



**Registered Number:
2366640**

Strategic report

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Find out more about Pennon

Corporate website
www.pennon-group.co.uk

Annual Report
www.pennon-group.co.uk/AR2017

Integrated reporting

Our business touches the lives of many stakeholders, from customers, employees, investors and suppliers to our communities, the environment and regulators.

Reflecting the integrated nature of our business, we seek to integrate our reporting on financial, economic, social and environmental aspects of our performance and how they contribute to long-term value creation. To support this ambition, this report has been prepared with reference to the principles of the International Integrated Reporting Council's International <IR> Framework.

As one of the **largest environmental infrastructure groups in the UK**, Pennon is at the top end of the FTSE 250, has assets of around **£5.9 billion** and a workforce of around **5,000** people.

Our mission

Together we will build the most trusted environmental solutions company in the UK, providing infrastructure and services that enhance our customers' lives, protect the environment and deliver growth for our shareholders.

Our pillars

Our six pillars form the foundations of our culture and the way we work.

Safety first The safety of our employees, customers and communities comes first. We will do everything safely and responsibly, or not at all.

Our people Our success comes from our talented people doing great things for our customers and each other.

Service and value We are committed to delivering exceptional service and value for our customers and communities.

Efficiency in everything we do We work smart, keep things simple and invest money wisely.

Progress through innovation From the technology and science we use, through to the way we approach what we do – innovation drives us forward.

Sustainability matters We take our responsibilities towards the environment seriously and aim to be sustainable in everything we do.

Our businesses

Water and wastewater

The merged water company of South West Water and Bournemouth Water provides water and wastewater services to a population of c.1.7 million in Cornwall, Devon and parts of Dorset and Somerset and water only services to c.0.5 million in parts of Dorset, Hampshire and Wiltshire.

South West Water was awarded enhanced status for its 2015-2020 Business Plan, and has the highest potential returns in the water sector.

Waste management

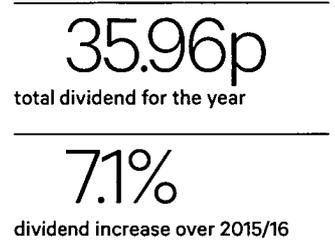
Viridor is a leading UK recycling, energy recovery and waste management company, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 customers across the UK.

The performance of the Group against our strategy underpins our confidence in delivering our long-established sector-leading dividend policy.

Pennon's long-established 10-year dividend policy of 4% year-on-year growth above RPI inflation to 2020 results in a doubling of dividend over 10 years (2010-2020)⁽¹⁾. This reflects the Board's confidence in the continued outperformance of our water business and our significant investment in our waste business, which is successfully delivering on its targeted contribution to Group earnings.

Read more page 42

(1) Future dividends growth based on policy of 4% + RPI forecast to 2020.



Overview

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Strong performance
underpinning
long-established
sector-leading
dividend growth

Group financial highlights

Highlights of the year

- Strong earnings growth across the Group
 - Delivered £107 million of EBITDA from energy recovery facilities (ERFs) ahead of c.£100 million target
 - Continued sector-leading return on regulated equity at 12.6%
- Continued delivery of long-established 10-year sector-leading dividend policy supported by earnings growth
- Good performance in cost base efficiency
 - South West Water total expenditure (totex) efficiency K6 to date £129 million
 - Bournemouth Water successfully integrated, on track to deliver cumulative synergies of c.£27 million by 2020
 - £17 million per annum of efficiencies across the Group by 2019, with £9 million per annum secured to date
- £385 million of capital investment in sustainable growth projects
- Group remains well funded with low cost efficient long-term financing.

