 2016
Consolidated statement of changes in equity for the year then ended	Statement of changes in equity for the year then ended
Consolidated cash flow statement for the year then ended	Cash flow statement for the year then ended
Related notes 1 to 46 to the financial statements	Related notes 1 to 46 to the financial statements

- The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and as regards the parent company financial statements as applied in accordance with the provisions of the Companies Act 2006

OVERVIEW OF OUR AUDIT APPROACH

Risks of material misstatement	<ul style="list-style-type: none"> • Completeness of provisions for uncertain tax positions and tax disclosures (Group, including SWW & Vindor) • Valuation of goodwill (Group) • Valuation of non-current assets (Vindor) • Valuation of landfill related provisions (Vindor) • Revenue recognition across the Group's operations • Valuation of the provision for doubtful debts (SWW)
Audit scope	<ul style="list-style-type: none"> • We performed an audit of the complete financial information of four components • The components where we performed full audit procedures accounted for 100% of Profit before taxation before non-underlying items 100% of Revenue and 95% of Total assets
Materiality	<ul style="list-style-type: none"> • Overall Group materiality of £10m which represents approximately 5% of Profit before taxation before non-underlying items

OUR ASSESSMENT OF RISKS OF MATERIAL MISSTATEMENT

We identified the risks of material misstatement described below as those that had the greatest effect on the overall audit strategy; the allocation of resources in the audit, and direction of the efforts of the audit team. The identified risks are consistent with prior year. In addressing these risks, we have performed the procedures below which were designed in the context of the financial statements as a whole and, consequently we do not express any opinion on these individual areas.

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p>COMPLETENESS OF PROVISIONS FOR UNCERTAIN TAX POSITIONS AND RELATED TAX DISCLOSURES (GROUP, INCLUDING SWW AND VIRIDOR)</p> <p>The Group's current tax liability of £371 million (2015: £52.2 million) shown in note 27 includes £371 million (2015: £36.6 million) in respect of open tax computations relating to prior years where liabilities are yet to be agreed with HM Revenue & Customs (HMRC).</p> <p>Pennon has a number of open periods with HMRC as a result of on-going enquiries into the interpretation of tax legislation regarding transactions undertaken by the Group. The Group evaluates uncertain tax items and where appropriate establishes provisions for uncertain tax positions based on the status of discussions with HMRC. Significant management judgement is required in estimating tax expected to be paid for uncertain tax items.</p> <p>There is also limited HMRC guidance available in relation to the tax treatment associated with IFRIC 12 'Service concession arrangements' accounting.</p> <p>Critical accounting judgements and estimates made by management in applying the Group's taxation accounting policy are disclosed in note 4.</p> <p>Audit Committee commentary is on page 68.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> We inspected the latest correspondence between the Group and HMRC. We read legal advice or opinion management have obtained in the period in relation to uncertain tax positions in order to verify whether the level of provision is based on up to date legal advice in response to HMRC's challenges. We obtained an updated view from internal tax specialists as to HMRC's current position on open matters. We assessed the level of provision maintained for uncertain tax positions in light of third party evidence obtained, the views of our tax specialists and the level of coverage provided by the provision for the total tax that could become payable. We tested whether the tax accounting and disclosures in note 9 and 27 complied with the requirements of IAS12 'Income Taxes'. We read the tax disclosures in the Annual Report and Accounts and evaluated the adequacy of these. 	<p>We concluded that the tax amounts and disclosures in the Annual Report and Accounts for the year ended 31 March 2016 are appropriate.</p> <p>We concur with the approach adopted in respect of uncertain tax positions, and conclude that the provision is appropriate, taking into account our review of third party advice and views of our internal tax specialists.</p>

INDEPENDENT AUDITOR'S REPORT CONTINUED

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p>VALUATION OF GOODWILL (GROUP)</p> <p>The value of goodwill is £385.0 million (2015: £339.3 million), as included in note 15. Goodwill has increased during the year following the acquisition of Bournemouth Water and an annual impairment test is required, with key assumptions being future allowed tariff increases, delivery of operational efficiencies and the discount rate applied.</p> <p>The value in use of the Viridor business, to which goodwill of £339.3 million has arisen, is based on assumptions over growth rates, future landfill volumes, power generation prices and discount rates, which require judgement.</p> <p>There is a risk that assumptions and judgements made by management, in calculating the value in use of the cash generating units (CGUs), could be susceptible to management bias.</p> <p>Critical accounting judgements and estimates made by management, when testing goodwill for impairment, are disclosed in note 4.</p> <p>Audit Committee commentary is on page 68.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> We validated management's determination that the Viridor waste management business was a single CGU. We tested the clerical accuracy of the models by reperformance of a sample of calculations. We agreed input data into the goodwill impairment model and cash flow forecasts to approved business plans, and for Viridor we performed sensitivity analysis over this data, including growth rates, volumes, and power generation prices. We benchmarked the discount rate calculation applied at Group level, using our internal valuation experts to assist in our review of whether management's assumptions are within an acceptable range based on comparative market data. We agreed whether disclosures made are in accordance with IFRS. 	<p>We concluded that management has determined cash generating units and allocated goodwill to those CGUs at an appropriate level, being the lowest level within the Group, at which goodwill is monitored for internal management purposes.</p> <p>We concluded that the discount rates and cash flow assumptions applied by management were within an appropriate range and supported management's conclusion that no impairment in goodwill was necessary.</p> <p>We concur with management's assessment that the recently acquired Bournemouth Water business has outperformed its budget for the year and therefore the newly recognised goodwill is not impaired.</p>
<p>VALUATION OF NON-CURRENT ASSETS (VIRIDOR)</p> <p>The net book value of Viridor's property, plant and equipment is £1,012 million (2015: £945.3 million), as included in note 17. The Group is required to review the carrying value of assets when impairment indicators are identified. During the year, a detailed exercise has been performed by management to re-evaluate the structure of the CGUs within the Viridor business. The risk of impairment may arise if management uses inappropriate assumptions to group assets into CGUs or if impairment indicators are not appropriately considered at year end.</p> <p>This risk has decreased in the current year due to the alignment of CGUs to reflect changes in the waste market and reorientation of Viridor's operations towards Energy Recovery Facilities (ERFs), which has resulted in a higher level of headroom.</p> <p>Critical accounting judgements and estimates made by management, in revising the CGUs and testing assets for impairment, are disclosed in note 4.</p> <p>Audit Committee commentary is on page 68.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> We discussed with management the change in approach to identifying the CGUs and obtained a detailed understanding of the changes in the business operations and environment underlying this change. We validated that the change in CGUs has been correctly applied to the grouping of assets and assessment of the contractual cash flows from customers to the revised CGUs. We tested the accounting entries arising from the revised CGUs from the calculations to the amounts recorded in the financial statements for impairment reversals and charges. We tested management's assessment of impairment at the year end, to supporting evidence and considered whether, in our opinion, there were any other indicators of impairment at the balance sheet date. We benchmarked the discount rates applied using our internal valuation experts to assist in our review of whether management's assumptions are within an acceptable range based on comparative market data. We tested the clerical accuracy of the impairment model by reperformance of the calculation. We also agreed input data into the impairment model and agreed cash flow forecasts to approved business plans. We agreed whether disclosures made are in accordance with IFRS. 	<p>We concluded that the revised CGU structure is appropriate and the timing of the revision to CGUs is consistent with the significant operational developments within the Viridor business.</p> <p>We concluded that the impairment assessment performed by management and the impairment adjustments recognised and disclosed, as a result of the revised CGU structure, are appropriate.</p>

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p>VALUATION OF LANDFILL RELATED PROVISIONS (VIRIDOR)</p> <p>Landfill related provisions of £182.1 million (2015: £193.0 million) are recorded in note 32 and consist of aftercare, restoration and remediation provisions.</p> <p>Calculation of the aftercare provision involves significant judgement in respect of the expected period of aftercare, the level of costs to be incurred and the discount rate to be used.</p> <p>Key areas of estimation for the restoration provision include the expected restoration costs, the void space to be filled and timing of site closure.</p> <p>Judgement over the remedial action required to comply with current environmental legislation where breaches have been identified is a key estimate for the remediation provision.</p> <p>There is risk that provisions could be misstated if inappropriate assumptions such as discount rates, are applied by management.</p> <p>Critical accounting judgements and estimates made by management when recognising landfill related provisions are disclosed in note 4.</p> <p>Audit Committee commentary is on page 68.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> We evaluated the forecast costs in the models agreeing these to supporting evidence such as budgets and current performance. We assessed the reasonableness of material judgements made, including expected gas generation and anticipated cost savings to detailed plans and current performance. We compared the reasonableness of key assumptions used in the calculation of the provisions including the discount rates, inflation rates, void space and remaining lives of the sites to available market information. We performed sensitivity analysis on these key assumptions. We tested the aftercare, restoration and remediation provision models, and verified that the models are clerically accurate. 	<p>We concluded that the assumptions supporting the landfill related provisions reflect management's best estimates, informed by latest external and internal data, and consider that the provisions are within an acceptable range.</p>

INDEPENDENT AUDITOR'S REPORT CONTINUED

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p>REVENUE RECOGNITION ACROSS THE GROUP'S OPERATIONS</p> <p>The Group's material revenue streams relate to the provision of water and sewerage services by South West Water water services by Bournemouth Water and revenue generated from the renewable energy recycling and waste management services provided by Vinidor ISAs (UK & Ireland) presume there is a risk of fraud relating to revenue recognition. For the Group given targets associated to financial performance and also pressures to meet market expectations there is a risk that revenue might be overstated. This risk over revenue recognition specifically arises in the following judgemental areas where there is opportunity to overstate revenue</p> <p>South West Water and Bournemouth Water</p> <ul style="list-style-type: none"> Income from measured water services requires an estimation of the amount of unbilled charges at the year end. This is calculated using a combination of system generated information based on previous customer volume usage together with management judgements as to the likely impact on usage of factors such as recent weather patterns. The accrued income balance at 31 March 2016 is £67.8 million (2015: £61.0 million) For unmeasured revenue the bills for each calendar year are raised in advance for the next financial year. Therefore there is a risk that revenues are recorded in the incorrect period if the advance billing element is not properly excluded and carried forward in the balance sheet 		<p>Our procedures include</p> <p>South West Water and Bournemouth Water</p> <ul style="list-style-type: none"> We obtained an understanding of the process for the supply of measured services meter reading and related billing in order to challenge the completeness of adjustments to reflect the accrual or deferral of revenue We tested key controls linked to system generated information and around the estimation process for measured revenue We compared the accrued income to bills raised post year end for a sample of customers and compared management's history of estimating the accrued income balance to bills raised in the subsequent year We performed a walkthrough of the process for unmeasured revenue and the annual billing cycle We performed controls testing related to the calculation of system generated billing for unmeasured revenue We obtained details of the billing runs in February and March and verified whether there were any other billing runs for unmeasured revenue that should be excluded from 2015/16 total revenue We corroborated the key assumptions and estimates made by management in recognising revenue by obtaining internal and external data on factors that influence demand from customers We tested whether contract terms and conditions are met and revenue recognised at the correct time in accordance with IFRS We performed detailed analytical procedures by comparing revenue balances for the year against expectation and obtaining support for significant variances We performed detailed testing of samples of transactions to underlying bills for both types of revenue In performing our journal testing we paid increased attention to entries impacting revenue particularly those raised close to the balance sheet date 	<p>South West Water and Bournemouth Water</p> <p>We concluded that the basis of calculation of the measured income accrual is appropriate. Management assumptions in respect of customer demand are within an acceptable range.</p> <p>Amounts identified as advance billing have been correctly recorded.</p>

Risk	Risk direction	Our response to the risk	What we concluded to the Audit Committee
<p>Viridor</p> <ul style="list-style-type: none"> Calculations of accrued income on waste management contracts and powergen revenue to be received involve estimation by management Accounting for revenue from long term service concession arrangements under IFRIC12 requires revenue to be recognised on construction during service delivery and as a capital return on the asset Recognising revenue in the correct period for invoices raised close to the balance sheet date may involve management judgement <p>Critical accounting judgements and estimates made by management in applying the Group's revenue recognition policy are disclosed in note 4</p> <p>Audit Committee commentary is on page 68</p>		<p>Viridor</p> <ul style="list-style-type: none"> We compared the key assumptions and estimates made by management in recognising revenue to prior year and monthly trends and to external customer confirmations For material items we re-performed the calculation to confirm the accuracy of the accrued and deferred income recorded by management In performing our journal testing we paid increased attention to entries impacting revenue, particularly those raised close to the balance sheet date We agreed whether the revenue recognition policies adopted comply with IFRSs in particular the requirements of IFRIC12 and whether margins used to recognise revenue are appropriate We performed cut off testing of invoices raised prior to and after the balance sheet date to ensure revenue has been recognised in the correct period 	<p>Viridor</p> <p>We concluded that revenue has been recorded in the correct accounting period accrued income has been appropriately recognised and IFRIC 12 appropriately applied</p>
<p>VALUATION OF THE PROVISION FOR DOUBTFUL DEBTS (SOUTH WEST WATER)</p> <p>As shown in note 22 there is a provision of £102.8 million (2015: £86.8 million) at the year end against gross trade debtors of £306.4 million (2015: £282.5 million)</p> <p>The South West Water provision is calculated using a combination of system generated information on historic debt recovery rates and management's judgement of the future likely recovery rates</p> <p>There is a risk that the assumptions used by management in calculating the bad debt provision may be inappropriate and the valuation of the provision against trade receivables may be misstated</p> <p>Critical accounting judgements and estimates made by management, in providing for doubtful debts are disclosed in note 4</p> <p>Audit Committee commentary is on page 68</p>		<p>Our procedures include</p> <ul style="list-style-type: none"> We tested controls over the integrity of data and the report utilised to generate the ageing and categorisation of debt within South West Water's billing system We tested historic data on collection rates and evaluated how this data was used in the preparation of the bad debt provision We corroborated the assumptions used by management in determining the amounts provided against the different categories and age of debt by comparing these assumptions to historic collection rates and by considering the impact of changes in the methods adopted operationally by management to collect debt and in the external environment We utilised collection information over the past three years to determine a range of the likely ultimate collection of debts existing at the balance sheet date and compared this to the provision recorded by management 	<p>We concluded that the doubtful debt provision is within an acceptable range and reflects recent history of collection of outstanding debts</p>

INDEPENDENT AUDITOR'S REPORT CONTINUED

THE SCOPE OF OUR AUDIT

TAILORING THE SCOPE

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for each entity within the Group. Taken together, this enables us to form an opinion on the consolidated financial statements. We take into account size, risk profile, the organisation of the group and effectiveness of group-wide controls, changes in the business environment and other factors such as recent internal audit results when assessing the level of work to be performed at each entity.

In assessing the risk of material misstatement to the Group financial statements, and to ensure we had adequate quantitative coverage of significant accounts in the financial statements, of the six reporting components of the Group, we performed an audit of the complete financial information of four components ('full scope component') which were selected based on their size or risk characteristics. These components include Pennon Group Plc, Viridor, South West Water and Bournemouth Water and represent the principal business units within the Group.

For the current year, the full scope components contributed 100% (2015: 99%) of the Group's profit before taxation before non-underlying items, 100% (2015: 99%) of the Group's Revenue and 95% (2015: 95%) of the Group's Total assets.

The remaining two components, individually and in aggregate, represent less than 1% of the Group's profit before taxation before non-underlying items. For these components which include Peninsula Insurance and Peninsula Leasing, we performed other procedures, including analytical review procedures, testing of consolidation journals and intercompany eliminations for each component to respond to potential risks of material misstatement to the Group financial statements.

CHANGES FROM THE PRIOR YEAR

There were two changes in scope from the prior year. The first was that Bournemouth Water, which was acquired by Pennon Group Plc in April 2015, was designated as full scope for the current year audit. The second change was that the scope determined for Peninsula Insurance was changed from specific scope to review scope, reflecting the fact that, with the growth in Group activities, including profit before taxation before non-underlying items, this component is now less than 1% of the Group.

INVOLVEMENT WITH COMPONENT TEAMS

There are three key locations where we perform audit procedures for the Group and its components: being Exeter, Taunton and Bournemouth. The Pennon Group Plc and South West Water accounting functions are based in Exeter and the audit teams of these components are led by the same audit executive. Separate teams audit Viridor in Taunton and Bournemouth Water in Bournemouth. The primary team interacted regularly with all teams during various stages of the audit, including review of key working papers, review of work performed to address the risks of material misstatement and attendance at key meetings with management.

OUR APPLICATION OF MATERIALITY

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

MATERIALITY

The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.

We determined materiality for the Group to be £10 million (2015: £10 million), which is 5% (2015: 5%) of profit before taxation before non-underlying items. We believe that profit before taxation before non-underlying items provides us with an appropriate measure of the underlying performance of the Group. We excluded non-underlying items on the basis that these are infrequent in occurrence and profit before taxation after non-underlying items is not indicative of the underlying performance of the Group. We also note that market and analyst commentary on the performance of the Group uses the same measure. We therefore, considered profit before taxation before non-underlying items to be the most relevant performance metric on which to base our materiality calculation.

Starting basis	Reported profit before taxation £206.3 million (2015: £197.0 million)
Adjustments	Non-underlying items – increase basis by £5.0 million (2015: £13.7 million)
Materiality	Totals £211.3 million (2015: £210.7 million) profit before taxation before non-underlying items Materiality of £10 million (5% of profit before taxation before exceptional items)

PERFORMANCE MATERIALITY

The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that performance materiality was 75% (2015 50%) of our planning materiality, namely £7.5 million (2015 £5 million). We have increased our assessment of performance materiality from 50% to 75% during the year, reflecting the fact that the prior year was a first year audit, and also based on our assessment of the Group's internal control environment and the extent and nature of audit findings identified in the prior period.

Audit work at component locations for the purpose of obtaining audit coverage over significant financial statement accounts is undertaken based on a percentage of total performance materiality. The performance materiality set for each component is based on the relative scale and risk of the component to the Group as a whole and our assessment of the risk of misstatement at that component. In the current year, the range of performance materiality allocated to components was £1.49 million to £7.07 million (2015 £1 million to £4.25 million).

REPORTING THRESHOLD

An amount below which identified misstatements are considered as being clearly trivial.

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.5 million (2015 £0.5 million), which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

SCOPE OF THE AUDIT OF THE FINANCIAL STATEMENTS

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Group's and the Parent Company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the Directors, and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITOR

As explained more fully in the Directors' Responsibilities Statement set out on page 101, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report is made solely to the Company's members as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work for this report, or for the opinions we have formed.