Read more page 38

Revenue

£1,353m
(+0.1%)

Dividend

35.96p
(+7.1%)

Assets

£5.9bn
(+3.5%)

EBITDA Statutory

£475m
(+8.5%)

EBITDA Underlying⁽¹⁾

£486m
(+8.4%)

EBITDA Adjusted⁽²⁾

£546m
(+7.4%)

Profit before tax Statutory

£211m
(+2.0%)

Profit before tax Underlying⁽¹⁾

£250m
(+18.3%)

Capital investment

£385m
(+21.4%)

Cash and committed facilities

£1.4bn

Shareholder profits⁽¹⁾

	£m
Profit before tax and non-underlying items	250
Non-underlying items before tax	(39)
Statutory profit before tax	211
Tax charge	(31)
Profit attributable to perpetual capital holders	(16)
Profit after tax attributable to shareholders	164

(1) Underlying earnings are presented alongside statutory results as the Directors believe they provide a more useful comparison on business trends and performance. Note 6 to the financial statements provides more detail on non-underlying items.

(2) Earnings before interest, tax, depreciation, amortisation (EBITDA) and non-underlying items, adjusted to include IFRIC 12 interest receivable and share of joint venture EBITDA better reflects all the earnings arising from our ERFs (see reconciliation on page 40).

Key performance indicators

Revenue (£m)

1,201.2	1,321.2	1,357.2	1,352.3	1,353.1
				+0.1%
2012/13	2013/14	2014/15	2015/16	2016/17

EBITDA (£m)

289.9 [▲]	394.8 [◆]	433.0 [■]	401.6 [▲]	407.3 [◆]	456.9 [■]	421.6 [▲]	411.0 [◆]	465.9 [■]	438.2 [▲]	448.4 [◆]	508.4 [■]	475.3 [▲]	486.0 [◆]	546.2 [■]
														+7.4%
2012/13	2013/14	2014/15	2015/16	2016/17										

▲ Statutory ◆ Underlying ■ Adjusted

Profit before tax (£m)

13.6 [▲]	190.0 [◆]	158.7 [▲]	207.3 [◆]	197.0 [▲]	210.7 [◆]	206.3 [▲]	211.3 [◆]	210.5 [▲]	250.0 [◆]
									+18.3%
2012/13	2013/14	2014/15	2015/16	2016/17					

▲ Statutory ◆ Underlying

Earnings per share (pence)

5.7 [▲]	40.3 [◆]	38.8 [▲]	42.6 [◆]	32.3 [▲]	39.8 [◆]	37.0 [▲]	39.5 [◆]	39.8 [▲]	47.0 [◆]
									+19.0%
2012/13	2013/14	2014/15	2015/16	2016/17					

▲ Statutory ◆ Before non-underlying items and deferred tax

Dividend per share (pence)

28.46	30.31	31.80	33.58	35.96
				+7.1%
2012/13	2013/14	2014/15	2015/16	2016/17

Interest rate on average net debt (%)

4.0	3.8	3.4	3.3	3.4
				+0.1%
2012/13	2013/14	2014/15	2015/16	2016/17

Regulatory capital value

as at 31 March (£m)

2,916	2,959	2,928	3,150	3,291
				+4.5%
2013	2014	2015	2016	2017

Group assets as at 31 March (£bn)

4.8	5.0	5.4	5.7	5.9
				+3.5%
2013	2014	2015	2016	2017

Group operational highlights

Highlights of the year

- Water business delivered net ODI rewards and improved performance in a number of areas:
 - No water restrictions
 - Exceeded leakage target resulting in ODI reward
 - Highest level of wastewater treatment compliance⁽¹⁾
 - 98.6% of bathing waters achieving the more stringent bathing water standards that were introduced in 2015
- Energy Recovery Facilities (ERFs) continued to drive growth – eight operational sites performing well, with average availability at greater than 90% for 2016/17
- Construction of four further ERFs is ongoing
 - Dunbar and South London (Beddington) progressing to budget
 - Glasgow's Recycling and Renewable Energy Centre is receiving waste and generating energy. New construction contracts are progressing well with ERF commissioning expected in 2017
 - Avonmouth ERF investment now underway with key construction and operational contracts in place. Completion expected in 2020/21
- Recycling self-help measures delivering increased margins and increased EBITDA⁽²⁾
- Negotiations with Greater Manchester Waste Disposal Authority (GMWDA) continue to ensure a well managed transition for the contract
- New retail venture for business customers established by Pennon Water Services and South Staffordshire Plc (incorporating South Staffs and Cambridge Water)
- Driving value through efficiency – integrating, sharing best practice, reducing costs through a Shared Service Review.

Read more pages 26 to 37

Total renewable energy generation

1,549GWh

Bathing water compliance ('sufficient quality' or higher)

98.6%

Total waste material inputs (tonnes)

7.6m

Drinking water quality (mean zonal compliance)

South West Water

99.96%

Bournemouth Water

99.98%

Riddor incidence rate

(per 100,000 employees)

683

Average ERF availability

>90%

Recycling volumes traded (tonnes)

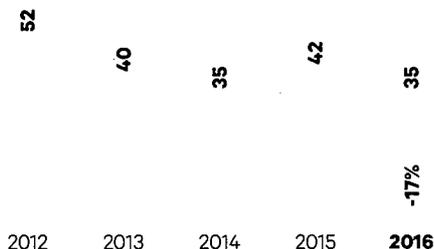
1.6m

(1) As measured by Numeric Compliance.

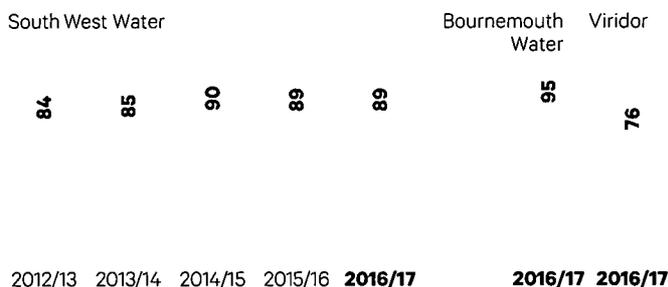
(2) Earnings before interest, tax, depreciation and amortisation.

Key performance indicators⁽¹⁾

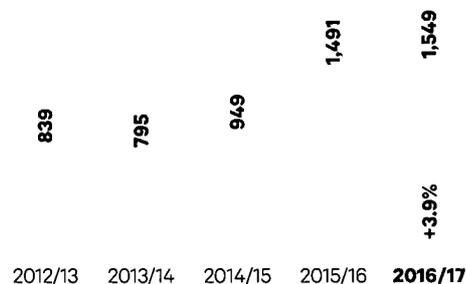
RIDDOR incidents⁽²⁾



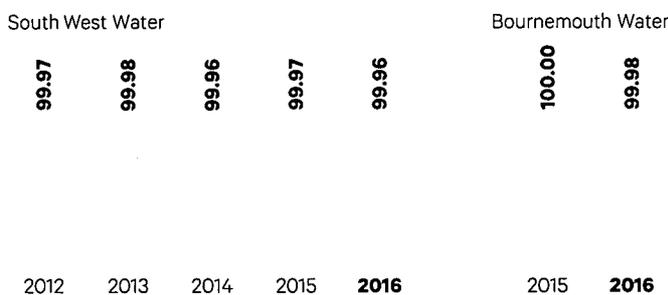
Customer satisfaction with overall service (%)



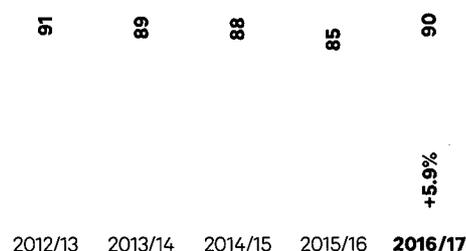
Total renewable energy generation (GWh)



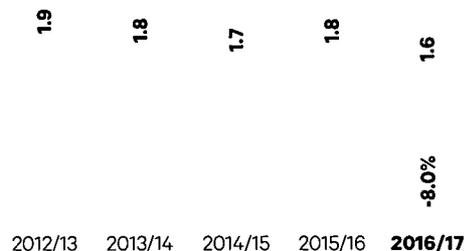
Drinking water quality mean zonal compliance (%)