INDEPENDENT AUDITOR'S REPORT CONTINUED

OPINION ON OTHER MATTERS PRESCRIBED BY THE COMPANIES ACT 2006

In our opinion

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006,
- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements

MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

ISAs (UK and Ireland) reporting	<p>We are required to report to you if, in our opinion, financial and non-financial information in the annual report is</p> <ul style="list-style-type: none"> • materially inconsistent with the information in the audited financial statements, or • apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit, or • otherwise misleading <p>In particular, we are required to report whether we have identified any inconsistencies between our knowledge acquired in the course of performing the audit and the directors' statement that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy, and whether the annual report appropriately addresses those matters that we communicated to the audit committee that we consider should have been disclosed</p>	We have no exceptions to report
Companies Act 2006 reporting	<p>We are required to report to you if, in our opinion</p> <ul style="list-style-type: none"> • adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us, or • the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns, or • certain disclosures of directors' remuneration specified by law are not made, or • we have not received all the information and explanations we require for our audit, or • a Corporate Governance Statement has not been prepared by the Company 	We have no exceptions to report
Listing Rules review requirements	<p>We are required to review</p> <ul style="list-style-type: none"> • the directors' statement in relation to going concern, set out on page 100, and longer-term viability set out on page 55, and • the part of the Corporate Governance Statement relating to the company's compliance with the provisions of the UK Corporate Governance Code specified for our review 	We have no exceptions to report

STATEMENT ON THE DIRECTORS' ASSESSMENT OF THE PRINCIPAL RISKS THAT WOULD THREATEN THE SOLVENCY OR LIQUIDITY OF THE ENTITY

ISAs (UK and Ireland) reporting

We are required to give a statement as to whether we have anything material to add or to draw attention to in relation to

We have no exceptions to report

- the directors' confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity
- the disclosures in the annual report that describe those risks and explain how they are being managed or mitigated
- the directors' statement in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements, and
- the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions

Ernst & Young LLP

Debbie O'Hanlon (Senior statutory auditor)

for and on behalf of

Ernst & Young LLP, Statutory Auditor

Reading

24 May 2016

Notes

1. The maintenance and integrity of the Pennon Group Plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.
2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 2016

	Notes	Before non- underlying items 2016 £m	Non-underlying items (Note 6) 2016 £m	Total 2016 £m	Before non- underlying items 2015 £m	Non-underlying items (Note 6) 2015 £m	Total 2015 £m
Revenue	5	1,352.3	–	1,352.3	1,357.2	–	1,357.2
Operating costs	7						
Employment costs		(180.0)	(8.6)	(188.6)	(164.3)	14.9	(149.4)
Raw materials and consumables used		(114.7)	–	(114.7)	(103.8)	–	(103.8)
Other operating expenses		(609.2)	(1.6)	(610.8)	(678.1)	(4.3)	(682.4)
Earnings before interest, tax, depreciation and amortisation	5	448.4	(10.2)	438.2	411.0	10.6	421.6
Depreciation, amortisation and impairment	7	(186.6)	–	(186.6)	(164.4)	(24.3)	(188.7)
Operating profit	5	261.8	(10.2)	251.6	246.6	(13.7)	232.9
Finance income	8	42.1	5.2	47.3	44.0	–	44.0
Finance costs	8	(96.2)	–	(96.2)	(84.8)	–	(84.8)
Net finance costs	8	(54.1)	5.2	(48.9)	(40.8)	–	(40.8)
Share of post-tax profit from joint ventures	20	3.6	–	3.6	4.9	–	4.9
Profit before tax	5	211.3	(5.0)	206.3	210.7	(13.7)	197.0
Taxation (charge)/credit	9	(72.1)	34.1	(38.0)	(57.4)	2.7	(54.7)
Profit for the year		139.2	29.1	168.3	153.3	(11.0)	142.3
Attributable to							
Ordinary shareholders of the parent		123.0	29.1	152.1	137.3	(11.0)	126.3
Perpetual capital security holders		16.2	–	16.2	16.0	–	16.0
Earnings per ordinary share (pence per share)	11						
– Basic				37.0			32.3
– Diluted				36.9			32.2
– Before non-underlying items and deferred tax				39.5			39.8

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 2016

	Notes	Before non- underlying items 2016 £m	Non-underlying items (Note 6) 2016 £m	Total 2016 £m	Before non- underlying items 2015 £m	Non-underlying items (Note 6) 2015 £m	Total 2015 £m
Profit for the year		139.2	29.1	168.3	153.3	(11.0)	142.3
Other comprehensive income/ (loss)							
<i>Items that will not be reclassified to profit or loss</i>							
Remeasurement of defined benefit obligations	30	(2.6)	–	(2.6)	(2.1)	–	(2.1)
Income tax on items that will not be reclassified	9, 31	0.6	(3.0)	(2.4)	0.4	–	0.4
Total items that will not be reclassified to profit or loss		(2.0)	(3.0)	(5.0)	(1.7)	–	(1.7)
<i>Items that may be reclassified subsequently to profit or loss</i>							
Share of other comprehensive income from joint ventures	20	2.4	–	2.4	1.1	–	1.1
Cash flow hedges		5.0	–	5.0	(36.8)	–	(36.8)
Income tax on items that may be reclassified	9, 31	(1.0)	(0.8)	(1.8)	5.7	–	5.7
Total items that may be reclassified subsequently to profit or loss		6.4	(0.8)	5.6	(30.0)	–	(30.0)
Other comprehensive income/ (loss) for the year net of tax	36	4.4	(3.8)	0.6	(31.7)	–	(31.7)
Total comprehensive income for the year		143.6	25.3	168.9	121.6	(11.0)	110.6
Total comprehensive income attributable to							
Ordinary shareholders of the parent		127.4	25.3	152.7	105.6	(11.0)	94.6
Perpetual capital security holders		16.2	–	16.2	16.0	–	16.0

The notes on pages 119 to 171 form part of these financial statements

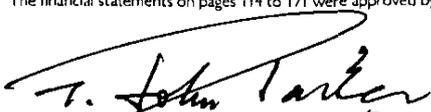
BALANCE SHEETS

AT 31 MARCH 2016

	Notes	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
Assets					
Non-current assets					
Goodwill	15	385 0	339 3	–	–
Other intangible assets	16	63 8	56 4	–	–
Property plant and equipment	17	3,897 3	3,578 8	0 1	0 1
Other non-current assets	19	267 8	291 1	905 5	790 0
Deferred tax assets	31	–	–	2 2	3 0
Derivative financial instruments	23	62 7	60 2	1 3	–
Investments in subsidiary undertakings	20	–	–	1,628 3	1 523 6
Investments in joint ventures	20	0 1	0 1	–	–
		4,676 7	4 325 9	2,537 4	2 316 7
Current assets					
Inventories	21	20 6	15 0	–	–
Trade and other receivables	22	323 5	287 7	77 4	156 2
Financial assets at fair value through profit	24	–	0 1	–	–
Derivative financial instruments	23	9 5	8 1	0 5	–
Cash and cash deposits	25	632 2	771 0	429 7	532 5
		985 8	1 081 9	507 6	688 7
Liabilities					
Current liabilities					
Borrowings	28	(65 0)	(113 6)	(287 2)	(333 9)
Financial liabilities at fair value through profit	24	(2 2)	–	–	–
Derivative financial instruments	23	(17 4)	(19 5)	(2 7)	(2 9)
Trade and other payables	26	(264 6)	(277 7)	(5 9)	(5 6)
Current tax liabilities	27	(37 1)	(52 2)	(53 5)	(23 8)
Provisions	32	(50 4)	(32 9)	–	–
		(436 7)	(495 9)	(349 3)	(366 2)
Net current assets		549 1	586 0	158 3	322 5
Non-current liabilities					
Borrowings	28	(3,051 6)	(2 854 5)	(877 1)	(885 4)
Other non-current liabilities	29	(113 2)	(110 1)	(8 7)	(8 7)
Financial liabilities at fair value through profit	24	(51 0)	(57 3)	(1 6)	(0 5)
Derivative financial instruments	23	(38 5)	(46 0)	(9 1)	(14 5)
Retirement benefit obligations	30	(40 9)	(59 6)	(3 0)	(4 2)
Deferred tax liabilities	31	(272 0)	(235 9)	–	–
Provisions	32	(171 0)	(194 4)	–	–
		(3,738 2)	(3 557 8)	(899 5)	(913 3)
Net assets		1,487 6	1 354 1	1,796 2	1 725 9
Shareholders' Equity					
Share capital	33	167 8	162 4	167 8	162 4
Share premium account	34	213 3	118 6	213 3	118 6
Capital redemption reserve	35	144 2	144 2	144 2	144 2
Retained earnings and other reserves	36	667 5	634 1	976 1	1 005 9
Total shareholders' equity		1,192 8	1 059 3	1,501 4	1 431 1
Perpetual capital securities	37	294 8	294 8	294 8	294 8
Total equity		1,487 6	1 354 1	1,796 2	1 725 9

The notes on pages 119 to 171 form part of these financial statements

The financial statements on pages 114 to 171 were approved by the Board of Directors and authorised for issue on 24 May 2016 and were signed on its behalf by:



Sir John Parker Chairman Pennon Group Plc

Registered Office Peninsula House, Rydon Lane Exeter, Devon, England EX2 7HR Registered in England Number 2366640

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 2016

	Share capital (Note 33) £m	Share premium account (Note 34) £m	Capital redemption reserve (Note 35) £m	Retained earnings and other reserves (Note 36) £m	Perpetual capital securities (Note 37) £m	Total equity £m
Group						
At 1 April 2014	151.3	4.9	144.2	602.4	294.8	1,197.6
Profit for the year	-	-	-	126.3	16.0	142.3
Other comprehensive loss for the year	-	-	-	(31.7)	-	(31.7)
Total comprehensive income for the year	-	-	-	94.6	16.0	110.6
Transactions with equity shareholders						
Dividends paid	-	-	-	(117.0)	-	(117.0)
Adjustment for shares issued under the Scrip Dividend Alternative	2.6	(2.6)	-	48.0	-	48.0
Convertible bond – equity issuance	8.5	116.3	-	(0.5)	-	124.3
Adjustment in respect of share-based payments (net of tax)	-	-	-	3.5	-	3.5
Distributions to perpetual capital security holders	-	-	-	-	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	4.3	4.3
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	-	-	-	(0.8)	-	(0.8)
Proceeds from treasury shares re-issued	-	-	-	3.9	-	3.9
Total transactions with equity shareholders	11.1	113.7	-	(62.9)	(16.0)	45.9
At 31 March 2015	162.4	118.6	144.2	634.1	294.8	1,354.1
Profit for the year	-	-	-	152.1	16.2	168.3
Other comprehensive income for the year	-	-	-	0.6	-	0.6
Total comprehensive income for the year	-	-	-	152.7	16.2	168.9
Transactions with equity shareholders						
Dividends paid	-	-	-	(129.5)	-	(129.5)
Adjustment for shares issued under the Scrip Dividend Alternative	0.3	(0.3)	-	6.3	-	6.3
Adjustment in respect of share-based payments (net of tax)	-	-	-	2.5	-	2.5
Equity issuance	4.9	95.4	-	-	-	100.3
Equity issuance related costs	-	(2.3)	-	-	-	(2.3)
Distributions to perpetual capital security holders	-	-	-	-	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	4.1	4.1
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	-	-	-	(1.1)	-	(1.1)
Proceeds from treasury shares re-issued	-	-	-	2.5	-	2.5
Proceeds from shares issued under the Sharesave Scheme	0.2	1.9	-	-	-	2.1
Total transactions with equity shareholders	5.4	94.7	-	(119.3)	(16.2)	(35.4)
At 31 March 2016	167.8	213.3	144.2	667.5	294.8	1,487.6

The notes on pages 119 to 171 form part of these financial statements

	Share capital (Note 33) £m	Share premium account (Note 34) £m	Capital redemption reserve (Note 35) £m	Retained earnings and other reserves (Note 36) £m	Perpetual capital securities (Note 37) £m	Total equity £m
Company						
At 1 April 2014	151.3	49	144.2	777.2	294.8	1,372.4
Profit for the year (note 10)	-	-	-	300.1	16.0	316.1
Other comprehensive loss for the year	-	-	-	(5.9)	-	(5.9)
Total comprehensive income for the year	-	-	-	294.2	16.0	310.2
Transactions with equity shareholders						
Dividends paid	-	-	-	(117.0)	-	(117.0)
Adjustment for shares issued under the scrip dividend alternative	2.6	(2.6)	-	48.0	-	48.0
Convertible bond – equity issuance	8.5	116.3	-	(0.5)	-	124.3
Distributions to perpetual capital security holders	-	-	-	-	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	4.3	4.3
Adjustment in respect of share-based payments (net of tax)	-	-	-	0.9	-	0.9
Charge in respect of share options vesting	-	-	-	(0.8)	-	(0.8)
Proceeds from treasury shares re-issued	-	-	-	3.9	-	3.9
Total transactions with equity shareholders	11.1	113.7	-	(65.5)	(16.0)	43.3
At 31 March 2015	162.4	118.6	144.2	1,005.9	294.8	1,725.9
Profit for the year (note 10)	-	-	-	91.4	16.2	107.6
Other comprehensive loss for the year	-	-	-	(0.4)	-	(0.4)
Total comprehensive income for the year	-	-	-	91.0	16.2	107.2
Transactions with equity shareholders						
Dividends paid	-	-	-	(129.5)	-	(129.5)
Adjustment for shares issued under the Scrip Dividend Alternative	0.3	(0.3)	-	6.3	-	6.3
Equity issuance	4.9	95.4	-	-	-	100.3
Equity issuance related costs	-	(2.3)	-	-	-	(2.3)
Distributions to perpetual capital security holders	-	-	-	-	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	-	-	-	-	4.1	4.1
Adjustment in respect of share-based payments (net of tax)	-	-	-	0.7	-	0.7
Charge in respect of share options vesting	-	-	-	(0.8)	-	(0.8)
Proceeds from treasury shares re-issued	-	-	-	2.5	-	2.5
Proceeds from shares issued under the Sharesave Scheme	0.2	1.9	-	-	-	2.1
Total transactions with equity shareholders	5.4	94.7	-	(120.8)	(16.2)	(36.9)
At 31 March 2016	167.8	213.3	144.2	976.1	294.8	1,796.2

The notes on pages 119 to 171 form part of these financial statements

CASH FLOW STATEMENTS FOR THE YEAR ENDED 31 MARCH 2016

	Notes	Group		Company	
		2016 £m	2015 £m	2016 £m	2015 £m
Cash flows from operating activities					
Cash generated/ (outflow) from operations	38	371 3	310 9	(41 7)	(103 8)
Interest paid	38	(79 1)	(62 0)	(35 3)	(34 7)
Tax (paid)/ received		(45 0)	(21 0)	(10 7)	15 2
Net cash generated/ (outflow) from operating activities		247 2	227 9	(87 7)	(123 3)
Cash flows from investing activities					
Interest received		14 9	20 3	51 3	50 7
Dividends received	46	6 0	6 0	140 7	311 6
Investments in subsidiary undertakings		–	–	(100 3)	(200 3)
Loan repayments received from joint ventures		27 5	0 3	–	–
Acquisitions, net of cash acquired	44	(91 0)	–	–	–
Purchase of property plant and equipment		(283 7)	(298 1)	(0 1)	(0 1)
Proceeds from sale of property plant and equipment		6 8	5 7	–	0 1
Net cash (used in)/ received from investing activities		(319 5)	(265 8)	91 6	162 0
Cash flows from financing activities					
Proceeds from treasury shares re-issued	33	2 5	3 9	2 5	3 9
Proceeds from issuance of ordinary shares		100 1	–	100 1	–
Purchase of ordinary shares by the Pennon Employee Share Trust		(1 1)	(0 8)	–	–
Deposit of restricted funds		(30 3)	(23 0)	(9 7)	1 4
Proceeds from new borrowing		80 0	345 0	1 0	345 0
Repayment of borrowings		(96 5)	(123 6)	(66 8)	(92 5)
Finance lease sale and lease back		30 4	160 1	–	–
Finance lease principal repayments		(38 4)	(99 5)	–	–
Dividends paid		(123 2)	(69 0)	(123 2)	(69 0)
Perpetual capital securities periodic return	37	(20 3)	(20 3)	(20 3)	(20 3)
Net cash (used in)/ generated from financing activities		(96 8)	172 8	(116 4)	168 5
Net (decrease)/ increase in cash and cash equivalents		(169 1)	134 9	(112 5)	207 2
Cash and cash equivalents at beginning of the year	25	574 8	439 9	532 5	325 3
Cash and cash equivalents at end of the year	25	405 7	574 8	420 0	532 5

The notes on pages 119 to 171 form part of these financial statements

NOTES TO THE FINANCIAL STATEMENTS

I. GENERAL INFORMATION

Pennon Group Plc is a company registered in the United Kingdom under the Companies Act 2006. The address of the registered office is given on page 115. During 2015/16 Pennon Group's business was operated through three main subsidiaries: South West Water Limited providing water and wastewater services for Devon, Cornwall and parts of Dorset and Somerset; Bournemouth Water Limited providing the water services for parts of Dorset, Hampshire and Wiltshire; and Vindor Limited's business is waste recycling and recovery.

2. PRINCIPAL 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 the years presented.

(A) BASIS OF PREPARATION

These financial statements have been prepared on the historical cost accounting basis (except for fair value items, principally acquisitions, transfers of assets from customers and certain financial instruments as described in accounting policy notes (b), (v) and (n) respectively) and in accordance with International Financial Reporting Standards (IFRS) and interpretations of the IFRS Interpretations Committee as adopted by the European Union and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. A summary of the principal 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 and interpretations in the year.

The going concern basis has been adopted in preparing these financial statements as stated by the Directors on page 100.

The new standards or interpretations which were mandatory for the first time in the year beginning 1 April 2015 did not have a material impact on the net assets or results of the Group.

Standards and interpretations in issue, but not yet effective, are not expected to have a material effect on the Group's net assets or results, except the following set out below:

- IFRS 15 'Revenue from contracts with customers' relates to revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. The standard will replace IAS 18 'Revenue' and IAS 11 'Construction contracts' and related interpretations. The standard is effective for annual periods beginning on or after 1 January 2018 and is subject to EU endorsement.
- The Group continues to assess the impact of the new standard on the Group's financial statements. The Group will make more detailed assessments of the impact over the next twelve months.
- IFRS 16 'Leases' no longer distinguishes between an on-balance sheet finance lease and an off-balance sheet operating lease. Instead, for virtually all lease contracts the lessee recognises a lease liability reflecting future lease payments and a 'right-of-use' asset. The standard is effective for annual periods beginning on or after 1 January 2019 and is subject to EU endorsement.
- The Directors anticipate that the adoption of IFRS 16 on 1 April 2019 will reduce operating costs, increase depreciation charges and increase finance costs. In addition, c. £100 million of property, plant and equipment will be recognised with a corresponding increase in borrowings and group net debt. Existing borrowing covenants are not impacted by changes in accounting standards.

The accounting policy for non-underlying items (z) previously referred to as exceptional items, has been refined to include items which due to their nature in the view of the Directors should be separately disclosed to enable a full understanding of the Group's financial performance.

(B) BASIS OF CONSOLIDATION

The Group financial statements include the results of Pennon Group Plc and its subsidiaries, joint ventures and associate undertakings.

The results of subsidiaries, joint ventures and associate 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 is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The results of joint ventures and associate undertakings are accounted for on an equity basis.

Intra-group trading, loan balances and transactions are eliminated on consolidation.

The acquisition method of accounting is used to account for the purchase of subsidiaries. The excess of the value transferred to the seller in return for control of the acquired business, together with the fair value of any previously held equity interest in that business over the Group's share of the fair value of the identifiable net assets, is recorded as goodwill.

(C) 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 recognised once the services or goods have been provided to the customer.

Income from main water and wastewater charges includes billed amounts for estimated usage and also an estimation of the amount of unbilled charges at the year-end based upon a defined methodology reflecting historical consumption and current tariffs.

Income from electricity generated from waste management landfill gas production during the year includes an estimation of the amount to be received under Renewables Obligation Certificates.

Accrued income from waste management contracts at the balance sheet date is recognised using management's expectation of amounts to be subsequently billed for services rendered to the client in accordance with the terms of the contract.

Income from recycling activities within waste management includes amounts based upon market prices for recycle products and industry schemes for waste electrical and electronic equipment ('WEEE' notes) and packaging volumes ('PRNs') processed.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

Revenue from long-term service concession arrangements is recognised based on the fair value of work performed. Where an arrangement includes more than one service, such as construction and operation of waste management facilities, revenue and profit are recognised in proportion to a fair value assessment of the total contract value split across the services provided.

(D) LANDFILL TAX

Landfill tax is included within both revenue and operating costs.

(E) 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 are based primarily on business segments. The reportable business segments comprise the water business which includes the regulated water and wastewater services undertaken by South West Water and the regulated water services undertaken by Bournemouth Water and the waste management business of Viridor. Segmental revenue and results include transactions between businesses. Inter-segmental transactions are eliminated on consolidation.

(F) GOODWILL

Goodwill arising on consolidation from the acquisition of subsidiary undertakings represents the excess of the purchase consideration over the fair value of net assets acquired, less any subsequent impairment charges.

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. For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the cash generating units or group of cash generating units, that is expected to benefit from the synergies of the combination. Each unit or group of units to which goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal reporting purposes. Goodwill is allocated and monitored at the reportable operating segment level. Further details are contained in accounting policy (j).

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

(G) OTHER INTANGIBLE ASSETS

Other intangible assets are recognised in relation to long-term service concessions contracts to the extent that future amounts to be received are not certain.

Other intangible assets include assets acquired in a business combination and 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 lives, with the expense charged to the income statement through operating costs.

(H) PROPERTY, PLANT AND EQUIPMENT

i) 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 and impairment charges. 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 Group. The cost of day-to-day servicing of infrastructure components is recognised in the income statement as it arises.

Infrastructure assets are depreciated evenly over their useful economic lives and are principally

Dams and impounding reservoirs	200 years
Water mains	40 – 120 years
Sewers	40 – 120 years

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

ii) 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 site 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.

iii) Landfill restoration

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.

iv) Other assets (including energy recovery facilities, property, overground plant and equipment)

Other assets are included at cost less accumulated depreciation.

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

Land and buildings – freehold buildings	30 – 60 years
Land and buildings – leasehold buildings	Over the estimated economic lives or the finance lease period, whichever is the shorter
Operational properties	40 – 80 years
Energy recovery facilities (including major refurbishments)	25 – 40 years
Fixed plant	20 – 40 years
Vehicles, mobile plant and computers	3 – 10 years

(h) Property, plant and equipment continued

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 directly attributable to the construction of a qualifying asset (an asset necessarily taking a substantial period of time to be prepared for its intended use) are capitalised as part of the asset. Assets transferred from customers are recognised at fair value as set out in accounting policy (v).

The assets' residual values and useful lives are reviewed annually. With effect from 1 April 2015, the useful lives for certain assets have been amended where both external benchmarking and internal experience indicates a change is required. Lives for some assets have increased whilst others have decreased. To accommodate this change the range of useful lives for water mains and sewers has increased from 100 to 120 years.

Gains and losses on disposal are determined by comparing sale proceeds with carrying amounts. These are included in the income statement.

(I) LEASED ASSETS

Assets held under finance leases are included as property, plant and equipment at the lower of their fair value at commencement or the present value of the minimum lease payments, 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.

(J) IMPAIRMENT OF NON-FINANCIAL ASSETS

Assets with 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 subject to amortisation or depreciation 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 an 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 market cost of capital of the cash generating unit. Impairments are charged to the income statement in the year in which they arise.

Non-financial assets other than goodwill that have been impaired are reviewed for possible reversal of the impairment at each reporting date.

Where a previously impaired asset or cash generating unit's recoverable amount is in excess of its carrying amount, previous impairments are reversed to the carrying value that would have expected to be recognised had the original impairment not occurred.

(K) INVESTMENT IN SUBSIDIARY UNDERTAKINGS

Investments in subsidiary undertakings are initially recorded at cost, being the fair value of the consideration paid. 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.