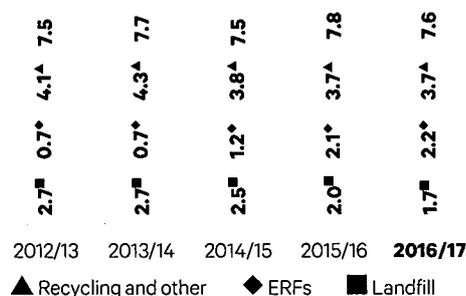
ERF availability⁽³⁾ (%)



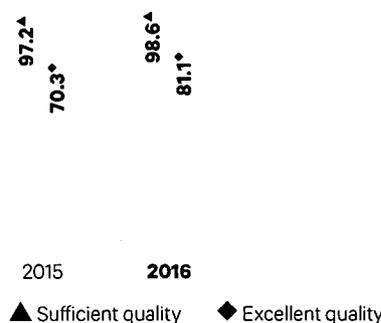
Recycling volumes traded (million tonnes)



Total waste material inputs (million tonnes)



Bathing water compliance⁽⁴⁾ (%)



(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 14.

(2) Incidents involving employees under the Reporting of Injuries, Diseases and Dangerous Occurrences Regulations. See page 18 for further details of our health and safety performance.

(3) Average availability for the year. Includes 100% capacity of joint ventures at Lakeside and Runcorn 1.

(4) 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).

Chairman's statement

Sir John Parker
Chairman

“Pennon Group performed well in the year, delivering on its strategy of market-leading performance across its businesses.”

Dear Shareholder

Pennon Group performed well in the year, delivering on its strategy of market-leading performance, efficiency and investing for growth. The Group has the UK's top two water businesses as measured by return on regulated equity (RoRE) while Viridor's expanding portfolio of Energy Recovery Facilities (ERFs) is on track to generate further growth in earnings over the next few years. The Group's Shared Services Review addressed a key strategic objective to drive value through increased efficiency during the year.

The Group's final dividend of 24.87 pence per share reflects an increase of 71% and maintains our long-standing sector-leading dividend policy of RPI plus 4% year-on-year growth. This should see dividends per share almost doubling over 10 years to 2020.

Pennon is committed to providing a safe place for our people to work, where health and wellbeing comes first.

Since my previous report we have continued to make good progress in establishing an effective Group structure by drawing together all aspects of the Group under the Pennon umbrella. Our CEO, with the support of a high-calibre executive team, is pulling together support functions at Group level that were previously held within each subsidiary. The two Managing Directors who are running the water and waste businesses as operational divisions report directly to the CEO. Pennon's Non-Executive Directors are now also members of the South West Water board, along with three dedicated South West Water non-executive directors, one of which is currently a vacancy.

Safety

The position of health and safety as the first item on the agenda for every Board meeting reflects the importance I and my colleagues attach to this crucial area. It also underlines our determination to increase employee engagement, address the culture and behaviours that lead to accidents and learn all relevant lessons for the future from any incident.

Regrettably, a tragic incident occurred in August 2016, resulting in the death of a Viridor employee whilst at work. Our thoughts are with his family, friends and colleagues as we work with the Health and Safety Executive in relation to this incident.

Governance

Key achievements during the year

- The Non-Executive Directors have quickly adapted to their expanded roles in respect of the subsidiary businesses
- We have created new senior executive roles at Group level and have brought in subject matter specialists of a high calibre who will drive a consistent and effective approach in safety, health and environmental impact
- The new Group executive meeting arrangements have allowed the senior executives from Pennon, South West Water and Viridor to operate collaboratively in one forum when dealing with Group-wide issues
- The change is also facilitating holistic discussion and has improved communications across the Group with clear lines of sight into the subsidiary companies
- The administration required to support the Board has come together quickly.