(L) INVESTMENT IN JOINT VENTURES

Joint ventures are entities over which the Group exercises 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 and statement of comprehensive income. 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.

(M) INVENTORIES

Inventories are stated at the lower of cost and net realisable value. The cost of finished goods and work in progress includes raw materials and the cost of bringing stocks to their present location and condition. It excludes borrowing costs. Net realisable value is the estimated selling price less cost to sell.

(N) CASH AND CASH DEPOSITS

Cash and cash deposits comprise cash in hand and short-term deposits held at banks. Bank overdrafts are shown within current borrowings.

(O) 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 fair value, net of transaction costs incurred. Following initial recognition, interest-bearing loans and borrowings are subsequently stated at amortised cost using the effective interest method.

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) Trade receivables

Trade receivables do not carry any interest receivable and are recognised initially at fair value and subsequently at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due in accordance with the original terms of the receivables.

iii) Trade payables

Trade payables are not interest-bearing and are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

iv) Financial assets arising from service concession arrangements

Where the provision of waste management services is performed through a contract with a public sector entity which controls a significant residual interest in asset infrastructure at the end of the contract, then consideration is treated as contract receivables, split between profit on the construction of assets, operation of the service and the provision of finance which is recognised in notional interest within finance income.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

v) Derivative financial instruments and hedging activities

The Group uses derivative financial instruments, principally interest rate swaps, foreign exchange forward contracts and cross-currency interest rate swaps to hedge risks associated with interest rate and exchange rate fluctuations. Derivative instruments are initially recognised at fair value on the date the derivative contract is entered into and subsequently remeasured at fair value for the reported balance sheet.

The Group designates certain hedging derivatives as either

- a hedge of a highly probable forecast transaction or change in the cash flows of a recognised asset or liability (a cash flow hedge) or
- a hedge of the exposure to change in the fair value of a recognised asset or liability (a fair value hedge).

The gain or loss on remeasurement is recognised to the income statement except for cash flow hedges which 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 ongoing basis. This effectiveness testing is reperformed at the end of each reporting period to ensure that the hedge remains highly effective.

Where a non-derivative transaction or series of transactions with the same counterparty has the aggregate effect in substance of a derivative instrument the transaction or series of transactions shall be recognised as a single derivative instrument at fair value with associated movements recorded in the income statement.

The full fair value of a hedging derivative is apportioned on a straight line basis between non-current and current assets and liabilities based on the remaining maturity of the hedging derivative.

Derivative financial instruments deemed held for trading, which are not subject to hedge accounting, are classified as a current asset or liability with any change in fair value recognised immediately in the income statement.

The Group uses cross-currency swaps for some of its foreign currency denominated private placement borrowings. The swaps either have the effect of (i) converting variable rate foreign currency borrowings into fixed rate sterling borrowings, (ii) converting fixed rate foreign currency borrowings into fixed rate sterling borrowings or (iii) converting fixed rate foreign currency borrowings into floating rate sterling borrowings.

vi) Financial instruments at fair value through profit

Financial instruments at fair value through profit reflect the fair value movement of the hedged risk on a hedged item which has been designated in a fair value hedging relationship. The fair values of these financial instruments are initially recognised on the date the hedging relationship is entered into and thereafter remeasured at each subsequent balance sheet date. The gain or loss on remeasurement for the period is recognised in the income statement.

(P) TAXATION INCLUDING DEFERRED TAX

The tax charge for the year comprises current and deferred tax. Tax is recognised in the income statement except to the extent that it relates to items recognised in the statement of comprehensive income or directly in equity. In this case the tax is also recognised in the statement of comprehensive income or directly in equity.

Current tax is calculated on the basis of tax laws enacted or substantively enacted at the balance sheet date. Management periodically evaluates tax items subject to interpretation and establishes provisions on individual tax items where in the judgement of management the position is uncertain.

The Group includes a number of companies, including the parent company, which are part of a tax group for certain aspects of the tax legislation. One of these aspects relates to group relief whereby current tax liabilities can be offset by current tax losses arising in other companies within the same tax group. Payments for group relief are included within the current tax disclosures.

Deferred tax is provided in full on temporary differences between the carrying amount of assets and liabilities in the financial statements and the tax base, except if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be realised. Deferred tax is determined using the tax rates enacted or substantively enacted at the balance sheet date, and expected to apply when the deferred tax liability is settled or the deferred tax asset is realised.

(Q) PROVISIONS

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. 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 notional interest within finance costs.

The Group's policies on specific provisions are

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, an asset in property, plant and equipment is recognised. Provisions are otherwise charged against profits based on the usage of void space.

ii) Environmental control and aftercare costs

Environmental control and after care costs are incurred during the operational life of each landfill site and 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 at the site. Further provisions required after the operational life of a site are recognised immediately in the income statement.

iii) Underperforming contracts

Where the unavoidable costs of meeting a contract's obligations exceed the economic benefits derived from that contract, the unavoidable costs less revenue anticipated under the terms of the contract, are recognised as a provision and charged to the income statement. An impairment loss on any assets dedicated to that contract is also recognised as described in accounting policy (j).

(R) SHARE CAPITAL AND TREASURY SHARES

Ordinary shares are classified as equity

Where the Company purchases the Company's equity share capital (treasury shares) the consideration paid including any directly attributable costs is deducted from equity until the shares are cancelled or re-issued. Where such shares are subsequently re-issued any consideration received net of any directly attributable transaction costs, is included in equity.

The Group balance sheet includes the shares held by the Pennon Employee Share Trust relating to employee share-based payments which have not vested at the balance sheet date. These are shown as a deduction from shareholders' equity until such time as they vest.

(S) 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 approved by shareholders at the Annual General Meeting.

(T) EMPLOYEE BENEFITS**i) Retirement benefit obligations**

The Group operates defined benefit and defined contribution pension schemes.

Defined benefit pension schemes

The liability recognised in the balance sheet in respect of defined benefit pension plans is the present value of the defined benefit obligation at the end of the year less the fair value of plan assets. If the value of a plan's assets exceeds the present value of its obligations, the resulting surplus is only recognised if the Group has an unconditional right to that surplus.

The defined benefit obligation is calculated by independent actuaries who advise on the selection of Directors' best estimates, using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high quality corporate bonds and that have terms to maturity approximating to the terms of the related pension obligation. The increase in liabilities of the Group's defined benefit pension schemes, expected to arise from employee service in the year, is charged against operating profit.

Changes in benefits granted by the employer are recognised immediately as past service cost in the income statement.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in the statement of comprehensive income in the period in which they arise.

Defined contribution scheme

Costs of the defined contribution pension scheme are charged to the income statement in the year in which they arise. The Group has no further payment obligations once the contributions have been paid.

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 shares which are expected to vest.

(U) PRE-CONTRACT AND DEVELOPMENT COSTS

Pre-contract and development costs including bid costs are expensed as incurred, except where it is probable that the contract will be awarded or the development completed, in which case they are recognised as an asset which is amortised to the income statement over the life of the contract.

(V) FAIR VALUES

The fair value of interest rate swaps is based on the market price to transfer the asset or liability at the balance sheet date in an ordinary transaction between market participants.

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 non-current bank loans and other loans, 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.

(W) TRANSFERS OF ASSETS FROM CUSTOMERS

Where an item of property, plant and equipment that must be used to connect customers to the network is received from a customer, or where cash is received from a customer for the acquisition or construction of such an item, that asset is recorded and measured on initial recognition at its fair value. The credit created by the recognition of the asset is recognised in the income statement. The period over which the credit is recognised depends upon the nature of the service provided, as determined by the agreement with the customer. Where the service provided is solely a connection to the network, the credit is recognised at the point of connection. If the agreement does not specify a period, revenue is recognised over a period no longer than the economic life of the transferred asset used to provide the ongoing service.

The fair value of assets on transfer from customers is determined using a cost valuation approach allowing for depreciation.

(X) FOREIGN EXCHANGE

Transactions denominated in foreign currencies are translated at the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in a foreign currency are translated at the closing balance sheet rate. The resulting gain or loss is recognised in the income statement.

(Y) PERPETUAL CAPITAL SECURITIES

Perpetual capital securities are issued securities that qualify for recognition as equity. Accordingly, any periodic returns are accounted for as dividends and recognised directly in equity and as a liability at the time the Company becomes obligated to pay the periodic return. This reflects the nature of the periodic returns and repayment of principal being only made at the Company's discretion. Any associated tax impacts are recognised directly in equity.

(Z) NON-UNDERLYING ITEMS

Non-underlying items are those that in the Directors' view are required to be separately disclosed by virtue of their size, nature or incidence to enable a full understanding of the Group's financial performance.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

3. FINANCIAL RISK MANAGEMENT

(A) FINANCIAL RISK FACTORS

The Group's activities expose it to a variety of financial risks: liquidity risk, market risk (interest rate and foreign currency risk) and credit risk.

The Group's treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages inflation and interest rate risk.

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

These risks and treasury operations are managed by the Chief Financial Officer 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, manage risk, optimise the use of surplus funds and manage overall interest rate performance. The Group does not engage in speculative activity.

i) Liquidity risk

The Group actively maintains a mixture of long-term and short-term committed facilities which are designed to ensure the Group has sufficient available funds for operations and planned expansions equivalent to at least one year's forecast requirements at all times. Details of undrawn committed facilities and short-term facilities are provided in note 28.

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

The Group and Water Business have entered into covenants with lenders. While terms vary, these typically provide for limits on gearing (primarily based on the Water Business's Regulatory Capital Value and Vindor Limited's EBITDA) and interest cover.

Contractual undiscounted cash flows, including interest payments, at the balance sheet date were:

	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
Group					
31 March 2016					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	390	116.1	327.5	1,293.4	1,776.0
Interest payments on borrowings	479	47.3	137.7	687.7	920.6
Finance lease liabilities including interest	41.1	45.0	175.5	2,130.7	2,392.3
Trade and other payables	264.6	–	–	–	264.6
Guarantees	159.7	–	–	–	159.7
Derivative financial liabilities					
Derivative contracts – net payments/ (receipts)	8.3	6.1	2.2	(67.0)	(50.4)
31 March 2015					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	81.8	113.6	410.0	1,027.0	1,632.4
Interest payments on borrowings	48.4	46.8	132.0	753.8	981.0
Finance lease liabilities including interest	43.6	46.3	198.2	2,157.8	2,445.9
Trade and other payables	2,777	–	–	–	2,777
Guarantees	169.8	–	–	–	169.8
Derivative financial liabilities					
Derivative contracts – net payments/ (receipts)	6.7	5.5	4.2	(105.4)	(89.0)
Company					
31 March 2016					
Non-derivative financial liabilities					
Borrowings excluding intercompany borrowings	–	74.6	225.8	576.7	877.1
Intercompany borrowings	287.2	–	–	–	287.2
Interest payments on borrowings	30.4	29.7	76.7	122.4	259.2
Trade and other payables	5.9	–	–	–	5.9
Guarantees	580.8	–	–	–	580.8
Derivative financial liabilities					
Derivative contracts – net payments	1.1	1.0	0.7	–	2.8
31 March 2015					
Non-derivative financial liabilities					
Borrowings excluding intercompany borrowings	50.7	74.9	310.0	500.5	936.1
Intercompany borrowings	283.2	–	–	–	283.2
Interest payments on borrowings	30.8	29.0	78.8	139.3	277.9
Trade and other payables	5.6	–	–	–	5.6
Guarantees	556.4	–	–	–	556.4
Derivative financial liabilities					
Derivative contracts – net payments	1.1	1.0	1.2	–	3.3

No liability is expected to arise in respect of the guarantees noted above. Guarantees are analysed in note 42.

ii) Market risk

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 67% (2015 72%) of Group net borrowings were at fixed rates (including at least 50% of South West Water's borrowings fixed for the period to March 2016) after the impact of financial derivatives. 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 note 23.

The interest rate for index-linked debt is based upon an RPI measure, which is also used in determining the amount of income from customers in South West Water and Bournemouth Water. 18% (2015 13%) of the Group's gross debt is RPI index-linked.

The Group has no significant interest-bearing assets upon which the net return fluctuates from market risk. Deposit interest receivable is expected to fluctuate in line with interest payable on floating rate borrowings. Consequently the Group's income and cash generated from operations (note 38) are independent of changes in market interest rates.

For 2016 if interest rates on variable net borrowings had been on average 0.5% higher/ lower with all other variables held constant, post-tax profit for the year and equity would have increased/ decreased by £0.1 million (2015 £0.4 million) for the equity sensitivity fair value, derivative impacts are excluded.

For 2016 if RPI on index-linked borrowings had been on average 0.5% higher/ lower with all other variables held constant, post-tax profit for the year and equity would have decreased/ increased by £1.9 million (2015 £1.5 million).

Foreign currency risk occurs at transactional and translation level from borrowings and transactions in foreign currencies. These risks are managed through forward contracts which provide certainty over foreign currency risk.

iii) Credit risk

Credit counterparty risk arises from cash and cash deposits, derivative financial instruments and exposure to customers, including outstanding receivables. Further information on the credit risk relating to trade receivables is given in note 22.

Counterparty risk arises from the investment of surplus funds and from the use of derivative financial 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. The Group's surplus funds are managed by the Group's treasury function and are usually placed in short-term fixed interest deposits or the overnight money markets. Deposit counterparties must meet a board approved minimum criteria based on their short term credit ratings.

(B) CAPITAL RISK MANAGEMENT

The Group's objectives when managing capital are to safeguard the Group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to minimise the cost of capital.

The Group's policy is to have a minimum of 12 months pre-funding of projected capital expenditure. At 31 March 2016 the Group had cash and facilities excluding restricted funds of over £1.7 billion meeting this objective.

In order to maintain or adjust the capital structure, the Group seeks to maintain a balance of returns to shareholders through dividends and an appropriate capital structure of debt and equity for each business segment and the Group.

The Group monitors capital on the basis of the gearing ratio. This ratio is calculated as net borrowings divided by total capital. Net borrowings are analysed in note 39 and calculated as total borrowings less cash and cash deposits. Total capital is calculated as total shareholders' equity plus net borrowings.

The gearing ratios at the balance sheet date were:

	2016 £m	2015 £m
Net borrowings (note 39)	2,484.4	2,197.1
Total equity	1,487.6	1,354.1
Total capital	3,972.0	3,551.2
Gearing ratio	62.5%	61.9%

South West Water and Bournemouth Water is also monitored on the basis of the ratio of its net borrowings to Regulatory Capital Value. Ofwat's optimum gearing for the K6 (2015-2020) regulatory period is set at 62.5%.

	South West Water		Bournemouth Water
	2016 £m	2015 £m	2016 £m
Regulatory Capital Value	2,997.3	2,928.0	152.9
Net borrowings	1,793.3	1,817.5	86.7
Net borrowings/Regulatory Capital Value	59.8%	62.1%	56.7%

The Group has entered into covenants with lenders and while terms vary these typically provide for limits on gearing and interest cover.

The Group has been in compliance with its covenants during the year.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

3. FINANCIAL RISK MANAGEMENT CONTINUED

(C) DETERMINATION OF FAIR VALUES

The Group uses the following hierarchy for determining the fair value of financial instruments by valuation technique

- quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1)
- inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2)
- inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3)

The Group's financial instruments are valued principally using level 2 measures as analysed in note 23

The fair value of financial instruments not traded in an active market (for example over-the-counter derivatives) is determined by using valuation techniques. A variety of methods and assumptions are used based on market conditions existing at each balance sheet date. Quoted market prices or dealer quotes for similar instruments are used for long-term debt. Other techniques, such as estimated discounted cash flows, are used to determine fair value for the remaining financial instruments. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows.

The carrying values less impairment provision, of trade receivables and payables are assumed to approximate to their fair values. The fair value of financial liabilities, principally environmental provisions, is calculated as the present value of the estimated future cash flows.

4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES

The Group's principal accounting policies are set out in note 2. Management is required to exercise significant judgement and make use of estimates and assumptions in the application of these policies. Estimates are based on factors including historical experience and expectations of future events that management believe to be reasonable. However, given the judgemental nature of such estimates, actual results could be different from the assumptions used.

IMPAIRMENT OF NON-FINANCIAL ASSETS AND GOODWILL

In order to determine whether impairments or reversals of previous impairments are required for non-financial assets, the Group estimates the recoverable amount of an individual asset or assets grouped at the lowest level for which there are separately identifiable cash flows (cash generating units). To reflect changes in the waste market, including the structural decline of landfill and the prominence of recycling and recovering value from waste, together with the reorientation of Vindor's operations towards ERFs, the Group has applied judgement in determining the allocation of CGUs. In the updated allocations non-strategic landfill assets are considered separate CGUs, as are landfill gas assets, with other remaining assets allocated to regional CGUs.

The impairment assessment of non-current financial assets is based on projections of future cash flows for the cash generating unit and the use of a terminal value to incorporate expectations of growth after the period covered by specific plans. The cash flows are discounted by the weighted average cost of capital appropriate to the business activity which is reviewed on an annual basis. Judgement and estimation is required in determining the appropriate cash flows and discount rate used in the assessment.

The lowest level to which goodwill is allocated, monitored and tested by management is the segmental level, in line with the segments set out in note 5. 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, which reflects an assessment of the cost of capital of the cash generating unit.

The principal assumptions used to assess impairment are set out in notes 15 and 17.

ENVIRONMENTAL AND LANDFILL RESTORATION PROVISIONS

Environmental control and aftercare costs are incurred during the operational life of each landfill site and for a considerable period thereafter. The period of aftercare post-closure and the level of costs expected are uncertain and can vary significantly from site to site. Key factors are the type of waste, the speed at which it decomposes, the volume of leachate requiring treatment and regulatory requirements specific to the site. The amounts expected to be incurred are based on landfill site operating lives, taking account of the anticipated decline in landfill activity.

The provisions are based on latest assumptions, reflecting recent historic data and future cost estimates.

The provisions are recognised in the financial statements at the net present value of the estimated future expenditure required to settle the Group's obligations. A discount rate is applied to recognise the time value of money and is unwound over the life of the provision. This is included in the income statement as a financial item within finance costs.

As at 31 March 2016 the Group's environmental and landfill restoration provisions were £182.1 million (2015: £193.0 million) (note 32).

Where a restoration provision gives access to future economic benefits, an asset is recognised and depreciated in accordance with the Group's depreciation policy. As at 31 March 2016 these assets had a net book value of £11.7 million (2015: £17.9 million) (note 17).

RETIREMENT BENEFIT OBLIGATIONS

The Group operates defined benefit pension schemes for which actuarial valuations are carried out as determined by the trustees at intervals of not more than three years. The last such valuation of the main scheme was as at 31 March 2016.

The pension cost and liabilities under IAS 19 are assessed in accordance with Directors' best estimates using the advice of an independent qualified actuary and assumptions in the latest actuarial valuation. The assumptions are based on member data supplied to the actuary and market observations for interest rates and inflation, supplemented by discussions between the actuary and management. The mortality assumption uses a scheme-specific calculation based on CMI 2016 actuarial tables with an allowance for future longevity improvement. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 30.

TAXATION

The Group's current tax provision of £37.1 million relates to management's judgement of the amount of tax payable on open tax computations where liabilities remain to be agreed with HMRC. The Group evaluates uncertain tax items where a tax item is subject to interpretation and remains to be agreed. Principally the uncertain tax items for which a provision is made, relate to the interpretation of tax legislation regarding financing arrangements that have been entered into in the normal course of business. Provisions established for uncertain items are made using a best estimate of the tax expected to be paid, based on a qualitative assessment of all relevant information.

In assessing any appropriate provision requirements for uncertain tax items, the Group considers progress made in discussions with HMRC, expert advice on the likely outcome and any recent developments in case law.

Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of the open matters, the final outcome may vary significantly. Whilst a range of outcomes is reasonably possible, the extent of this range is additional liabilities of up to £20 million to a reduction in liabilities of up to £52 million. Any such variations will affect the tax financial results in the year in which such a determination is made.

In addition to provisions established for uncertain tax items, the Group has other uncertain tax items where the Group has paid in full the tax HMRC interpret as due, and therefore would benefit by up to £70 million should such tax positions be concluded in the Group's favour.

SERVICE CONCESSION ARRANGEMENTS

Consideration from public sector entities for the operation of waste management service concessions is treated as contract receivables or other intangible assets, depending upon the right to receive cash from the asset. Consideration relating to contract receivables is split between profit on the construction of assets, operation of the service and provision of finance, recognised as interest receivable. Management's allocation between these three elements is assessed to reflect external market conditions according to the type of service provided.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES CONTINUED

LANDFILL COSTS

The estimation of landfill reserves is of particular importance in assessing landfill costs since the projected 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. In estimating the operational life of a landfill site, consideration is given to the expected ongoing decline in the landfill market. Where Viridor plans or has constructed a competing energy recovery facility at certain existing landfill sites, the void which consequently is no longer expected to be used is excluded from the calculation of operational life. The 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 advisers.

A number of factors impact on the depreciation of landfill reserves including the available void space, future capital expenditure and operating costs. The assumptions are revised as these factors change.

The estimate of gas production at landfill sites post-closure reduces the depreciation of landfill reserves. An assessment is undertaken for individual sites of the historic profile of gas production during landfilling activity and the projected generation post-closure according to the type of waste contained in the landfill and expected profile of gas production over time.

REVENUE RECOGNITION

The Group recognises revenue at the time of delivery of services. Payments received in advance of services delivered are recorded as a liability.