Read more pages 54 to 62

7.1%

increase in dividend per share

78%

of employees completed an annual engagement survey

We strive for the highest standards of health and safety to achieve our objective of a harm free environment. Pennon is committed to providing a safe place for our people to work where health and wellbeing comes first. The Board has supported the appointment of a Group director of Safety, Health, Quality and Sustainability, who will devise and implement a strategy to raise the Group's health and safety performance.

Employees and culture

Throughout the Group, there is a spirit of pride and professionalism and these are key qualities at a time of change. We have no shortage of new talent joining the company too, through graduate recruitment and our award-winning apprenticeship programmes. We are determined to recognise talent in both the Group's businesses and to support development of people from early on in their careers, not just in top-level succession planning.

As many aspects of the Group's structure are still relatively new, we intend to provide more information about Pennon's culture and values in next year's annual report. Our subsidiary companies each have a strong sense of purpose supported by their own set of corporate values and this provides a sound foundation on which to build. I firmly believe that by getting the structure and governance of the Group right, and by attracting and developing the right people, the right culture and values will follow.

Culture and values

- We are working with employees to bring together a core set of organisational values and build a culture that can be lived throughout the Group
- This process is drawing on the heritage and strengths of our principal operations
- Six pillars (set out on pages 14-15) underpin our values that will be shaped by employees during the year ahead
- Our customer-facing businesses Viridor, South West Water and Bournemouth Water are established brands that are recognised and valued by the public
- We are already bringing our businesses closer together under new and modern branding.

We are developing a culture that can be lived throughout the Group.

Meanwhile, on behalf of the Board, I would like to take this opportunity to thank all our employees for their professional approach and their dedication to the many communities and stakeholders we serve daily.

Shared services and other Group synergies

Efforts to centralise key corporate services and operational functions following the Shared Services Review reflecting our more unified Group are progressing well. This is part of an efficiency programme that is increasing integration, encouraging the sharing of best practice and creating shareholder value. This work has been facilitated by the creation of the role of Group Chief Executive Officer, which has now been in existence for over a year and is binding the Pennon Group more closely together.

Sustainability

As a leading environmental infrastructure company, the Group actively contributes to the UK's long-term needs for water, energy and waste management and we aim to ensure that all our business activities have a positive economic, social and environmental impact. Our evaluation of risk consistently addresses sustainability requirements. The Board's Sustainability Committee oversaw the Group's performance during the year in maintaining a responsible approach to business operations.

Chairman's statement continued

Governance

The Group's revised framework for governance and decision-making introduced in April 2016 is operating well and allowing us to pursue synergies across the Group. Further details are provided on pages 58 to 62. Our Senior Independent Director, Gill Rider, completed an assessment during the year of the new approach. This was conducted alongside an independent external evaluation of the Board's structure, operation and performance. Based on these appraisals and on my own experience, I believe the Group has a robust governance structure that is delivering efficient and transparent decision-making while preserving the degree of regulatory independence that Ofwat requires for the water business. I commend the Group's commitment to the new governance framework.

The Group has a robust governance structure that is delivering efficient and transparent decision-making.

Board changes

Ian McAulay stepped down as the Chief Executive Officer of Viridor during the year and we thank him for his contribution and wish him well in the future. Phil Piddington was appointed to the new role of Managing Director of Viridor in September 2016. The change in the management team and structure at Viridor, which mirrors the arrangements in place at South West Water, better reflects the objectives of the Group and will drive stronger accountability. Moreover, the appointment of Phil Piddington demonstrates that the Group is adding new skills and executing succession planning well.

Steve Johnson stepped down as a non-executive director of South West Water in April 2016 following his appointment to a new external executive position.

Boardroom diversity

Our Board is made up of 2 women and 4 men.