South West Water and Bournemouth Water raise bills and recognise revenue in accordance with their entitlement to receive revenue in line with the limits established by the Periodic Review price-setting process. For water and wastewater customers with water meters, revenue 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.

Viridor estimates income from certain contractual revenue streams based on tonnages, cost and historic data which are dependent on agreement with the customer after the delivery of the service.

PROVISION FOR DOUBTFUL DEBTS

At the balance sheet date each subsidiary evaluates the collectability of trade receivables and records provisions for doubtful debts based on experience including 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. As at 31 March 2016 the Group's current trade receivables were £303.6 million against which £95.6 million had been provided for impairment (note 22).

NON-UNDERLYING ITEMS

In establishing which items are disclosed separately as non-underlying, to enable a full understanding of the Group's financial performance, the Directors exercise their judgement in assessing the size, nature or incidence of specific items.

5. SEGMENTAL INFORMATION

Operating segments are reported in a manner consistent with internal reporting provided to the Chief Operating Decision-Maker, which has been identified as the Pennon Group Plc Board. The earnings measures below are used by the Board in making decisions.

The water business comprises the regulated water and wastewater services undertaken by South West Water and the regulated water services undertaken by Bournemouth Water. The waste management business is the waste recycling and recovery services provided by Viridor. Segment assets include goodwill and other intangible assets, property, plant and equipment, inventories, trade and other receivables and cash and cash deposits. Segment liabilities comprise operating liabilities and exclude taxation. The other segment liabilities include the Company's financing arrangements and Group taxation liabilities. Capital expenditure comprises additions to property, plant and equipment, including additions resulting from acquisitions through business combinations.

	2016 £m	2015 £m
Revenue		
Water	547.0	522.2
Waste management	806.2	835.9
Other	12.0	10.9
Less intra-segment trading*	(12.9)	(11.8)
	1,352.3	1,357.2
Segment result		
Operating profit/ (loss) before depreciation, amortisation and non-underlying items (EBITDA)		
Water	335.2	331.3
Waste management	116.5	80.4
Other	(3.3)	(0.7)
	448.4	411.0
Operating profit/ (loss) before non-underlying items		
Water	224.5	225.4
Waste management	40.9	21.6
Other	(3.6)	(0.4)
	261.8	246.6
Profit before tax and non-underlying items		
Water	165.7	167.9
Waste management	30.7	27.7
Other	14.9	15.1
	211.3	210.7
Profit before tax		
Water	160.5	179.7
Waste management	25.7	1.0
Other	20.1	16.3
	206.3	197.0

* Intra-segment transactions between and to different segments is under normal market based commercial terms and conditions. Intra-segment revenue of the other segment is at cost.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

5. SEGMENTAL INFORMATION CONTINUED

	Water £m	Waste management £m	Other £m	Eliminations £m	Group £m
Balance sheet					
31 March 2016					
Assets (excluding investments in joint ventures)	3,385 8	1,911 1	1,715 9	(1,350 4)	5,662 4
Investments in joint ventures	-	0 1	-	-	0 1
Total assets	3,385 8	1,911 2	1,715 9	(1,350 4)	5,662 5
Liabilities	(2,502 4)	(1,513 2)	(1,509 7)	1,350 4	(4,174 9)
Net assets	883 4	398 0	206 2	-	1,487 6
31 March 2015					
Assets (excluding investments in joint ventures)	3 067 7	1 828 7	1 779 6	(1 268 3)	5 407 7
Investments in joint ventures	-	0 1	-	-	0 1
Total assets	3 067 7	1 828 8	1 779 6	(1 268 3)	5 407 8
Liabilities	(2 359 2)	(1 413 4)	(1 549 4)	1 268 3	(4 053 7)
Net assets	708 5	415 4	230 2	-	1 354 1

Segment liabilities of the water and waste management segments comprise operating liabilities. The other segment liabilities include the Group taxation liabilities.

	Notes	Water £m	Waste management £m	Other £m	Group £m
Other information					
31 March 2016					
Amortisation of other intangible assets	7	0 7	3 0	-	3 7
Capital expenditure (including acquisitions)		220 6	154 5	0 1	375 2
Depreciation	7	110 3	72 5	0 1	182 9
Finance income (before non-underlying items)	8	3 0	28 2	10 9	42 1
Finance costs	8	61 8	12 3	22 1	96 2
31 March 2015					
Amortisation of other intangible assets	7	-	2 7	-	2 7
Capital expenditure	17	145 1	156 3	-	301 4
Depreciation	7	105 9	56 1	(0 3)	161 7
Impairment	7	-	24 3	-	24 3
Finance income	8	2 8	30 6	10 6	44 0
Finance costs	8	60 3	14 0	10 5	84 8

Geographic analysis of revenue based on location of customers

	2016 £m	2015 £m
Revenue		
United Kingdom	1,296.1	1,317.6
Rest of European Union	10.5	10.4
China	38.8	25.3
Rest of World	6.9	3.9
	1,352.3	1,357.2

The Group's country of domicile is the United Kingdom and is the country in which it generates the majority of its revenue. The Group's non-current assets are all located in the United Kingdom.

6. NON-UNDERLYING ITEMS

Non-underlying items are those that in the Directors' view are required to be separately disclosed by virtue of their size, nature or incidence to enable a full understanding of the Group's financial performance.

	Notes	2016 £m	2015 £m
Operating (costs)/ credits			
Restructuring costs ^(a)	32	(10.2)	-
Pension costs – past service ^(b)	30	-	14.9
Environmental provisions ^(c)	32	-	6.7
Underperforming contracts ^(d)	32	-	(11.0)
Impairment of property, plant and equipment ^(e)	17	-	(24.3)
Total net operating costs		(10.2)	(13.7)
Remeasurement of fair value movement in derivatives ^(f)	8	5.2	-
Deferred tax change in rate ^(g)	31	33.1	-
Tax credit arising on non-underlying items	9	1.0	2.7
Net non-underlying credit/ (charge)		29.1	(11.0)

(a) During the year a one-off charge of £10.2 million was made to the restructuring provision reflecting announced reorganisations across the Group.

(b) Last year a non-underlying credit was recognised relating to changes made to the Group's defined benefit scheme. Changes implemented last year capped pensionable pay for active members, reducing past service cost.

(c) Last year landfill environmental provisioning was reassessed £6.7 million lower reflecting lower expected restoration and after care costs, partly offset by a reduction in discount rate.

(d) A small number of contracts last year were assessed as underperforming. On this basis a provision of £11.0 million was established.

(e) Following a detailed review of the allocation of non-financial assets to cash generating units, an impairment of £60.9 million has been recognised in relation to Vinidor's non-strategic landfill assets and a £60.9 million reversal of impairment has been recognised in the newly aggregated regional cash generating units. Further details of the review are set out in note 17.

In 2014/15 the profitability of a small number of landfill energy sites has been impacted by higher than anticipated site costs and lower than expected volumes due to site specific circumstances. As a result, a net non-underlying impairment charge of £24.3 million has been recognised to write down the carrying value of landfill energy property, plant and equipment. Included in the net charge are impairment reversals of £9.2 million.

(f) For certain derivative financial instruments, where market volatility and counterparty credit risk result in hedge accounting becoming less certain, hedge accounting is discontinued and non-cash fair value movements are recognised in the income statement as non-underlying items.

(g) Following the enactment during the year the rate of corporation tax reduced from 20% to 19% from April 2017 and reduces further to 18% from April 2020, a one-off credit of £33.1 million has been recognised in the income statement. In addition, a charge of £3.8 million has been recognised in the statement of comprehensive income and a charge of £0.1 million has been recognised directly in equity.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

7. OPERATING COSTS

	Notes	2016 £m	2015 £m
Employment costs before non-underlying items	13	180 0	164 3
Raw materials and consumables		114 7	103 8
Other operating expenses before non-underlying items include			
Profit on disposal of property, plant and equipment		(4 3)	(3 7)
Operating lease rentals payable			
– Plant and machinery		16 9	15 7
– Property		9 0	9 2
Research and development expenditure		0 1	0 1
Trade receivables impairment	22	8 4	12 8
Depreciation of property, plant and equipment			
– Owned assets		140 0	125 6
– Under finance leases		42 9	36 1
– Impairment of property, plant and equipment	6	–	24 3
Amortisation of other intangible assets	16	3 7	2 7

Operating costs include a £10.2 million charge (2015 £13.7 million charge) relating to non-underlying items as detailed in note 6

Fees payable to the Company's auditors in the year were

	2016 £000	2015 £000
Fees payable to the Company's auditors and its associates for the audit of parent Company and consolidated financial statements	94	75
Fees payable to the Company's auditors and its associates for other services		
The audit of Company's subsidiaries	635	471
Audit related assurance services	50	50
Other non-audit services	122	7
Total fees	901	603
Fees payable to the Company's auditors in respect of Pennon Group pension schemes		
Audit	30	17

Expenses reimbursed to the auditors in relation to the audit of the Group were £45,000 (2015 £40,000)

A description of the work of the Audit Committee is set out in its report on pages 66 to 69 which includes an explanation of how the auditors' objectivity and independence are safeguarded when non-audit services are provided by the auditors' firm

8. NET FINANCE COSTS

	Notes	2016			2015		
		Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt							
Bank borrowing and overdrafts		(48 7)	–	(48 7)	(32 2)	–	(32 2)
Interest element of finance lease rentals		(33 5)	–	(33 5)	(32 9)	–	(32 9)
Other finance costs		(2 8)	–	(2 8)	(6 5)	–	(6 5)
Interest receivable		–	6 3	6 3	–	11 3	11 3
Interest receivable on shareholder loans to joint ventures		–	10 7	10 7	–	11 4	11 4
		(85 0)	17 0	(68 0)	(71 6)	22 7	(48 9)
Notional interest							
Interest receivable on service concession arrangements		–	16 7	16 7	–	13 5	13 5
Retirement benefit obligations	30	(1 8)	–	(1 8)	(2 7)	–	(2 7)
Unwinding of discounts in provisions		(9 4)	–	(9 4)	(10 5)	–	(10 5)
		(11 2)	16 7	5 5	(13 2)	13 5	0 3
Net gains on derivative financial instruments arising from the combination of non-derivative instruments		–	8 4	8 4	–	7 8	7 8
Net finance cost before non-underlying items		(96 2)	42 1	(54 1)	(84 8)	44 0	(40 8)
Non-underlying items							
Fair value remeasurement of non-designated derivative financial instruments providing commercial hedges	6	–	5 2	5 2	–	–	–
Net finance cost after non-underlying items		(96 2)	47 3	(48 9)	(84 8)	44 0	(40 8)

In addition to the above finance costs of £9.4 million (2015 £22.5 million) have been capitalised on qualifying assets included in property, plant and equipment and other intangible assets

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

9. TAXATION

	Notes	Before non-underlying items 2016 £m	Non-underlying items (Note 6) 2016 £m	Total 2016 £m	Before non-underlying items 2015 £m	Non-underlying items (Note 6) 2015 £m	Total 2015 £m
Analysis of charge in year							
Current tax charge		32.9	(1.7)	31.2	39.2	0.6	39.8
Deferred tax – other		39.2	0.7	39.9	18.2	(3.3)	14.9
Deferred tax arising on change of rate of corporation tax		–	(33.1)	(33.1)	–	–	–
Total deferred tax charge	31	39.2	(32.4)	6.8	18.2	(3.3)	14.9
Tax charge for year		72.1	(34.1)	38.0	57.4	(2.7)	54.7

UK corporation tax is calculated at 20% (2015 21%) of the estimated assessable profit for the year

UK corporation tax is stated after a credit relating to prior year current tax of £1.4 million (2015 credit of £5.5 million) and a prior year deferred tax charge of £15.9 million (2015 £9.7 million)

The 2016 deferred tax charge includes a credit of £33.1 million reflecting a reduction in the rate of UK corporation tax

The tax for the year differs from the theoretical amount which would arise using the standard rate of corporation tax in the UK (20%) from

	2016 £m	2015 £m
Profit before tax	206.3	197.0
Profit before tax multiplied by the standard rate of UK corporation tax of 20% (2015 21%)	41.3	41.4
Effects of		
Expenses not deductible for tax purposes	1.6	4.1
Financial transaction deemed ineligible	12.0	3.7
Joint ventures profits not taxed	(0.7)	(1.0)
Change in rate of corporation tax	(33.1)	–
Adjustments to tax charge in respect of prior years	14.5	4.2
Depreciation charged on non-qualifying assets	2.4	2.3
Tax charge for year	38.0	54.7

The adjustments to the tax charge in respect of prior years, include a charge of £30 million for an uncertain tax item relating to a financial transaction partly offset by an updated assessment of other uncertain tax items following discussions with HMRC on complex tax legislation relating to the deductibility of financial arrangements and relief claims for capital expenditure plus submission of the prior year tax returns resulting in lower tax being due compared to the assessment made for the 2014/15 charge

The average applicable tax rate for the year before non-underlying items was 34% (2015 27%). The average applicable tax rate for the year after non-underlying items was 18% (2015 28%)

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised

	2016 £m	2015 £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge/ (credit) on defined benefit pension schemes	2.4	(0.4)
Deferred tax charge/ (credit) on cash flow hedges	1.8	(5.7)
Amounts recognised directly in equity		
Deferred tax charge on share-based payments	0.3	–
Current tax credit on perpetual capital securities periodic return	(4.1)	(4.3)

10. PROFIT OF THE PARENT COMPANY

	2016 £m	2015 £m
Profit attributable to ordinary shareholders equity dealt within the accounts of the parent company	91.4	300.1

As permitted by Section 408 of the Companies Act 2006 no income statement or statement of comprehensive income is presented for the Company

II. 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 36), 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 Performance and Co-investment Plan and the deferred shares element of the Annual Incentive Bonus Plan to the extent that the performance criteria for vesting of the awards are expected to be met

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

	2016	2015
Number of shares (millions)		
For basic earnings per share	410.9	390.9
Effect of dilutive potential ordinary shares from share options	1.8	1.8
For diluted earnings per share	412.7	392.7

BASIC AND DILUTED EARNINGS PER ORDINARY SHARE

Earnings per ordinary share before non-underlying items and deferred tax are presented as the Directors believe that this measure provides a more useful comparison on business trends and performance, since deferred tax reflects distortive effects of changes in corporation tax rates and the level of long-term capital investment. Earnings per share have been calculated

	2016			2015		
	Profit after tax £m	Earnings per share Basic p	Earnings per share Diluted p	Profit after tax £m	Earnings per share Basic p	Earnings per share Diluted p
Statutory earnings	152.1	37.0	36.9	126.3	32.3	32.2
Deferred tax charge before non-underlying items	39.2	9.5	9.5	18.2	4.7	4.6
Non-underlying items (net of tax)	(29.1)	(7.0)	(7.1)	11.0	2.8	2.8
Earnings before non-underlying items and deferred tax	162.2	39.5	39.3	155.5	39.8	39.6

12. DIVIDENDS

	2016 £m	2015 £m
Amounts recognised as distributions to ordinary equity holders in the year		
Interim dividend paid for the year ended 31 March 2015 9.98p (2014 9.39p) per share	39.8	34.8
Final dividend paid for the year ended 31 March 2015 21.82p (2014 20.92p) per share	89.7	82.2
	129.5	117.0
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2016 10.46p per share	43.1	
Proposed final dividend for the year ended 31 March 2016 23.12p per share	95.4	
	138.5	

The proposed interim and final dividends have not been included as liabilities in these financial statements

The proposed interim dividend for 2016 was paid on 1 April 2016 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

13 EMPLOYMENT COSTS

	Notes	2016 £m	2015 £m
Wages and salaries		158 0	143 9
Social security costs		15 3	13 8
Pension costs	30	20 1	179
Share-based payments	33	2 8	3 5
Non-underlying items	6 30	8 6	(149)
Total employment costs		204 8	164 2
Charged			
Employment costs (excluding non-underlying items) – consolidated income statement		180 0	164 3
Non-underlying items – consolidated income statement	6	8 6	(149)
Capital schemes – property plant and equipment		16 2	14 8
Total employment costs		204 8	164 2

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.

	2016	2015
Employees (average full time equivalent number)		
The average monthly number of employees (including Executive Directors) was		
Water	1,706	1,408
Waste management	3,230	3,101
Other	51	49
Group totals	4,987	4,558

The total number of employees at 31 March 2016 was 5,033 (2015 4,590)

14. DIRECTORS' EMOLUMENTS

	2016 £000	2015 £000
Executive Directors		
Salary	1,152	1,119
Performance-related bonus paid or payable	416	382
Share-based payments	555	750
Other emoluments including payments in lieu of pension provision	258	327
Non-executive Directors	529	506
	2,910	3,084

The cost of share-based payments represents the amount charged to the income statement as described in note 33.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £220,000 (2015 £642,000).

Total gains made by Directors on the exercise of share options were £2,000 (2015 £nil).

Total emoluments include £1,200,000 (2015 £1,359,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2016 one Director (2015 one) is accruing retirement benefits under defined benefit pension schemes in respect of which the Group contributed £29,000 (2015 £5,000).

At 31 March 2016 one Director (2015 one) is a member of the Group's defined contribution pension scheme in respect of which the Group contributed £52,000 (2015 £49,700).

At 31 March 2016 three Directors received payments in lieu of pension provision (2015 three).

More detailed information concerning Directors' emoluments (including pensions and the highest paid Director) and share interests is shown in the Directors' remuneration report on pages 77 to 98.

15. GOODWILL

	£m
Cost	
At 1 April 2014	339.3
At 31 March 2015	339.3
Recognised on acquisition of subsidiaries (note 44)	45.7
At 31 March 2016	385.0
Carrying amount	
At 1 April 2014	339.3
At 31 March 2015	339.3
At 31 March 2016	385.0

Goodwill acquired in a business combination is allocated at acquisition to the cash generating unit (CGU) expected to benefit from that business combination. £342.7 million of the goodwill balance is allocated to the waste management business, with the remaining £42.3 million allocated to the water business, representing the lowest levels at which goodwill is monitored and tested.

IMPAIRMENT TESTING OF GOODWILL

The Group tests goodwill for impairment annually or more frequently if there are any indications that impairment may have arisen.

The recoverable amount of the water business segment, for which goodwill was first recognised during the year on the acquisition of Bournemouth Water, is assessed with reference to performance expectations compared to those assumed at time of acquisition. Key assumptions used to assess the value of this goodwill included future allowed tariff increases and delivery of operational efficiencies.

The recoverable amount of the waste management segment, to which the majority of goodwill is allocated, is determined based on value-in-use calculations which, under IAS 36 Impairment of Assets, require the use of base cash flow projections that reflect reasonable and supportable assumptions with specific restrictions on the estimates to be used. These include limitations on reflecting cash flows to take account of future cost restructuring, or improvement or enhancement of asset performance. Uncommitted projects are excluded. Discount rates are required to be derived independently of the Group's capital structure and reflect management's prudent estimate of a rate that investors would require if they were to choose a similar investment.

The base cash flow projections have been derived by prudently adjusting key assumptions underlying the Group's detailed budget and strategic plan projections. These cover a period of seven years and are prepared as part of the annual planning cycle. This period is believed to lead to a more realistic estimate of future cash flows than five years.

These plans are based on detailed market-by-market forecasts of projected volumes, prices and costs for each business activity. These forecasts reflect, on an individual operational site basis, numerous assumptions and estimates. The key assumptions include anticipated changes in market size and volumes, recycle prices, energy selling prices, gate fees, the level of future landfill tax, and cost inflation. Management has determined the value assigned to each assumption based on historical experience, market surveys, industry analysis and current legislation. For business activities with an indefinite life, a terminal growth rate has been used.

Management has applied the following assumptions to the cash flow projections:

Assumption	Basis for assumption
Discount rate Pre-tax discount rates used range from 7% to 10% across the CGUs business activities – (2015: 7.5% to 10%)	Discount rates have been determined based on an estimate of the waste management segment's weighted average cost of capital adjusted for the different risk profiles of the segment's business activities to the extent that the cash flows have not already been adjusted. Investments in joint ventures reflect an expected equity return only.
Long-term growth rates 0.5% applied to overheads beyond the period of the detailed projections (2015: 0.5%) 2.5% applied to other cash flows beyond the period of the detailed projections (2015: 2.5%)	Ongoing efficiencies and benefits from economies of scale Based on forecasts of growth in waste management markets and the UK economy

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

16. OTHER INTANGIBLE ASSETS

	Service concession arrangements £m	Customer contracts £m	Patents £m	Other £m	Total £m
Acquired intangible assets					
Cost					
At 1 April 2014	19.6	32.7	0.2	–	52.5
Additions	28.5	–	–	–	28.5
At 31 March 2015	48.1	32.7	0.2	–	81.0
Additions	6.9	–	–	0.3	7.2
Recognised on acquisition of subsidiaries (note 44)	–	1.6	–	2.3	3.9
At 31 March 2016	55.0	34.3	0.2	2.6	92.1
Accumulated amortisation					
At 1 April 2014	–	21.8	0.1	–	21.9
Charge for year	–	2.7	–	–	2.7
At 31 March 2015	–	24.5	0.1	–	24.6
Charge for year	–	3.0	0.1	0.6	3.7
At 31 March 2016	–	27.5	0.2	0.6	28.3
Carrying amount					
At 1 April 2014	19.6	10.9	0.1	–	30.6
At 31 March 2015	48.1	8.2	0.1	–	56.4
At 31 March 2016	55.0	6.8	–	2.0	63.8

Service concession arrangements once available for use are amortised over the useful life of each contract. The average remaining life is 24 years (2015 25 years).