Read more page 71

Diversity

We actively promote equality and diversity across the Group and hold a strong belief that we will be a better business if we can understand the views, opinions and backgrounds of our customers, communities, shareholders and employees. Currently a third of our Board members are women, exceeding our target of at least 25% female representation. Additionally, the Board continues to pursue a progressive diversity agenda. You will find further information on our Diversity Policy in our Nomination Committee Report on page 71.

We will be a better business if we can understand the views, opinions and backgrounds of our customers, communities, shareholders and employees.

Looking to the future

The Group has strong financial control, sound administration and our governance is robust and transparent. Moreover, we are building the assets and the teams to secure further growth. With the commitment of everybody working at Pennon Group under the direction of a strong leadership, we have every reason to be confident about the future.



Sir John Parker
Chairman

Pennon Group plc
23 May 2017

Pennon Board visits Ardley ERF

Board members regularly visit operational sites and take the opportunity to meet employees and see a plant at work. In April 2016 the Board visited Bournemouth Water's headquarters and received a tour of the water treatment works.

The Board meeting in February 2017 was held at Ardley ERF and included a tour of the plant and its award-winning Visitor Centre which received 3,483 visitors this year.

Board members also met the Ardley-based Energy trading team that implements the Group's energy risk management strategy and has aligned energy contracts to optimise cost and carbon benefits. This same team also manages the energy trading for both output and usage, which has helped the Group achieve greater energy efficiency.

Market overview

With clear market opportunities for both the water and waste businesses, the Group is well prepared to capitalise on the changing regulatory water markets and is in a strong position to deliver growth through its increasing market share of the UK's energy recovery operations.

1

UK water sector

2

Water regulators

3

Non-household retail market

UK water industry (2016)

16

operators
in the UK

1.2m

businesses and other
non-household customers
can choose who they buy
water and wastewater
services from

1	Water only companies ⁽¹⁾	6
2	Water and waste companies	10

The water industry serves 50 million household and business customers in England and Wales, who are supplied with drinking water and have their wastewater taken away and treated. These services are provided by 16 privately-owned regional companies of which 10 are providers of both water and wastewater services.

The UK water industry supplies clean water to properties through a mains network that is 420,000km long (source: Water UK). It manages more than 16 billion litres of wastewater a day through 624,200km of sewers and 9,000 wastewater treatment plants.

(1) There are six regional companies. In addition there are nine other small water providers.

DEFRA sets the overall water and sewerage policy framework in England.

Ofwat is the economic regulator for the water sector in England and Wales. Every five years companies submit business plans as part of a Price Review process. South West Water's 2015-20 plan was awarded 'enhanced' status as part of the 2014 Price Review.

The Environment Agency (EA) is the principal environmental regulator of the water and sewerage sector.

The Drinking Water Inspectorate (DWI) is the drinking water quality regulator. They check companies supply safe drinking water and meet Water Quality Regulations.

The Consumer Council for Water (CCWater) represents consumers and takes up unresolved complaints.

On 1 April 2017, the non-household retail market was opened, allowing up to 1.2 million businesses and other non-household customers across the country to choose which retailer they buy water and wastewater services from.

The non-household market operates through a controlled portal operated by the Market Operator Services Limited (MOSL). It has required the separation of the wholesale and retail arms of water businesses.

Pennon Water Services (PWS) was established to manage the non-household retail business for Pennon and has formed a retail venture with South Staffordshire plc.

4

Waste inputs to Energy Recovery Facilities

UK combustible waste (2016)

26m
tonnes

- 1 Municipal household waste **15m tn**
- 2 Commercial and industrial waste **11m tn**

We estimate that in the UK, 26 million tonnes of waste were suitable for combustion in Energy Recovery Facilities (ERFs) in 2016, comprising an estimated 15 million tonnes of municipal household waste and 11 million tonnes of commercial and industrial waste. All the ERFs in the UK processed a combined 12 million tonnes of this waste in 2016. Our facilities processed two million tonnes in 2016.