Customer contracts are amortised over the useful life of each contract which at acquisition ranged between two and 15 years. The weighted average remaining life is three years (2015 three years).

Patents are amortised over their estimated useful lives which at acquisition was 13 years. The average remaining life is two years (2015 three years).

Other, including computer software, is amortised over the useful life of the assets which at acquisition was three years. The average remaining life is two years.

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

During the year borrowing costs of £2.1 million (2015 £1.4 million) have been capitalised on qualifying assets at an average borrowing rate of 4.2% (2015 4.1%).

The principle assumptions used to assess impairment are set out in note 17.

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
Group							
Cost							
At 1 April 2014	481.9	1,608.6	641.3	1,622.5	63.4	730.5	5,148.2
Additions	9.7	11.5	3.5	34.8	–	241.9	301.4
Assets adopted at fair value	–	6.9	–	0.1	–	–	7.0
Grants and contributions	–	(1.8)	–	–	–	–	(1.8)
Disposals	(0.5)	(1.2)	(0.1)	(25.6)	–	–	(27.4)
Transfers/ reclassifications	2.6	17.5	4.9	519.8	4.0	(536.8)	12.0
At 31 March 2015	493.7	1,641.5	649.6	2,151.6	67.4	435.6	5,439.4
Additions	10.5	19.3	1.0	35.4	–	218.0	284.2
Arising on acquisition (note 44)	41.5	121.1	27.4	35.2	–	3.8	229.0
Assets adopted at fair value	–	6.6	0.8	–	–	–	7.4
Grants and contributions	–	(5.5)	–	–	–	–	(5.5)
Disposals	(28.8)	(1.2)	(0.1)	(18.2)	(2.8)	–	(51.1)
Transfers/ reclassifications	7.5	43.1	14.8	425.9	–	(491.3)	–
At 31 March 2016	524.4	1,824.9	693.5	2,629.9	64.6	166.1	5,903.4
Accumulated depreciation							
At 1 April 2014	312.8	178.6	203.5	960.3	42.6	–	1,697.8
Charge for year	22.7	23.9	11.7	98.7	6.9	–	163.9
Impairment charge/ reversal for the year	–	–	–	24.3	–	–	24.3
Disposals	(0.2)	(1.2)	(0.1)	(23.9)	–	–	(25.4)
At 31 March 2015	335.3	201.3	215.1	1,059.4	49.5	–	1,860.6
Charge for year	21.2	23.6	12.4	123.5	4.6	–	185.3
Impairment charge/ reversal for the year	36.0	–	–	(36.0)	–	–	–
Disposals	(20.3)	(1.2)	(0.1)	(17.0)	(1.2)	–	(39.8)
At 31 March 2016	372.2	223.7	227.4	1,129.9	52.9	–	2,006.1
Net book value							
At 1 April 2014	169.1	1,430.0	437.8	662.2	20.8	730.5	3,450.4
At 31 March 2015	158.4	1,440.2	434.5	1,092.2	17.9	435.6	3,578.8
At 31 March 2016	152.2	1,601.2	466.1	1,500.0	11.7	166.1	3,897.3

Of the total depreciation charge of £185.3 million (2015 £163.9 million) £1.4 million (2015 £1.3 million) has been charged to capital projects, £1.0 million (2015 £0.9 million) has been offset by deferred income and £182.9 million (2015 £161.7 million) has been charged against profits

Asset lives and residual values are reviewed annually

During the year borrowing costs of £7.3 million (2015 £21.1 million) have been capitalised on qualifying assets at an average borrowing rate of 4.1%

IMPAIRMENT TESTING FOR PROPERTY, PLANT AND EQUIPMENT AND INTANGIBLE ASSETS

Property, plant and equipment and finite lived intangible assets are reviewed for impairment when any indicators of impairment are identified. Most of the individual assets do not generate independent cash flows and as a result, for the purposes of impairment reviews the assets are grouped into cash generating units (CGUs). The CGUs of the waste management segment comprise individual assets which together constitute the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or group of assets.

The carrying value of these individual assets is compared to the recoverable amount of the CGUs, which is based predominantly on value-in-use. Value-in-use calculations use the same base cash flow projections used for testing goodwill (note 15) and are derived by adjusting the Group's detailed budget and strategic plan which cover a period of seven years and are approved by the Board annually. The key assumptions are the same as for the impairment testing of goodwill (note 15).

To reflect changes in the waste market including the structural decline of landfill, and the prominence of recycling and recovering value from waste, together with the reorientation of Vinor's operations towards ERFs the allocation of CGUs has been refreshed.

The updated allocations ensure CGUs reflect the lowest level of independent cash inflows. Non-strategic landfill assets are considered separate CGUs as are landfill gas assets, with other remaining assets allocated to regional CGUs.

The result of this change in CGUs is an impairment of non-strategic landfill sites of £60.9 million and a £60.9 million reversal of assets, including strategic landfill sites and recycling assets, allocated to regional CGUs.

For certain CGUs the recoverable amount is determined by reference to the fair value less costs to sell of the underlying assets using external and internal valuations of property and equipment and management's estimate of disposal costs.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

17. PROPERTY, PLANT AND EQUIPMENT CONTINUED

For the purposes of disclosing the results of the impairment review the CGUs have been grouped together by asset class of non-strategic landfill CGUs or regional CGUs. The key assumptions in the Group's detailed budget and strategic plan are the same as those used for testing goodwill (note 15). The assumptions applied to these cash flow projections are:

Assumption	Basis for assumption
Discount rate The pre-tax discount rate used for landfill is 9% The pre-tax discount rate used for regional CGUs ranges from 7% - 10%	Discount rates have been determined based on an estimate of the waste management segment's weighted average cost of capital adjusted for the different risk profiles of the segment's business activities to the extent that the cash flows have not already been adjusted
Long-term growth rates	
0.5% applied to overheads beyond the period of the detailed projections	Ongoing efficiencies and benefits from economies of scale
2.5% applied to other cash flows beyond the strategic plan period up to the end of the life of the assets on projected volumes	Based on forecasts of growth in waste management markets and the UK economy

Using management cash flow projections, a 1.5% increase in real long-term growth rate of overheads or a 0.5% increase in discount rate or a 0.5% reduction in the long-term growth rate of other cash flows, or a 5% reduction in overall net cash flows, with all other variables held constant would not have a material impact on the impairment charge or impairment reversal in the year.

Assets held under finance leases included above were:

	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant vehicles and computers £m	Construction in progress £m	Total £m
Cost					
At 31 March 2015	398.0	422.3	492.3	1.1	1,313.7
At 31 March 2016	409.5	439.8	515.9	0.2	1,365.4
Accumulated depreciation					
At 31 March 2015	47.4	96.9	210.1	–	354.4
At 31 March 2016	52.6	107.2	252.6	–	412.4
Net book amount					
At 31 March 2015	350.6	325.4	282.2	1.1	959.3
At 31 March 2016	356.9	332.6	263.3	0.2	953.0

	Fixed and mobile plant vehicles and computers £m
Company	
Cost	
At 1 April 2014	0.3
Additions	0.1
Disposals	(0.1)
At 31 March 2015	0.3
Additions	0.1
Disposals	(0.1)
At 31 March 2016	0.3
Accumulated depreciation	
At 1 April 2014	0.1
Charge for year	0.1
Disposals	–
At 31 March 2015	0.2
Charge for year	0.1
Disposals	(0.1)
At 31 March 2016	0.2
Net book value	
At 1 April 2014	0.2
At 31 March 2015	0.1
At 31 March 2016	0.1

Asset lives and residual values are reviewed annually

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

18. FINANCIAL INSTRUMENTS BY CATEGORY

The accounting policies for financial instruments have been applied to the line items

	Notes	Fair value			Amortised cost		Total £m
		Derivatives used for fair value hedging £m	Derivatives used for cash flow hedging £m	Derivatives not in a hedge accounting relationship £m	Loans and receivables £m	Trade receivables and trade payables £m	
Group							
31 March 2016							
Financial assets							
Trade receivables	22	-	-	-	-	208.0	208.0
Other receivables	19.22	-	-	-	283.0	-	283.0
Derivative financial instruments	23	1.8	3.4	670	-	-	72.2
Cash and cash deposits	25	-	-	-	632.2	-	632.2
Total		1.8	3.4	670	915.2	208.0	1,195.4
Financial liabilities							
Borrowings	28	-	-	-	(3,116.6)	-	(3,116.6)
Derivative financial instruments	23	-	(46.9)	(9.0)	-	-	(55.9)
Trade payables	26	-	-	-	-	(95.9)	(95.9)
Total		-	(46.9)	(9.0)	(3,116.6)	(95.9)	(3,268.4)
31 March 2015							
Financial assets							
Trade receivables	22	-	-	-	-	195.7	195.7
Other receivables	19.22	-	-	-	300.2	-	300.2
Derivative financial instruments	23	68.1	0.2	-	-	-	68.3
Cash and cash deposits	25	-	-	-	771.0	-	771.0
Total		68.1	0.2	-	1,071.2	195.7	1,335.2
Financial liabilities							
Borrowings	28	-	-	-	(2,968.1)	-	(2,968.1)
Derivative financial instruments	23	(6.5)	(45.9)	(13.1)	-	-	(65.5)
Trade payables	26	-	-	-	-	(102.5)	(102.5)
Total		(6.5)	(45.9)	(13.1)	(2,968.1)	(102.5)	(3,136.1)
Company							
31 March 2016							
Financial assets							
Amounts owed by subsidiaries	19.22	-	-	-	974.2	-	974.2
Other receivables	22	-	-	-	74	-	74
Derivative financial instruments	23	1.8	-	-	-	-	1.8
Cash and cash deposits	25	-	-	-	429.7	-	429.7
Total		1.8	-	-	1,413.3	-	1,413.1
Financial liabilities							
Amounts due to subsidiaries	26	-	-	-	(0.3)	-	(0.3)
Borrowings	28	-	-	-	(1,164.3)	-	(1,164.3)
Derivative financial instruments	23	-	(7.6)	(4.2)	-	-	(11.8)
Trade payables	26	-	-	-	-	(0.3)	(0.3)
Total		-	(7.6)	(4.2)	(1,164.6)	(0.3)	(1,176.7)
31 March 2015							
Financial assets							
Amounts owed by subsidiaries	19.22	-	-	-	945.2	-	945.2
Cash and cash deposits	25	-	-	-	532.5	-	532.5
Total		-	-	-	1,477.7	-	1,477.7
Financial liabilities							
Amounts due to subsidiaries	26	-	-	-	(0.3)	-	(0.3)
Borrowings	28	-	-	-	(1,219.3)	-	(1,219.3)
Derivative financial instruments	23	(0.7)	(13.1)	(3.6)	-	-	(17.4)
Trade payables	26	-	-	-	-	(0.1)	(0.1)
Total		(0.7)	(13.1)	(3.6)	(1,219.6)	(0.1)	(1,237.1)

19. OTHER NON-CURRENT ASSETS

Non-current receivables

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Amounts owed by subsidiary undertakings	–	–	905.1	789.6
Amounts owed by related parties (note 46)	78.3	97.6	–	–
Service concession arrangements	179.4	182.9	–	–
Other receivables	10.1	10.6	0.4	0.4
	267.8	291.1	905.5	790.0

Non-current receivables were due

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Between 1 and 2 years	36.7	20.3	66.4	63.0
Over 2 years and less than 5 years	29.4	31.5	250.4	229.1
Over 5 years	201.7	239.3	588.7	497.9
	267.8	291.1	905.5	790.0

The fair values of non-current receivables were

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Amounts owed by subsidiary undertakings	–	–	1,000.5	897.5
Amounts owed by related parties	145.4	170.7	–	–
Service concession arrangements	179.4	182.9	–	–
Other receivables	10.1	10.6	0.4	0.4
	334.9	364.2	1,000.9	897.9

The fair value of amounts owed by related parties is based on cash flows using a rate based on the borrowings rate of 2.5% (2015 2.5%)

The discount rate is equal to London Interbank Offered Rate plus an allowance to reflect an appropriate credit margin

The effective interest rate on amounts owed by related parties was 12.3% (2015 12.3%)

Other receivables include site development and pre-contract costs of £9.6 million (2015 £9.3 million)

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

20. INVESTMENTS

SUBSIDIARY UNDERTAKINGS

	£m
Company	
At 1 April 2014	1 323 3
Additions	200 3
At 31 March 2015	1 523 6
Additions	104 7
At 31 March 2016	1,628 3

JOINT VENTURES

	Shares £m
Group	
At 1 April 2014	0 1
Share of post-tax profit	4 9
Share of other comprehensive profit	1 1
Dividends received	(6 0)
At 31 March 2015	0 1
Share of post-tax profit	3 6
Share of other comprehensive profit	2 4
Dividends received	(6 0)
At 31 March 2016	0 1

The recoverable amount of investments is determined based on value-in-use calculations which are set out in note 15

Details of the Group's principal subsidiary joint venture and unconsolidated structured entity undertakings are set out in note 40

The Group's joint ventures and associate listed below all have share capital consisting solely of ordinary shares which is held directly by the Group

Name of Entity	Place of business/ country of incorporation	% of ownership	Measurement method
Lakeside Energy from Waste Holdings Limited ⁽¹⁾	England	50	Equity
Viridor Laing (Greater Manchester) Holdings Limited ⁽²⁾	England	50	Equity
INEOS Runcorn (TPS) Holdings Limited ⁽³⁾	England	20	Equity

(1) Lakeside Energy from Waste Holdings Limited provides energy recovery facility services

(2) Viridor Laing (Greater Manchester) Holdings Limited is delivering the 25 year Greater Manchester Waste PFI contract which is a combined energy and renewable energy project

(3) INEOS Runcorn (TPS) Holdings Limited provides energy facility facilities. The Group's economic interest is 37.5% as set out in note 40

The Group's joint ventures and associate are all private companies and there are no quoted market prices available for their shares

Summarised financial information for the Group's joint ventures and associate

SUMMARISED BALANCE SHEET

	2016			2015		
	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m
Current						
Cash and cash equivalents	14.4	61.2	24.3	22.0	104.4	29.3
Other current assets	9.5	27.4	17.5	7.5	8.9	11.0
Total current assets	23.9	88.6	41.8	29.5	113.3	40.3
Borrowings	-	-	-	(0.1)	-	-
Other current liabilities	(3.7)	(43.2)	(11.4)	(6.1)	(42.4)	(20.0)
Total current liabilities	(3.7)	(43.2)	(11.4)	(6.2)	(42.4)	(20.0)
Non-current						
Assets	122.6	288.8	289.7	130.6	328.0	297.2
Borrowings	(114.0)	(331.4)	(322.1)	(125.8)	(387.3)	(319.1)
Other liabilities	(38.0)	(43.2)	(53.6)	(39.6)	(56.4)	(46.0)
Total non-current liabilities	(152.0)	(374.6)	(375.7)	(165.4)	(443.7)	(365.1)
Net liabilities	(9.2)	(40.4)	(55.6)	(11.5)	(44.8)	(47.6)
Net debt	(99.6)	(270.2)	(297.8)	(103.9)	(282.9)	(289.8)
Associated shareholder loans	17.8	73.6	94.6	18.5	114.4	84.2
Net debt (excluding shareholder loans)	(81.8)	(196.6)	(203.2)	(85.4)	(168.5)	(205.6)

Summarised statement of comprehensive income

	2016			2015		
	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m
Revenue	46.7	148.0	56.2	49.6	141.4	57.0
EBITDA	31.3	6.2	34.3	36.2	6.0	21.8
Depreciation and amortisation	(7.9)	(1.2)	(10.7)	(7.9)	(1.3)	(2.9)
Interest receivable on service concession arrangements	-	23.4	-	-	24.2	-
Other net interest charge	(9.0)	(29.6)	(30.0)	(9.4)	(32.6)	(24.3)
Pre-tax profit/ (loss)	14.4	(1.2)	(6.4)	18.9	(3.7)	(5.4)
Income tax (expense)/ income	(1.2)	1.1	(1.4)	(2.5)	1.1	-
Post-tax profit/ (loss)	13.2	(0.1)	(7.8)	16.4	(2.6)	(5.4)
Other comprehensive income/ (loss)	1.1	4.5	(0.2)	(7.8)	(15.1)	(16.4)
Total comprehensive income/ (loss)	14.3	4.4	(8.0)	8.6	(17.7)	(21.8)
Dividends paid by joint venture	(12.0)	-	-	(12.0)	-	-

The information above reflects the amounts presented in the financial statements of the joint ventures and associate adjusted for differences in accounting policies between the Group and the joint ventures and associate. The information reflects 100% of the joint ventures and associate results and net liabilities.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

20. INVESTMENTS CONTINUED

RECONCILIATION OF SUMMARISED FINANCIAL INFORMATION

Reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture/ associate

	2016			2015		
	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m	Lakeside Energy from Waste Holdings Limited £m	Viridor Laing (Greater Manchester) Holdings Limited £m	INEOS Runcorn (TPS) Holdings Limited £m
Opening net liabilities 1 April	(11 5)	(44 8)	(47 6)	(8 1)	(27 1)	(25 8)
Profit/ (loss) for the year	13 2	(0 1)	(7 8)	16 4	(2 6)	(5 4)
Other comprehensive income/ (loss)	1 1	4 5	(0 2)	(7 8)	(15 1)	(16 4)
Dividends paid	(12 0)	-	-	(12 0)	-	-
Closing net liabilities	(9 2)	(40 4)	(55 6)	(11 5)	(44 8)	(47 6)
Interest in joint venture	(4 6)	(20 2)	(20 9)	(5 8)	(22 4)	(23 8)
Share of net liabilities not recognised	4 7	20 2	20 9	5 9	22 4	23 8
Carrying value	0 1	-	-	0 1	-	-

Net liabilities in excess of the Group's interest are not recognised unless the Group has a legal or constructive obligation to fund those liabilities

21. INVENTORIES

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Raw materials and consumables	20 6	15 0	-	-

22. TRADE AND OTHER RECEIVABLES – CURRENT

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Trade receivables	303.6	282.5	-	-
Less provision for impairment of receivables	(95.6)	(86.8)	-	-
Net trade receivables	208.0	195.7	-	-
Amounts owed by related parties (note 45)	17.9	19.7	-	-
Amounts owed by subsidiary undertakings	-	-	69.1	155.6
Other receivables	14.3	10.9	7.4	0.3
Prepayments and accrued income	83.3	61.4	0.9	0.3
	323.5	287.7	77.4	156.2

Trade receivables include accrued income relating to customers with water budget plans

The Directors consider that the carrying amounts of trade and other receivables approximate to their fair value

There is no concentration of credit risk in trade receivables. The Group has a large number of customers who are dispersed and there is no significant loss on trade receivables expected that has not been provided for. The Group has created IAS 39 portfolio provisions but cannot practicably identify which receivables specifically are the ones impaired. It is Group policy to consider a receivable in a portfolio to which an impairment has been allocated on a collective basis as not being impaired for the purposes of IFRS 7 disclosures until the loss can be specifically identified with the receivable.

The ageing of trade receivables which are past due but not specifically impaired was

	2016 £m	2015 £m
Group		
Past due 1 – 30 days	37.8	33.6
Past due 31 – 120 days	18.7	20.8
More than 120 days	148.8	134.4

The aged trade receivables above are taken directly from aged sales ledger records before deduction of credit balances and other adjustments

The Group's operating businesses specifically review separate categories of debt to identify an appropriate provision for impairment. South West Water Limited and Bournemouth Water Limited have a duty under legislation to continue to provide domestic customers with services regardless of payment.

The movement in the allowance for impairment in respect of trade receivables was

	2016 £m	2015 £m
At 1 April	86.8	86.1
Arising on acquisition (note 44)	1.0	-
Provision for receivables impairment	8.4	12.8
Receivables written off during the year as uncollectable	(4.1)	(19.2)
Cumulative amounts previously excluded from debt	3.5	7.1
At 31 March	95.6	86.8

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

23. DERIVATIVE FINANCIAL INSTRUMENTS

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Derivatives used for cash flow hedging				
Non-current assets	2 4	0 2	-	-
Current assets	1 0	-	-	-
Current liabilities	(14 7)	(13 2)	(2 7)	(2 9)
Non-current liabilities	(32 2)	(32 7)	(4 9)	(10 2)
Derivatives used for fair value hedging				
Non-current assets	1 3	60 0	1 3	-
Current assets	0 5	8 1	0 5	-
Current liabilities	-	(2 4)	-	-
Non-current liabilities	-	(4 1)	-	(0 7)
Derivatives not in a hedge accounting relationship				
Non-current assets	59 0	-	-	-
Current assets	8 0	-	-	-
Current liabilities	(2 7)	(3 9)	-	-
Non-current liabilities	(6 3)	(9 2)	(4 2)	(3 6)

The fair value of hedging derivatives is split between current and non-current assets or liabilities based on the maturity of the cash flows

The ineffective portion recognised in the income statement arising from hedging relationships was £nil (2015 £nil)

Interest rate swaps, primarily cash flow hedges, and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50% of Group net borrowings are at fixed rate. At 31 March 2016 67% of Group net borrowings were at fixed rate (2015 72%)

At 31 March 2016 the Group had interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £1,078 0 million and a weighted average maturity of 3 9 years (2015 £1 103 0 million with 4 4 years). The weighted average interest rate of the swaps for their nominal amount was 2 0% (2015 2 1%)

Derivatives deemed held for trading includes a derivative with a fair value of £4 2 million (2015 £3 6 million) which does not qualify for hedge accounting under IAS 39 but is designed to improve the Group's overall interest rate performance. This derivative arises from a combination of non-derivative instruments entered into during the year that when combined result in a derivative instrument. Included in the derivative instrument is a £200 million floating interest rate-linked loan from Peninsula MB Limited to the Company and a fixed rate £200 million obligation due to the Company from Peninsula MB Limited. This derivative has an expected life of 10 years.

VALUATION HIERARCHY

The Group uses the following hierarchy for determining the fair value of financial instruments by valuation technique:

- quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1)
- inputs other than quoted prices included within level 1 that are observable for the asset or liability either directly (that is as prices) or indirectly (that is derived from prices) (level 2)
- inputs for the asset or liability that are not based on observable market data (that is unobservable inputs) (level 3)

The fair value of financial instruments not traded in an active market (level 2 for example over-the-counter derivatives) is determined by using valuation techniques. A variety of methods and assumptions are used based on market conditions existing at each balance sheet date. Quoted market prices or dealer quotes for similar instruments are used for long-term debt. Other techniques, such as estimated discounted cash flows, are used to determine fair value for the remaining financial instruments. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows.

The Group's financial instruments are valued principally using level 2 measures

	Group		Company	
	2016	2015	2016	2015
Level 2 inputs	£m	£m	£m	£m
Assets				
Derivatives used for cash flow hedging	3.4	0.2	-	-
Derivatives used for fair value hedging	1.8	68.1	1.8	-
Derivatives not in a hedge accounting relationship	67.0	-	-	-
Total assets	72.2	68.3	1.8	-
Liabilities				
Derivatives used for cash flow hedging	46.9	45.9	7.5	13.1
Derivatives used for fair value hedging	-	6.5	-	0.7
Derivatives not in a hedge accounting relationship	4.8	9.5	-	-
Total liabilities	51.7	61.9	7.5	13.8

Financial instruments valued using level 3 measures are valued by the counterparty using cash flows discounted at prevailing mid-market rates. The fair value of such financial instruments is not significantly sensitive to unobservable inputs

	Group		Company	
	2016	2015	2016	2015
Level 3 inputs	£m	£m	£m	£m
Liabilities				
Derivatives deemed held for trading	4.2	3.6	4.2	3.6

The following table presents the changes in level 3 financial instruments for the year:

	Group		Company	
	2016	2015	2016	2015
Level 3 inputs	£m	£m	£m	£m
At 1 April	(3.6)	(2.4)	(3.6)	(2.4)
Gains recognised in net finance costs	8.4	7.8	8.4	7.8
Settlement of recognised gains	(9.0)	(9.0)	(9.0)	(9.0)
At 31 March	(4.2)	(3.6)	(4.2)	(3.6)

24. FINANCIAL INSTRUMENTS AT FAIR VALUE THROUGH PROFIT

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Current assets	-	0.1	-	-
Current liabilities	(2.2)	-	-	-
Non-current liabilities	(51.0)	(57.3)	(1.6)	(0.5)

Financial instruments at fair value through profit reflect the fair value movement of the hedged risk on a hedged item which had been designated in a fair value hedging relationship

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

25. CASH AND CASH DEPOSITS

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Cash at bank and in hand	44 5	49 6	92 7	42 4
Short-term bank deposits	31 1	125 0	31 1	125 0
Other deposits	556 6	596 4	305 9	365 1
Total cash and cash deposits	632 2	771 0	429 7	532 5

Group short-term deposits have an average maturity of one day

Group other deposits have an average maturity of 53 days

Group other deposits include restricted funds of £216.8 million (2015 £186.5 million) to settle long-term lease liabilities (note 28) and £9.7 million (2015 £9.7 million) relating to letters of credit. Restricted funds are available for access, subject to being replaced by an equivalent valued security.

For the purposes of the cash flow statement, cash and cash equivalents comprise:

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Cash and cash deposits as above	632 2	771 0	429 7	532 5
Less: deposits with a maturity of three months or more (restricted funds)	(226 5)	(196 2)	(9 7)	–
	405 7	574 8	420 0	532 5

26. TRADE AND OTHER PAYABLES – CURRENT

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Trade payables	95 9	102 5	0 3	0 1
Amounts owed to subsidiary undertakings	–	–	0 3	0 3
Amounts owed to joint ventures (note 46)	3 9	1 2	–	–
Other tax and social security	52 3	64 2	0 3	0 3
Accruals and other payables	112 5	109 8	5 0	4 9
	264 6	277 7	5 9	5 6

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

27. CURRENT TAX LIABILITIES

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Corporation tax creditor	–	15 6	–	–
Continuing uncertain tax items	51 6	36 6	53 5	23 8
Clarified tax items	(14 5)	–	–	–
Current tax liabilities	37 1	52 2	53 5	23 8

28. BORROWINGS

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Current				
Short-term loans	0.3	50.9	–	50.7
European Investment Bank	38.7	31.1	–	–
Amounts owed to subsidiary undertakings (note 46)	–	–	287.2	283.2
	39.0	82.0	287.2	333.9
Obligations under finance leases	26.0	31.6	–	–
Total current borrowings	65.0	113.6	287.2	333.9
Non-current				
Bank and other loans	403.2	338.0	323.3	338.0
Private placements	553.8	547.4	553.8	547.4
Bond 2040	133.3	133.0	–	–
RPI index-linked bonds	412.2	258.8	–	–
European Investment Bank	234.5	273.2	–	–
	1,737.0	1,550.4	877.1	885.4
Obligations under finance leases	1,314.6	1,304.1	–	–
Total non-current borrowings	3,051.6	2,854.5	877.1	885.4
Total borrowings	3,116.6	2,968.1	1,164.3	1,219.3

The Company issued a £100 million private placement in July 2007 maturing in 2022. Interest is payable at a fixed rate of 3.3%.

South West Water Finance Plc issued a £200 million RPI index-linked bond in July 2008 maturing in 2057 with a cash coupon of 1.99%.

South West Water Finance Plc issued a £150 million bond in July 2010 maturing in 2040 with a cash coupon of 5.875%.

Bournemouth Water Limited issued a £65 million RPI index-linked bond in April 2005 maturing in 2033 with a cash coupon of 3.084%.

The fair values of non-current borrowings, valued using level 2 measures (as set out in note 23) were:

	2016		2015	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Group				
Bank and other loans	403.2	403.2	338.0	338.0
Private placements	553.8	600.0	547.4	606.9
Bond 2040	133.3	198.4	133.0	199.9
RPI index-linked bond	412.2	364.6	258.8	203.4
European Investment Bank	234.5	209.3	273.2	250.6
	1,737.0	1,775.5	1,550.4	1,598.8
Obligations under finance leases	1,314.6	1,163.0	1,304.1	1,182.0
	3,051.6	2,938.5	2,854.5	2,780.8
Company				
Bank and other loans	323.3	323.3	338.0	337.9
Private placements	553.8	600.0	547.4	606.9
	877.1	923.3	885.4	944.8

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

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

28. BORROWINGS CONTINUED

The maturity of non-current borrowings was

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Between 1 and 2 years	141 7	133 7	74 6	74 9
Over 2 year and less than 5 years	427 0	465 2	225 8	310 0
Over 5 years	2,482 9	2 255 6	576 7	500 5
	3,051 6	2 854 5	877 1	885 4

The weighted average maturity of non-current borrowings was 22 years (2015 23 years)

Finance lease liabilities – minimum lease payments were

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Within 1 year	41 1	50 6	–	–
Over 1 year and less than 5 years	220 5	251 3	–	–
Over 5 years	2,130 7	2 167 6	–	–
	2,392 3	2 469 5	–	–
Less future finance charges	(1,051 7)	(1 133 8)	–	–
Present value of finance lease liabilities	1,340 6	1 335 7	–	–

The maturity of finance lease liabilities was

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Within 1 year	26 0	23 7	–	–
Over 1 year and less than 5 years	124 8	123 8	–	–
Over 5 years	1,189 8	1 188 2	–	–
	1,340 6	1 335 7	–	–

Included above are accrued finance charges arising on obligations under finance leases totalling £138 8 million (2015 £132 8 million) of which £1 7 million (2015 £2 9 million) is repayable within one year

The period for repayment of certain leases includes an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits £71 7 million at 31 March 2016 (2015 £70 7 million), are currently being held to settle the lease liability subject to rights to release by negotiation with the lessor. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

The period for repayment of certain other existing leases includes an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits £142.3 million at 31 March 2016 (2015 £115.8 million) are currently being held to settle the lease liability subject to rights to release by negotiation with the lessor. The deposits are subject to a registered charge given as security to the lessor for the outstanding balance.

Undrawn committed borrowing facilities at the balance sheet date were:

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Floating rate				
Expiring within 1 year	100.0	150.0	50.0	-
Expiring after 1 year	975.0	820.4	240.0	420.0
	1,075.0	970.4	290.0	420.0

In addition at 31 March 2016 the Group had undrawn uncommitted short-term bank facilities of £25.0 million (2015 £25.0 million) available to the Company or South West Water Limited.

29. OTHER NON-CURRENT LIABILITIES

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Amounts owed to subsidiary undertakings	-	-	8.7	8.7
Other payables	113.2	110.1	-	-
	113.2	110.1	8.7	8.7

Other payables include deferred income resulting from the adoption at fair value of assets transferred from customers in the water segment.

Included in other payables are amounts provided by the Group in relation to claims received which are considered by the Directors and the management of the Group to be the best estimate of the amounts that might be finally settled. Further disclosures have not been provided in accordance with IAS 37 paragraph 92.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

30. RETIREMENT BENEFIT OBLIGATIONS

During the year the Group operated a number of defined benefit pension schemes and also 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 for the main fund that one-half of all trustees, other than the Chairman, are nominated by members of the schemes' including pensioners.

DEFINED CONTRIBUTION SCHEMES

Pension costs for defined contribution schemes were £7.5 million (2015: £5.4 million)

DEFINED BENEFIT SCHEMES**Assumptions**

The principal actuarial assumptions at 31 March were

	2016	2015	2014
	%	%	%
Rate of increase in pensionable pay	2.9	2.9	3.4
Rate of increase for current and future pensions	2.9	2.9	3.2
Rate used to discount schemes' liabilities and expected return on schemes' assets	3.30	3.35	4.30
Inflation	2.9	2.9	3.4

MORTALITY

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience. The mortality assumption uses a scheme-specific calculation based on CMI 2013 actuarial tables with an allowance for future longevity improvement.

The average life expectancy in years of a member having retired at age 62 on the balance sheet date is projected as

	2016	2015	2014
Male	25.1	25.0	24.9
Female	27.3	27.2	27.1

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

	2016	2015	2014
Male	26.5	26.4	26.3
Female	29.6	29.5	29.4

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%	+/- 0.1%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.2%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.4%
Inflation	+/- 0.5%	+/- 6.3%
Life expectancy	+/- 1 year	+/- 3.6%

The amounts recognised in the balance sheet were

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Present value of financial obligations	(826 0)	(742 2)	(50 7)	(50 8)
Fair value of plan assets	792 7	692 7	47 7	46 6
Deficit of funded plans	(33 3)	(49 5)	(3 0)	(4 2)
Impact of minimum funding asset ceiling	(7 6)	(10 1)	-	-
Net liability recognised in the balance sheet	(40 9)	(59 6)	(3 0)	(4 2)

The movement in the net defined benefit obligation over the accounting period is as follows

	2016			2015		
	Present value of obligation £m	Fair value of plan assets £m	Total £m	Present value of obligation £m	Fair value of plan assets £m	Total £m
At 1 April	(752 3)	692 7	(59 6)	(687 7)	608 4	(79 3)
Arising on acquisition (note 44)	(86 6)	88 5	1 9	-	-	-
Current service cost	(12 6)	-	(12 6)	(12 5)	-	(12 5)
Past service cost and gains and losses on settlements*	-	-	-	14 6	-	14 6
Interest (expense)/ income	(27 3)	25 5	(1 8)	(28 6)	25 9	(2 7)
	(39 9)	25 5	(14 4)	(26 5)	25 9	(0 6)
Remeasurements						
(Loss)/ return on plan on assets excluding amounts included in interest expense	-	(19 7)	(19 7)	-	58 7	58 7
Gain from change in demographic assumptions	-	-	-	19 0	-	19 0
Gain/ (loss) from change in financial assumptions	2 7	-	2 7	(81 5)	-	(81 5)
Experience gains	14 4	-	14 4	1 7	-	1 7
	17 1	(19 7)	(2 6)	(60 8)	58 7	(2 1)
Contributions						
Employers	-	33 8	33 8	-	22 4	22 4
Plan participants	(1 1)	1 1	-	(1 2)	1 2	-
Payments from plans						
Benefit payments	29 2	(29 2)	-	23 9	(23 9)	-
	28 1	5 7	33 8	22 7	(0 3)	22 4
At 31 March	(833 6)	792 7	(40 9)	(752 3)	692 7	(59 6)

* includes non underlying credit of £14.9 million in 2015

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

30. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

The movement in the Company's net defined benefit obligation over the accounting period is as follows

	2016			2015		
	Present value of obligation	Fair value of plan assets	Total	Present value of obligation	Fair value of plan assets	Total
	£m	£m	£m	£m	£m	£m
1 April	(50.8)	46.6	(4.2)	(47.2)	41.0	(6.2)
Current service cost	(0.3)	–	(0.3)	(0.4)	–	(0.4)
Past service cost and gains and losses on settlement	–	–	–	1.2	–	1.2
Interest (expense)/ income	(1.7)	1.5	(0.2)	(2.0)	1.8	(0.2)
	(2.0)	1.5	(0.5)	(1.2)	1.8	0.6
Remeasurements						
(Loss)/ return on plan on assets excluding amounts included in interest expense	–	(0.9)	(0.9)	–	3.7	3.7
Gain from change in demographic assumptions	–	–	–	1.4	–	1.4
Loss from change in financial assumptions	–	–	–	(5.8)	–	(5.8)
Experience gains	0.3	–	0.3	0.1	–	0.1
	0.3	(0.9)	(0.6)	(4.3)	3.7	(0.6)
Contributions						
Employers	–	2.3	2.3	–	2.0	2.0
Payments from plans						
Benefit payments	1.8	(1.8)	–	1.9	(1.9)	–
	1.8	0.5	2.3	1.9	0.1	2.0
31 March	(50.7)	47.7	(3.0)	(50.8)	46.6	(4.2)

Changes in the effect of the asset ceiling during the year were

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Irrecoverable asset at start of the year	10.1	10.3	–	–
Interest on irrecoverable surplus	0.3	0.4	–	–
Actuarial losses	(2.8)	(0.6)	–	–

The Group has two smaller pension schemes which are in surplus. One of these surpluses is deemed to have irrecoverable assets in accordance with IFRIC 14 'The Limit on Defined Benefit Asset, Minimum Funding Requirements and their Interaction'.

The schemes' assets were

	2016			2015		
	Quoted prices in active market	Prices not quoted in active market	Fund %	Quoted prices in active market	Prices not quoted in active market	Fund %
	£m	£m	%	£m	£m	%
Equities	247.9	–	31	240.4	–	35
Government bonds	87.2	–	11	106.2	–	15
Other bonds	134.2	–	17	123.3	–	18
Diversified growth	170.8	–	22	71.2	–	10
Property	50.4	8.3	7	44.8	1.5	7
Other (including cash funds)	80.0	13.9	12	95.9	9.4	15
	770.5	22.2	100	681.8	10.9	100

Other assets at 31 March 2016 represented principally cash contributions received from the Group towards the year end which were invested during the subsequent financial year

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

	2016			2015		
	Quoted prices in active market	Prices not quoted in active market	Fund	Quoted prices in active market	Prices not quoted in active market	Fund
	£m	£m	%	£m	£m	%
Equities	143	–	30	154	–	33
Government bonds	80	–	17	82	–	18
Other bonds	97	–	20	64	–	14
Diversified growth	56	–	12	57	–	12
Property	40	–	8	36	–	8
Other	61	–	13	73	–	15
	477	–	100	466	–	100

Through its defined benefit pension plan, the Group is exposed to a number of risks, the most significant of which are detailed below

Asset volatility	The liabilities are calculated using a discount rate set with reference to corporate bond yields. If assets underperform this yield, this will create a deficit. The schemes hold a significant proportion of growth assets (equities and diversified growth funds) which are expected to outperform corporate bonds in the long-term but can give rise to volatility and risk in the short-term. The allocation to growth assets is monitored such that it is suitable with the schemes' long-term objectives.
Changes in bond yields	A decrease in corporate bond yields will increase the schemes' liabilities, although this will be partially offset by an increase in the value of the schemes' bond holdings.
Inflation risk	The majority of the schemes' benefit obligations are linked to inflation, and higher inflation will lead to higher liabilities (although, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation). The majority of the assets are either unaffected by or loosely correlated with inflation, meaning that an increase in inflation will also increase the deficit.
Life expectancy	The majority of the schemes' obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the liabilities.

In conjunction with its investment advisers, the trustees have structured the schemes' investments with the objective of balancing investment returns and levels of risk. The asset allocation for the main scheme has three principal elements:

- holding of cash funds and bonds which are expected to be less volatile than most other asset classes and reflects market movements in the schemes' liabilities
- a proportion of equities with fund managers having freedom in making investment decisions to maximise returns
- investment of a proportion of the schemes' assets in alternative asset classes which give the potential for diversification (currently property and diversified growth)

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 increases in pensionable pay.

The future cash flows arising from the payment of the defined benefits are expected to be settled primarily in the period between 15 and 40 years from the balance sheet date.

The last triennial actuarial valuation of the principal defined benefit scheme was at 31 March 2013. The Group has made a deficit recovery contribution of £23.7 million to the main scheme during the year (2015: £11.0 million). The Group monitors funding levels on an annual basis and expects to pay total contributions of around £10 million during the year ended 31 March 2017.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

31. DEFERRED TAX

Deferred tax is provided in full on temporary differences under the liability method using enacted tax rates (2015 20%)

Movements on deferred tax were

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Liabilities/ (assets) at 1 April	235.9	227.1	(3.0)	(1.3)
Charged/ (credited) to the income statement	39.2	18.2	0.5	(0.1)
Charged/ (credited) to equity	4.5	(6.1)	0.5	(1.6)
Change of rate in income statement – non-underlying	(33.1)	–	(0.2)	–
Other non-underlying charges in the income statement	0.7	(3.3)	–	–
Arising on acquisition (note 44)	24.8	–	–	–
Liabilities/ (assets) at 31 March	272.0	235.9	(2.2)	(3.0)

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

The majority of the Group's deferred tax liability is expected to be recovered over more than one year

The majority of the Company's deferred tax asset is expected to be recovered over more than one year

All deferred tax assets and liabilities within the same jurisdiction are offset

The deferred tax balance has been reduced by a credit of £29.1 million to recognise the changes in the rate of corporation tax enacted on 18 November 2015 to reduce the rate at 1 April 2017 from 20% to 19%, followed by a further reduction from 1 April 2020 to 18%. This credit includes a credit of £33.1 million recognised in the income statement and a debit of £3.9 million recognised in equity. If the Government proposals contained in the Finance Bill 2016 to reduce the rate of corporation tax by a further 1% for the financial year 2021 (2% reduction in total) had been enacted at the balance sheet date, the impact would have been a further reduction of approximately £15.0 million.

The movements in deferred tax assets and liabilities were

GROUP

Deferred tax liabilities

	Accelerated tax	Fair value	Revenue on	Other	Total
	depreciation £m	adjustments £m	service concession arrangements £m	£m	£m
At 1 April 2014	239.1	11.1	17.3	0.2	267.7
(Credited)/ charged to the income statement	(1.4)	(1.2)	20.0	0.1	17.5
Non-underlying credit to the income statement	(2.7)	–	–	–	(2.7)
At 31 March 2015	235.0	9.9	37.3	0.3	282.5
Arising on acquisition	18.3	19.1	–	–	37.4
Charged/ (credited) to the income statement	16.3	(1.7)	7.5	–	22.1
Non-underlying (credit)/ charge to the income statement	(25.9)	(2.7)	(5.1)	0.6	(33.1)
At 31 March 2016	243.7	24.6	39.7	0.9	308.9

Deferred tax assets

	Long term	Retirement	Derivatives	Share based	Tax losses	Fair value	Other	Total
	liabilities incl provisions £m	benefit obligations £m		payments £m		adjustment £m		
At 1 April 2014	(15.8)	(15.9)	(3.3)	(1.7)	(1.4)	–	(2.5)	(40.6)
Charged/ (credited) to the income statement	(0.5)	1.5	–	0.1	–	–	(0.4)	0.7
Credited to equity	–	(0.4)	(5.7)	–	–	–	–	(6.1)
Non-underlying (credit)/ charge to the income statement	(3.6)	3.0	–	–	–	–	–	(0.6)
At 31 March 2015	(19.9)	(11.8)	(9.0)	(1.6)	(1.4)	–	(2.9)	(46.6)
Arising on acquisition	(0.1)	0.4	–	–	–	(12.9)	–	(12.6)
Charged/ (credited) to the income statement	14.0	3.7	–	–	(0.7)	0.7	(0.6)	17.1
Non-underlying charge/ (credit) to the income statement	1.1	(2.1)	–	–	0.2	1.2	0.3	0.7
(Credited)/ charged to equity	–	(0.6)	1.0	0.2	–	–	–	0.6
Non-underlying charge to equity	–	3.0	0.8	0.1	–	–	–	3.9
At 31 March 2016	(4.9)	(7.4)	(7.2)	(1.3)	(1.9)	(11.0)	(3.2)	(36.9)
Net liability								
At 31 March 2015								235.9
At 31 March 2016								272.0

COMPANY

Deferred tax assets

	Retirement benefit obligations £m	Derivatives £m	Share based payments £m	Other £m	Total £m
At 1 April 2014	(1 2)	–	(0 4)	0 3	(1 3)
Charged/ (credited) to the income statement	0 5			(0 6)	(0 1)
(Credited)/ charged to equity	(0 1)	(1 6)	0 1	–	(1 6)
At 31 March 2015	(0 8)	(1 6)	(0 3)	(0 3)	(3 0)
Charged to the income statement	0 3	–	–	0 1	0 4
Non-underlying credit to income statement	(0 2)	–	–	–	(0 2)
(Credited)/ charged to equity	(0 1)	0 2	0 1	–	0 2
Non-underlying charge to equity	0 3	0 1	–	–	0 4
At 31 March 2016	(0 5)	(1 3)	(0 2)	(0 2)	(2 2)

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

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Remeasurement of defined benefit obligations	(2 4)	0 4	(0 2)	0 1
Cash flow hedges	(1 8)	5 7	(0 3)	1 6
Deferred tax on other comprehensive loss (gain)/ loss	(4 2)	6 1	(0 5)	1 7
Share-based payments	(0 3)	–	(0 1)	(0 1)
	(4 5)	6 1	(0 6)	1 6

32. PROVISIONS

	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Total £m
Group				
At 1 April 2015	193 0	2 0	32 3	227 3
Charged to the income statement	11 2	–	4 9	16 1
Non-underlying charge (note 6)	–	10 2	–	10 2
Released	(8 8)	–	(3 5)	(12 3)
Utilised	(13 3)	(0 5)	(6 1)	(19 9)
At 31 March 2016	182 1	11 7	27 6	221 4

The amount charged to the income statement includes £9 4 million (2015 £10 5 million) charged to finance costs as the unwinding of discounts in provisions

The analysis of provisions between current and non-current is

	2016 £m	2015 £m
Current	50 4	32 9
Non-current	171 0	194 4
	221 4	227 3

Environmental and landfill restoration provisions are incurred during the operational life of each landfill site and for a considerable period thereafter. The period of aftercare post-closure and the level of costs expected are uncertain and can vary significantly from site to site. Key factors are the type of waste, the speed at which it decomposes, the volume of leachate requiring treatment and regulatory requirements specific to the site. Environmental and landfill restoration provisions are expected to be substantially utilised throughout the operational life of a site and for landfill sites within 60 years of closure. The provisions have been established assuming current waste management technology based upon estimated costs at future prices which have been discounted to present value.

During the year a landfill asset was disposed which resulted in the release of a £8 8 million environmental and landfill restoration provision. The release of the provision has also been recognised within profit on disposal of property, plant and equipment.

The restructuring provision relates principally to severance costs and will be utilised within one year.

Other provisions include underperforming contracts of £15 6 million (2015 £18 3 million) which are provided for at the net present value of the operating losses of the underperforming contracts and are to be utilised over the remaining period of the contract to which they relate.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

33. SHARE CAPITAL

ALLOTTED, CALLED-UP AND FULLY PAID

Group and Company	Number of shares		£m
	Treasury shares	Ordinary shares	
At 1 April 2014 ordinary shares of 40 7p each	1 282,690	370,552 276	151.3
Shares issued in respect of the £125 million convertible bond	–	20 909 635	8.5
Shares issued under the Scrip Dividend Alternative	–	6 365 622	2.6
Shares re-issued under the Company's Performance and Co-investment Plan	(131 685)	131 685	–
For consideration of £0.8 million, shares re-issued to the Pennon Employee Share Trust	(99 455)	99 455	–
For consideration of £0.1 million shares re-issued under the Executive Share Option Scheme	(5 027)	5 027	–
For consideration of £3.0 million shares re-issued under the Company's Sharesave Scheme	(657 008)	657 008	–
At 31 March 2015 ordinary shares of 40 7p each	389 515	398 720 708	162.4
Shares issued in respect of equity issuance	–	12 084 337	4.9
Shares issued under the Scrip Dividend Alternative	–	760,626	0.3
For consideration of £1.1 million shares re-issued to the Pennon Employee Share Trust	(143 538)	143 538	–
For consideration of £0.1 million shares re-issued under the Executive Share Option Scheme	(8 305)	8,305	–
For consideration of £1.3 million, shares re-issued under the Company's Sharesave Scheme	(227 316)	227 316	–
For consideration of £2.1 million shares issued under the Company's Sharesave Scheme	–	395 767	0.2
At 31 March 2016 ordinary shares of 40 7p each	10,356	412,340,597	167.8

The 12 084,337 share issuance was on a non pre-emptive basis to replenish cash resources following the acquisition of Bournemouth Water in April 2015. The discount achieved was 0.5% and proceeds raised net of discount and costs were £98 million. The percentage increase in issued share capital due to the issuance was 3%.

Shares held as treasury shares may be sold or re-issued for any of the Company's share schemes or cancelled.

EMPLOYEE SHARE SCHEMES

The Group operates a number of equity-settled share plans for the benefit of employees. Details of each plan are:

i) Sharesave Scheme

An all-employee savings related plan is operated that enables employees including Executive Directors to invest up to a maximum of £500 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 year 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	
			2016	2015
8 July 2008	517p	2011 – 2015	–	6
6 July 2009	386p	2012 – 2016	44	49
28 June 2010	431p	2013 – 2017	41	205
29 June 2011	536p	2014 – 2018	150	156
29 June 2012	588p	2015 – 2017	103	561
3 July 2013	538p	2016 – 2018	540	581
14 July 2014	611p	2017 – 2019	687	772
24 June 2015	683p	2018 – 2020	1,291	–
			2,856	2,330

The number and weighted average exercise price of Sharesave options are

	2016		2015	
	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	2,330	561	2,330	515
Granted	1,364	683	811	611
Forfeited	(170)	622	(97)	559
Exercised	(623)	545	(657)	457
Expired	(45)	596	(57)	550
At 31 March	2,856	619	2,330	561

The weighted average price of the Company's shares at the date of exercise of Sharesave options during the year was 779p (2015 811p). The options outstanding at 31 March 2016 had a weighted average exercise price of 619p (2015 561p) and a weighted average remaining contractual life of 2.1 years (2015 1.9 years).

The aggregate fair value of Sharesave options granted during the year was £1.7 million (2015 £0.8 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model at the date of issue of the options were:

	2016	2015
Weighted average share price	854	764p
Weighted average exercise price	683	611p
Expected volatility	17.0%	17.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.8%	1.4%
Expected dividend yield	4.0%	4.0%

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

ii) Performance and Co-investment Plan

Executive Directors and senior management receive a conditional award of ordinary shares in the Company and are also required to hold a substantial personal shareholding in the Company. The eventual number of shares, if any, which vest is dependent upon the achievement of conditions of the plan over the restricted period, being not less than three years.

The number and price of shares in the Performance and Co-investment Plan are:

	2016		2015	
	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	1,195	744	1,200	711
Granted	420	811	400	799
Vested	-	-	(132)	698
Lapsed	(417)	764	(273)	698
At 31 March	1,198	761	1,195	744

The awards outstanding at 31 March 2016 had a weighted exercise price of 761p (2015 744p) and a weighted average remaining contractual life of 1.3 years (2015 1.3 years).

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

33. SHARE CAPITAL CONTINUED

The aggregate fair value of awards granted during the year was £1.7 million (2015 £1.9 million) determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2016	2015
Weighted average share price	811p	799p
Expected volatility	17.0%	17.0%
Risk-free rate	0.8%	1.4%

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

iii) Annual 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. There is no performance condition since vesting is conditional upon continuous service with the Group for a period of three years from the award. The number and weighted average price of shares in the Annual Incentive Bonus Plan are:

	2016		2015	
	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	316	758	315	727
Granted	154	791	107	822
Vested	(152)	790	(106)	728
Lapsed	(11)	776	–	–
At 31 March	307	759	316	758

The awards outstanding at 31 March 2016 had a weighted average exercise price of 759p (2015 758p) and a weighted average remaining contractual life of 1.6 years (2015 1.3 years). The Company's share price at the date of the awards ranged from 693p to 822p.

The aggregate fair value of awards granted during the year was £1.2 million (2015 £0.9 million) determined from market value. No option pricing methodology is applied since dividends paid on the shares are receivable by the participants in the scheme.

Further details of the plans and options granted to Directors included above are shown in the Directors' remuneration report.

34. SHARE PREMIUM ACCOUNT

	£m
Group and Company	
At 1 April 2014	4.9
Convertible bond – equity issuance	116.3
Adjustment for shares issued under the Scrip Dividend Alternative	(2.6)
At 31 March 2015	118.6
Equity placing	95.4
Equity issuance related costs	(2.3)
Adjustment for shares issued under the Scrip Dividend Alternative	(0.3)
Shares issued under the Sharesave Scheme	1.9
At 31 March 2016	213.3

35. CAPITAL REDEMPTION RESERVE

The capital redemption reserve represents the redemption of B shares and cancellation of deferred shares arising from a capital return to shareholders undertaken during 2006

	£m
Group and Company	
At 1 April 2014	144.2
At 31 March 2015	144.2
At 31 March 2016	144.2

36. RETAINED EARNINGS AND OTHER RESERVES

	Own shares £m	Hedging reserve £m	Retained earnings £m	Total £m
Group				
At 1 April 2014	(17)	(39)	608.0	602.4
Profit for the year	–	–	126.3	126.3
Other comprehensive loss for the year	–	(33.0)	(0.6)	(33.6)
Transfer from hedging reserve to property, plant and equipment	–	1.9	–	1.9
Dividends paid relating to 2014	–	–	(117.0)	(117.0)
Adjustment for shares issued under the Scrip Dividend Alternative	–	–	48.0	48.0
Credit to equity in respect of share-based payments (net of tax)	–	–	3.5	3.5
Charge in respect of share options vesting	0.7	–	(0.7)	–
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	(0.8)	–	–	(0.8)
Convertible bond – equity issuance	–	–	(0.5)	(0.5)
Proceeds from treasury shares re-issued	–	–	3.9	3.9
At 31 March 2015	(1.8)	(35.0)	670.9	634.1
Profit for the year	–	–	152.1	152.1
Other comprehensive loss for the year	–	(0.2)	(2.6)	(2.8)
Transfer from hedging reserve to property, plant and equipment	–	3.4	–	3.4
Dividends paid relating to 2015	–	–	(129.5)	(129.5)
Adjustment for shares issued under the Scrip Dividend Alternative	–	–	6.3	6.3
Credit to equity in respect of share-based payments (net of tax)	–	–	2.5	2.5
Charge in respect of share options vesting	0.8	–	(0.8)	–
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	(1.1)	–	–	(1.1)
Proceeds from treasury shares re-issued	–	–	2.5	2.5
At 31 March 2016	(2.1)	(31.8)	701.4	667.5

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 Annual Incentive Bonus Plan

The market value of the 309,000 ordinary shares (2015: 304,000 ordinary shares) held by the trust at 31 March 2016 was £2.5 million (2015: £2.5 million)

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

36. RETAINED EARNINGS AND OTHER RESERVES CONTINUED

Company	Hedging reserve £m	Retained earnings £m	Total £m
At 1 April 2014	–	777.2	777.2
Profit for the year	–	300.1	300.1
Other comprehensive loss for the year	(5.5)	(0.4)	(5.9)
Dividends paid relating to 2014	–	(117.0)	(117.0)
Adjustment for shares issued under the Scrip Dividend Alternative	–	48.0	48.0
Credit to equity in respect of share-based payments (net of tax)	–	0.9	0.9
Charge in respect of share options vesting	–	(0.8)	(0.8)
Convertible bond – equity issuance	–	(0.5)	(0.5)
Proceeds from treasury shares re-issued	–	3.9	3.9
At 31 March 2015	(5.5)	1,011.4	1,005.9
Profit for the year	–	91.4	91.4
Other comprehensive loss for the year	0.5	(0.9)	(0.4)
Dividends paid relating to 2015	–	(129.5)	(129.5)
Adjustment for shares issued under the Scrip Dividend Alternative	–	6.3	6.3
Credit to equity in respect of share-based payments (net of tax)	–	0.7	0.7
Charge in respect of share options vesting	–	(0.8)	(0.8)
Proceeds from treasury shares re-issued	–	2.5	2.5
At 31 March 2016	(5.0)	981.1	976.1

37. PERPETUAL CAPITAL SECURITIES

Group and Company	£m
At 1 April 2014	294.8
Distributions to perpetual capital security holders	(20.3)
Current tax relief on distributions to perpetual capital security holders	4.3
Profit for the year attributable to perpetual capital security holders	16.0
At 31 March 2015	294.8
Distributions to perpetual capital security holders	(20.3)
Current tax relief on distributions to perpetual capital security holders	4.1
Profit for the year attributable to perpetual capital security holders	16.2
At 31 March 2016	294.8

On 8 March 2013 the Company issued £300 million perpetual capital securities. Costs directly associated with the issue of £5.2 million are set off against the value of the issuance. They have no fixed redemption date but the Company may at its sole discretion, redeem all, but not part, of these securities at their principal amount on 8 March 2018 or any subsequent periodic return payment date after this.

The Company has the option to defer periodic returns on any relevant payment date as long as a dividend on the ordinary shares has not been paid or declared in the previous 12 months. Deferred periodic returns shall be satisfied only on redemption or payment of dividend on ordinary shares, all of which only occur at the sole discretion of the Company.

As the Company paid a dividend in the 12 months prior to the periodic return date of 8 March 2016, a periodic return of £20.3 million was paid during the year.

38. ANALYSIS OF CASH FLOWS GIVEN IN THE STATEMENT OF CASH FLOWS

Reconciliation of profit for the year to cash generated from operations

CASH GENERATED FROM OPERATIONS

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Continuing operations				
Profit for the year	168.3	142.3	107.6	316.1
Adjustments for				
Share-based payments	2.8	3.5	0.8	1.0
Profit on disposal of property, plant and equipment	(4.3)	(3.7)	-	-
Depreciation charge	182.9	161.7	0.1	0.1
Amortisation of intangible assets	3.7	2.7	-	-
Non-underlying impairment of property, plant and equipment	-	24.3	-	-
Non-underlying provision charge	10.2	4.3	-	-
Non-underlying movement in derivatives	(5.2)	-	-	-
Non-underlying defined benefit pension credit	-	(14.9)	-	(1.2)
Share of post-tax profit from joint ventures	(3.6)	(4.9)	-	-
Finance income	(42.1)	(44.0)	(52.3)	(51.0)
Finance costs	96.2	84.8	37.2	35.6
Dividends receivable	-	-	(140.7)	(311.6)
Taxation charge	38.0	54.7	44.9	11.7
Changes in working capital				
Increase in inventories	(5.5)	(2.9)	-	-
Decrease/(increase) in trade and other receivables	10.5	(17.1)	(37.4)	(101.6)
Increase in service concession arrangements receivable	(15.6)	(71.9)	-	-
(Decrease)/increase in trade and other payables	(27.0)	5.7	0.3	(1.2)
Decrease in retirement benefit obligations from contributions	(21.2)	(9.6)	(2.2)	(1.7)
Decrease in provisions	(16.8)	(4.1)	-	-
Cash generated/ (outflow) from operations	371.3	310.9	(41.7)	(103.8)

Reconciliation of total interest paid

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Interest paid in operating activities	79.1	62.0	35.3	34.7
Interest paid in investing activities	9.4	22.5	-	-
Total interest paid	88.5	84.5	35.3	34.7

39. NET BORROWINGS

	Group		Company	
	2016 £m	2015 £m	2016 £m	2015 £m
Cash and cash deposits	632.2	771.0	429.7	532.5
Borrowings – current				
Other current borrowings	(39.0)	(82.0)	-	(50.7)
Finance lease obligations	(26.0)	(31.6)	-	-
Amounts owed to subsidiary undertakings	-	-	(287.2)	(283.2)
Total current borrowings	(65.0)	(113.6)	(287.2)	(333.9)
Borrowings – non-current				
Bank and other loans	(1,502.5)	(1,277.2)	(877.1)	(885.4)
Other non-current borrowings	(234.5)	(273.2)	-	-
Finance lease obligations	(1,314.6)	(1,304.1)	-	-
Total non-current borrowings	(3,051.6)	(2,854.5)	(877.1)	(885.4)
Total net borrowings	(2,484.4)	(2,197.1)	(734.6)	(686.8)

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

40. SUBSIDIARY, JOINT VENTURE AND ASSOCIATE UNDERTAKINGS AT 31 MARCH 2016

Principal subsidiary companies	Country of incorporation, registration and principal operations
Water	
South West Water Limited*	England
South West Water Finance Plc	England
Source Contact Management Limited	England
Bournemouth Water Investments Limited*	England
Bournemouth Water Limited	England
Pennon Water Services Limited*	England
Waste management	
Viridor Limited*	England
Viridor Waste Limited	England
Viridor Waste Exeter Limited	England
Viridor Waste Suffolk Limited	England
Viridor Waste (West Sussex) Limited	England
Viridor Waste Management Limited	England
Viridor EnviroScot Limited	Scotland
Viridor Resource Management Limited	England
Viridor Waste Kent Limited	England
Viridor Oxfordshire Limited	England
Viridor EfW (Runcorn) Limited	England
Viridor Waste (Landfill Restoration) Limited	England
Viridor Waste (Somerset) Limited	England
Viridor Waste (Thames) Limited	England
Viridor Waste (Greater Manchester) Limited	England
Viridor Polymer Recycling Limited	England
Viridor Tndent Park Limited	England
Viridor (Glasgow) Limited	Scotland
Viridor (Lancashire) Limited	England
Viridor Peterborough Limited	England
Viridor South London Limited	England
Viridor Clyde Valley Limited	Scotland
Other	
Peninsula Insurance Limited*(1)	Guernsey

Other trading companies	Country of incorporation	Other dormant companies	Country of incorporation
Alderney Water Limited	England	A A Best & Sons Limited	Scotland
Aquacare (BWH) Limited	England	Acetip	England
Avon Valley Water Limited	England	Albion Water (Shotton) Limited	England
BWH Enterprises Limited	England	Analaq Limited*	England
Dragon Waste Limited (81%)	England	Astley Minerals Limited	England
Peninsula Leasing Limited*	England	Basecall Limited	England
Peninsula Properties (Exeter) Limited	England	Centre for Environmental Research Limited	England
Peninsula Trustees Limited*	England	City Reclamation Services Limited	England
Pennon Defined Contribution Pension Trustee Limited*	England	Corby Skip Hire Limited	England
Pennon Pension Trustees Limited*	England	DMP (Holdings) Limited*	England
Pennon Share Plans (Guernsey) Limited*	Guernsey	ELE Datasystems	England
Pennon Share Schemes Trustees Limited*	England	Exe Continental	England
Pennon Trustee Limited*	England	Greater Manchester Sites Limited	England
Raikes Lane Limited	England	Greenhill Environmental Limited*	England
Source Collections Limited	England	Handside Limited	England
Source for Business Limited	England	Haul Waste Limited*	England
Viridor Waste (Somerset) Pension Scheme & Life Assurance Limited	England	Hodgejoy Recycling Limited	England
West Hampshire Water Limited	England	Industrial Waste Disposals (Sheffield) Limited	England
		Lavelle & Sons Limited	England
		Mac-Glass Recycling Limited	Scotland
		Oakley Recycling Limited	England
		Oakley Skip Hire Limited	England
		Parkwood Environmental Limited	England
		Parkwood Group Limited	England
		Parkwood Recycling Limited	England
		Pearsons Group Holdings Limited	England
		Peninsula	England

	Country of incorporation		Country of incorporation
Other dormant companies		Other dormant companies	
Peninsula Water Limited*	England	Vindor Glass Recycling Limited	England
Pennon Power Limited*	England	Vindor London Recycling Limited	England
Pennon South West Limited*	England	Vindor New England (EfW) Limited	England
Pennon Waste Management Limited*	England	Vindor Resource (Peterborough) Limited	England
pHOX Systems Limited	England	Vindor Resource Transport Limited	England
Pilsworth Forest (1996) Limited	England	Vindor South Lanarkshire Limited	Scotland
Pilsworth Forest Limited	England	Vindor South West Limited*	England
Roseland Plant Co Limited	England	Vindor Waste (Adapt) Limited	England
Rydon Properties Limited	England	Vindor Waste (Allwaste Disposal) Limited	England
Seal Security Systems Limited*	England	Vindor Waste (Atherton) Holdings Limited	England
Sheffield Waste Disposal Company Limited	England	Vindor Waste (Atherton) Limited	England
Shore Recycling (Ozone) Limited	England	Vindor Waste (Bristol Holdings) Limited	England
SWW Pension Trustees Limited*	England	Vindor Waste (Bristol) Limited	England
Thames Incineration and Recycling Limited	England	Vindor Waste (Bury) Limited	England
Thames Incineration Services Limited	England	Vindor Waste (Corby) Limited	England
Thames Tankering Services Limited	England	Vindor Waste (Earls Barton) Limited	England
Thames Waste Limited	England	Vindor Waste (East Anglia) Limited	England
The Metropolitan Water Company Limited	England	Vindor Waste (Medway Holdings) Limited	England
Tokenmarch Limited	England	Vindor Waste (Medway) Limited	England
Vindor (Cheshire) Limited	England	Vindor Waste (Sheffield) Limited	England
Vindor (Community Recycling MK) Limited	England	Vindor Waste (Thetford) Limited	England
Vindor (Community Recycling MKH) Limited	England	Vindor Waste (Wastenot Recycling) Limited	England
Vindor (Erith) Limited	England	Vindor Waste 2 Limited*	England
Vindor (Martock) Limited	England	Vindor Waste Disposal Limited	England
Vindor (Winsford) Limited	England	Vindor Waste Hampshire Limited	England
Vindor Contracting Limited	England	Vindor Waste Wootton Limited	England
Vindor Electrical Recycling (Holdings) Limited	Scotland	VWM (Scotland) Limited	Scotland
Vindor Electrical Recycling Limited	Scotland	Waste Treatment Limited	England
Vindor Enterprises Limited*	England	Water West Limited*	England

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

(!) Captive insurance company established with the specific objective of financing risks emanating from within the Group

The subsidiary undertakings are wholly owned unless stated otherwise and all shares in issue are ordinary shares. All companies above are consolidated in the Group financial statements.

Interests in unconsolidated structured entities

The Company holds 75% of the ordinary share capital of Peninsula MB Limited a company which raises funds through the issuance of debt instruments and third party lending but does not control the company since it does not have the power to affect returns. Consequently the company has not been consolidated into the Pennon Group.

Pennon Group Plc has borrowed a £200 million floating interest rate-linked loan from Peninsula MB Limited and is owed a fixed rate £200 million obligation from Peninsula MB Limited.

Joint ventures and associate

All joint ventures, the associate and the subsidiary undertakings of Lakeside Energy from Waste Holdings Limited, Vindor Laing (Greater Manchester) Holdings Limited, INEOS Runcorn (TPS) Holdings Limited and Shelford Composting Limited are incorporated and registered in England which is also their country of operation.

	Share capital in issue	Percentage held	Principal activity
Joint ventures			
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
Shares in Lakeside Energy from Waste Holdings Limited are held by Vindor Waste Management Limited			
Vindor Laing (Greater Manchester) Holdings Limited	12 000 ordinary shares	50%	
Vindor Laing (Greater Manchester) Limited			Waste management
Shares in Vindor Laing (Greater Manchester) Holdings Limited are held by Vindor Waste Management Limited			
Shelford Composting Limited	50 A ordinary shares	-	
	50 B ordinary shares	100%	Waste management
Associate			
INEOS Runcorn (TPS) Holdings Limited	1 000 A ordinary shares	20%	
	186,750 B1 ordinary shares	50%	
	62,250 B2 ordinary shares	-	
INEOS Runcorn (TPS) Limited			Waste management
Shares in INEOS Runcorn (TPS) Holdings Limited are held by Vindor Waste Management Limited			
The Group's economic interest in INEOS Runcorn (TPS) Holdings Limited is 37.5% as returns from the investment are based on holdings of B1 and B2 ordinary shares			

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

41. OPERATING LEASE COMMITMENTS

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
The future aggregate minimum lease payments under non-cancellable operating leases are				
Within 1 year	107	110	-	-
Over 1 year and less than 5 years	292	320	-	-
Over 5 years	800	824	-	-
	1199	1254	-	-

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 42 years and rentals are reviewed on average at five-yearly intervals.

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

42. CONTINGENT LIABILITIES

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Guarantees				
Borrowing facilities of subsidiary undertakings	-	-	421.1	386.6
Performance bonds	159.7	169.8	159.7	169.8
Other	4.0	4.0	4.0	4.0
	163.7	173.8	584.8	560.4

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.

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.

In connection with the application of the audit exemption under Section 479A of the Companies Act 2006 the Company has guaranteed all the outstanding liabilities as at 31 March 2016 of certain of its subsidiaries: Peninsula Leasing Limited, Pennon Power Limited, Exe Continental and Vindor Waste 2 Limited since these companies qualify for the exemption.

The Group is subject to litigation from time to time as a result of its activities. The Group establishes provisions in connection with litigation where it has a present legal or constructive obligation as a result of past events and where it is more likely than not an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

Significant management judgement is required to estimate the tax provisions relating to uncertain tax items that remain to be agreed with HMRC. It is reasonably possible that the outcomes and settlements may differ from the estimated current tax liabilities shown in the consolidated balance sheet.

Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of the open matters, the final outcome may vary significantly. Whilst a range of outcomes is reasonably possible, the extent of the range is additional liabilities of up to £20 million to a reduction in liabilities of up to £52 million. Any such variations will affect the tax financial results in the year in which such a determination is made.

In addition to provisions established for uncertain items, the Group has paid in full the tax HMRC interpret as due, and therefore would benefit by up to £70 million should such tax positions be concluded in the Group's favour.

43. CAPITAL COMMITMENTS

	Group		Company	
	2016	2015	2016	2015
	£m	£m	£m	£m
Contracted but not provided	374.4	350.3	-	-

44. ACQUISITIONS

On 15 April 2015 Pennon Group Plc acquired 100% of the issued share capital of Sembcorp Bournemouth Water Investments Limited (renamed 'Bournemouth Water Investments Limited') including its non-regulated subsidiaries from Sembcorp Holdings Limited for a cash consideration of £100.3 million. Sembcorp Bournemouth Water Investments Limited is the holding company for Sembcorp Bournemouth Water Limited (renamed Bournemouth Water Limited).

The acquisition was in line with the Group's strategy to increase shareholder returns from the anticipated future synergies and outperformance arising from the merger into South West Water.

The acquisition has been accounted for using the acquisition method. Goodwill of £42.3m million has been capitalised attributable to the anticipated future synergies and outperformance arising from the merger into South West Water.

On 1 June 2015 Vindor Waste Management Limited acquired Commercial Recycling Limited's waste collection division in Dorset and Somerset for an initial £4.5 million. An additional payment of up to £1.0 million could be made in the future depending upon certain performance-related criteria. The acquisition has been accounted for using the acquisition method.

Goodwill of £3.4 million has been capitalised attributable to the profitability of the acquired business.

No amount of goodwill related to these acquisitions is expected to be deductible for tax purposes.

The residual excesses over the net assets acquired in each business combination has been recognised as goodwill.

	Bournemouth Water Investments Limited £m	Waste Collection Division £m
Fair values on acquisition		
Intangible assets	2.3	1.6
Property, plant and equipment	228.5	0.5
Inventories	0.1	–
Trade and other receivables	23.8	–
Cash and cash deposits	13.8	–
Retirement benefit surplus	1.9	–
Borrowings	(160.2)	–
Trade and other payables	(19.7)	–
Other liabilities	(0.5)	–
Taxation - current	(2.7)	–
Deferred tax liabilities	(24.8)	–
Provisions	(0.2)	–
Net assets acquired	62.3	2.1
Goodwill	42.3	3.4
Total consideration	104.6	5.5
Satisfied by		
Cash	100.3	4.5
Transfer of amounts due to Bournemouth Water Investments Limited	4.3	–
Deferred consideration	–	1.0
	104.6	5.5
Net cash outflow arising on acquisition		
Cash consideration	100.3	4.5
Cash and cash deposits acquired	(13.8)	–
	86.5	4.5
Revenue for the period since acquisition to 31 March 2016	41.9	4.6
Profit before tax for the period since acquisition to 31 March 2016	6.0	0.7
Directly attributable costs included in other operating expenses	2.9	0.2

The fair value of trade and other receivables in Bournemouth Water Investments Limited on acquisition was £23.8 million. This included gross contracted amounts receivable of £21.8 million, of which cash flows of £1.0 million were not expected to be collected.

	£m
Goodwill movement	
At 1 April 2015	339.3
Acquisition of Bournemouth Water Investments Limited	42.3
Acquisition of the waste collection division of Commercial Recycling Limited	3.4
At 31 March 2016	385.0

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

45. POST BALANCE SHEET EVENTS

On 1 April 2016 the Company sold the entire share capital of Bournemouth Water Investments Limited to South West Water Limited for £104 million. The consideration was satisfied through Pennon Group Plc subscribing for an additional £100 million of new share capital in South West Water Limited and transferring a £4 million loan due to Bournemouth Water Limited to South West Water Limited.

46. RELATED PARTY TRANSACTIONS

During the year Group companies entered into the following transactions with joint ventures and associate related parties who are not members of the Group.

	2016	2015
	£m	£m
Sales of goods and services		
Vindor Laing (Greater Manchester) Limited	87.3	99.0
INEOS Runcorn (TPS) Limited	18.5	5.6
Purchase of goods and services		
Vindor Laing (Greater Manchester) Limited	0.3	–
Lakeside Energy from Waste Limited	12.1	12.6
INEOS Runcorn (TPS) Limited	4.3	1.1
Dividends received		
Lakeside Energy from Waste Holdings Limited	6.0	6.0
Year-end balances		
	2016	2015
	£m	£m
Receivables due from related parties		
Vindor Laing (Greater Manchester) Limited (loan balance)	36.8	57.2
Lakeside Energy from Waste Limited (loan balance)	8.9	9.3
INEOS Runcorn (TPS) Limited (loan balance)	35.5	31.4
	81.2	97.9
Vindor Laing (Greater Manchester) Limited (trading balance)	11.3	12.8
Lakeside Energy from Waste Limited (trading balance)	1.0	1.0
INEOS Runcorn (TPS) Limited (trading balance)	2.7	5.6
	15.0	19.4
Payables due to related parties		
Lakeside Energy from Waste Limited (trading balance)	2.3	1.1
INEOS Runcorn (TPS) Limited (trading balance)	1.6	0.1
	3.9	1.2

The £81.2 million (2015 £97.9 million) receivable relates to loans to related parties included within receivables and due for repayment in instalments between 2016 and 2033. Interest is charged at an average of 13.0% (2015 13.0%).

Company

The following transactions with subsidiary undertakings occurred in the year

	2016	2015
	£m	£m
Sales of goods and services (management fees)	10.5	9.5
Purchase of goods and services (support services)	0.4	0.5
Interest receivable	38.6	35.6
Interest payable	0.1	0.1
Dividends received	140.7	311.6

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 which would also be available to unrelated third parties.

Year-end balances

	2016	2015
	£m	£m
Receivables due from subsidiary undertakings		
Loans	965.6	936.6
Trading balances	8.6	8.5

Interest on £70.0 million of the loans has been charged at a fixed rate of 4.5%, on £373.6 million at a fixed rate of 5.0%, on £28.0 million at a fixed rate of 6.0% and on £0.5 million at a fixed rate of 1.4% (2015 £70.5 million at 4.5%, nil at 5.0%, £332.5 million at 6.0% and £0.5 million at 1.4%). Interest on £443.5 million of the loans is charged at 12 month LIBOR + 1.0% (2015 £403.1 million). These loans are due for repayment in instalments over the period 2016 to 2043.

Interest on £50.0 million of the loans has been charged at 1 month LIBOR + 1.0% (2015 £130.0 million). This loan is expected to be repaid in 2016/17. During the year there were no provisions (2015 nil) in respect of loans to subsidiaries not expected to be repaid.

	2016	2015
	£m	£m
Payables due to subsidiary undertakings		
Loans	287.2	283.2
Trading balances	14.6	14.6

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

FIVE-YEAR FINANCIAL SUMMARY

	2016 £m	2015 £m	2014 £m	2013 £m	2012* £m
Income statement					
Revenue	1,352.3	1,357.2	1,321.2	1,201.1	1,233.1
Operating profit before non-underlying items	261.8	246.6	257.5	245.6	268.8
Net finance costs before non-underlying items	(54.1)	(40.8)	(53.9)	(61.4)	(72.3)
Share of profit in joint ventures	3.6	4.9	3.7	5.8	4.0
Profit before tax and non-underlying items	211.3	210.7	207.3	190.0	200.5
Net non-underlying items before tax	(5.0)	(13.7)	(48.6)	(176.4)	–
Taxation (charge)/ credit	(38.0)	(54.7)	(0.6)	7.0	(28.1)
Profit for the year	168.3	142.3	158.1	20.6	172.4
Attributable to					
Ordinary shareholders of the parent	152.1	126.3	142.5	20.6	172.4
Perpetual capital security holders	16.2	16.0	15.6	–	–
Dividends proposed/declared	138.5	129.5	117.0	103.9	96.0
Earnings per ordinary share (basic)					
From continuing operations					
Earnings per share	37.0p	32.3p	38.8p	5.7p	48.1p
Deferred tax before non-underlying items	9.5p	4.7p	(7.0)p	(4.0)p	(0.8)p
Non-underlying items (net of tax)	(7.0)p	2.8p	10.8p	38.6p	–
Earnings per share before non-underlying and deferred tax	39.5p	39.8p	42.6p	40.3p	47.3p
Declared dividends per share	33.58p	31.80p	30.31p	28.46p	26.52p
	2016 £m	2015 £m	2014 £m	2013 £m	2012* £m
Capital expenditure					
Acquisitions	91.0	–	–	14.8	29.2
Property, plant and equipment	284.2	301.4	360.8	410.1	257.4
Balance sheet					
Non-current assets	4,676.3	4,325.9	4,076.6	3,846.0	3,592.5
Net current assets	549.5	586.0	241.9	378.5	11.8
Non-current liabilities	(3,738.2)	(3,557.8)	(3,120.9)	(3,152.4)	(2,775.2)
Net assets	1,487.6	1,354.1	1,197.6	1,072.1	829.1
Number of employees (average for year)					
Water	1,706	1,408	1,356	1,354	1,335
Waste management	3,230	3,101	3,044	3,180	3,148
Other businesses	51	49	51	50	46
	4,987	4,558	4,451	4,584	4,529

* Prior to the application of IAS 19 (Revised) Employee Benefits

SHAREHOLDER INFORMATION

FINANCIAL CALENDAR

Financial year end	31 March
27th Annual General Meeting	1 July 2016
Ex-dividend date for 2016 final dividend	7 July 2016*
Record date for 2016 final dividend	8 July 2016*
2016 final dividend payable	2 September 2016*
2016/17 half-yearly results announcement	25 November 2016
2017 interim dividend payable	April 2017
2017 final results announcement	May 2017
28th Annual General Meeting	July 2017
2017 final dividend payable	September 2017

SCRIP DIVIDEND ALTERNATIVE*

Ordinary shares quoted ex-dividend	7 July 2016
Record date for final dividend	8 July 2016
Posting of scrip dividend offer	22 July 2016
Final date for receipt of forms of mandate	15 August 2016
Posting of dividend cheques and share certificates	1 September 2016
Final cash dividend payment date	2 September 2016
First day of dealing in the new ordinary shares	2 September 2016

* Subject to obtaining shareholder approval at the 2016 Annual General Meeting to the payment of a final dividend for the year ended 31 March 2016

SHAREHOLDER ANALYSIS AT 31 MARCH 2016

Holding of shares	Number of shareholders	% of total shareholders	% of ordinary shares
1-100	2 457	11.05	0.02
101-1 000	9 312	41.89	1.21
1 001-5 000	8,854	39.83	4.66
5 001-50 000	1 231	5.54	2.32
50 001-100 000	88	0.40	1.53
100,001 +	288	1.30	89.26
	22,230		
	Number of accounts	% of total accounts	% of total shares
Individuals	17 839	80.25	6.70
Companies	125	0.56	0.25
Trust companies (pension funds etc)	9	0.04	0.01
Banks and nominees	4 257	19.15	93.03
	22 230		

SHAREHOLDER INFORMATION CONTINUED

MAJOR SHAREHOLDINGS

The net position on 31 March 2016 of investors who have notified interests in the issued share capital of the Company pursuant to the Financial Conduct Authority's Disclosure and Transparency Rules is as follows

	Number of voting rights (direct and indirect)	% of voting rights
Pictet Asset Management SA	25 599 217	6.21%
The Capital Group Companies Inc	25 268 507	6.13%
Lazard Asset Management LLC	24,547 305	5.95%
Ameriprise Financial Inc	20 328 154	4.93%
RARE Infrastructure Limited	19 366 782	4.70%
AXA Investment Managers SA	18,088 394	4.39%
Invesco Limited	17,212 959	4.17%
UBS Investment Bank	16 610 004	4.03%
Legal & General Group Plc	13 458 627	3.26%
Royal London Asset Management Limited	12,453 831	3.02%

On 12 May 2016 Lazard Asset Management LLC notified the Company that it held 20 257 364 shares (equivalent to 4.91% of voting rights)

No further changes to interests in the Company's issued share capital have been disclosed to the Company between 31 March 2016 and 20 May 2016 (being a date not more than one month prior to the date of the Company's Notice of Annual General Meeting)

REGISTRAR

All enquiries concerning shareholdings including notification of change of address, loss of a share certificate or dividend payments should be made to the Company's registrar Capita Asset Services, who can be contacted as follows

Capita Asset Services
Pennon Group Share Register
The Registry
34 Beckenham Road
Beckenham
Kent BR3 4TU

Telephone **0371 664 9234** (calls are charged at standard network rates)
Lines are open 8.30am-5.30pm Monday-Friday
Overseas telephone **+44 371 664 9234**
Email **pennon@capita.co.uk**
Website **capitashareportal.com**

SHARE DEALING SERVICE

The telephone share dealing service offered by Stocktrade enables shareholders to buy and sell shares in the Company on a low-cost basis. For further details of this service, contact Stocktrade on +44 (0)131 240 0414 and quote: Pennon Group Dial & Deal Service. Commission is 1% (subject to a minimum charge of £25.00)

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 the Company's registrar, Capita Asset Services.

INDIVIDUAL SAVINGS ACCOUNTS

Shareholders may gain tax advantages by holding their shares in the Company in an Individual Savings Account (ISA).

SCRIP DIVIDEND ALTERNATIVE

Subject to obtaining shareholder approval at the 2016 Annual General Meeting for the payment of a final dividend for the year ended 31 March 2016, full details of the scrip dividend alternative and how to participate will be sent to shareholders on 22 July 2016. The full timetable for offering the scrip dividend alternative is given on the opposite page.

The scrip dividend alternative provides shareholders with an opportunity to invest the cash dividend they receive on their Pennon Group Plc shares to buy further shares in the Company without incurring stamp duty or dealing expenses.

ONLINE PORTFOLIO SERVICE

The online portfolio service provided by Capita Asset Services gives shareholders access to more information on their investments. Details of the portfolio service are available online at **www.capitashareportal.com**

ELECTRONIC COMMUNICATIONS

The Company has passed a resolution which allows it to communicate with its shareholders by means of its website.

Shareholders currently receiving a printed copy of the annual report who now wish to sign up to receive all future shareholder communications electronically can do so by registering with Capita Asset Services share portal. Go to **www.capitashareportal.com** to register, select 'Account Registration' and then follow the on-screen instructions by inputting your surname, your Investor Code (which can be found on your proxy form) and your postcode, as well as entering an email address and selecting a password.

By registering to receive your shareholder communications electronically, you will also automatically receive your Dividend Tax Vouchers electronically.

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 via **www.capitashareportal.com**. Shareholders who register an email preference will not receive a paper proxy form. Instead, they will receive an email alert advising them of general meetings of the Company with links to the notices of meetings and annual reports.

PENNON'S WEBSITE

www.pennon-group.co.uk provides news and details of the Company's activities plus links to its subsidiaries' websites

The Investor Information section contains up-to-date information for shareholders including detailed share price information, financial results, dividend payment dates and amounts, and stock exchange announcements. There is also a comprehensive shareholder services section which includes information on buying, selling and transferring shares, and how to notify a change in personal circumstances, for example a change of address.

BEWARE OF SHARE FRAUD

The following is taken from the ScamSmart section of the Financial Conduct Authority's website (www.scamsmart.fca.org.uk). Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment.

While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

HOW TO AVOID SHARE FRAUD

- 1 Keep in mind that firms authorised by the Financial Conduct Authority (FCA) are unlikely to contact you out of the blue with an offer to buy or sell shares.
- 2 Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
- 3 Check the Financial Services Register from www.fca.org.uk to see if the person and firm contacting you is authorised by the FCA.
- 4 Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
- 5 Use the firm's contact details listed on the Register if you want to call it back.
- 6 Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
- 7 Search the FCA Warning List of unauthorised firms at www.scamsmart.fca.org.uk. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme. Seek impartial advice from a financial adviser before you make an investment.
- 8 Remember: if it sounds too good to be true, it probably is!

5,000 people contact the Financial Conduct Authority about share fraud each year, with victims losing an average of £20,000

REPORT A SCAM

If you are approached by fraudsters, please tell the FCA using the share fraud reporting form at www.fca.org.uk/scams where you can find out more about investment scams.

You can also call the FCA Consumer Helpline on 0800 111 6768.

If you have already paid money to share fraudsters, you should contact Action Fraud on 0300 123 2040.

Pennon Group Plc
Peninsula House
Rydon Lane
Exeter
Devon
England EX2 7HR

www.pennon-group.co.uk

Registered in England & Wales
Registered Number: 2366640