We expect that new ERFs being constructed will increase the UK's energy from waste capacity to c.15-16 million tonnes by 2020. During the same period Viridor will bring into operation ERFs at Glasgow, Beddington, Dunbar and Avonmouth, providing a total capacity for Viridor ERFs of 3.2 million tonnes of waste.

5

Recycled waste materials

4m
tonnes of recyclable waste materials processed in the UK in 2016

Viridor is a market leader in processing comingled waste streams (where recyclables are mixed in the same bin) collected by councils and their contractors. In 2016, we processed c.0.7 million tonnes of comingled mixed recyclable waste out of an estimated total of four million tonnes, indicating a 18% market share in comingled recycle. The volume of waste for recycling is expected to increase marginally reflecting population growth and possibly more so, if national and local government policies, especially in England, align to encourage further recycling. 45% of household waste is currently recycled against the existing national target to recycle 50% of household waste by 2020.

6

Waste to landfill

13.7m
tonnes of waste to landfill in 2015

12.5m
tonnes of waste to landfill in 2016

The UK mainland disposed of 12.5 million tonnes of active waste (i.e. household black bag waste and similar unrecyclable waste from industrial and commercial sources) into landfills in 2016 compared to 13.7 million tonnes in 2015. In 2016 our landfill sites received 1.7 million tonnes of active waste, which comprised 14% market share.

In addition to this, we received 0.7 million tonnes of inert inactive waste for daily cover and restoration purposes.

We expect the volume of waste being sent to landfill to continue to reduce as the availability of ERFs increase, with an ongoing baseline requirement for landfill disposal of waste that is not suitable for recycling or recovery.

Business model

Through our business model, we fulfil our vision to deliver sustainable shareholder value by providing high quality environmental infrastructure and customer services.

Our strategy is to lead in the UK's water and waste sectors, invest for sustainable growth and drive value through efficiency.

What we do...

We provide water and wastewater services in the most efficient and sustainable way possible

Read more page 26

We transform waste into energy, high quality recyclates and raw materials

Read more page 32

...the strengths we rely on

Our strengths

The best people

The talent, commitment and hard work of our people is the foundation of our success. As a responsible employer we are focused on employee wellbeing, retention, training and development, productivity and, above all, an unwavering commitment to health and safety.

Strong relationships with our suppliers

We work closely with our suppliers and take the steps necessary to ensure their performance meets our expectations. We expect them to uphold our standards, align with our policies, protect human rights and promote good working conditions.

Effective governance

Strong governance framework provides oversight and support to Group businesses including robust decision-making and performance management processes.

Efficient financing

The strength of our proposition and investor confidence in our performance and reputation means that we are well funded with efficient long-term financing.

High quality assets

We invest in the construction of world-class facilities and plants that use state-of-the-art technology. We engage the best people to maintain and operate our fleet of assets, to ensure we always maximise returns.

Well managed risk

Comprehensive and fully embedded risk management processes assist us in identifying and managing risks and opportunities to deliver the Group's strategy and objectives.

Our pillars

Safety first

The safety of our employees, customers and communities comes first. We will do everything safely and responsibly, or not at all.

Our people

Our success comes from our talented people doing great things for our customers and each other.

Service and value

We are committed to delivering exceptional service and value for our customers and communities.

...and our strategy

Long-term priorities

1
Leadership in UK water and waste

We aim to lead in the water and waste sectors by capitalising on Group strengths, capabilities, best practice and synergies and achieving the right balance between risk and reward.

Read more page 22

2
Leadership in cost base efficiency

We are focused on driving down overheads and operating in the most efficient way to minimise costs.

Read more page 23

3
Driving sustainable growth

We actively seek opportunities to invest for growth, whether through investment to increase our asset portfolio, initiatives to expand our customer base or partnerships with other organisations.

Read more page 23

(1) As measured by the service incentive mechanism (SIM). See page 30 for details.

(2) Before non-underlying items and deferred tax.

(3) 116 beaches (81.1%) classified as 'excellent'.

...to create value

Value created for our stakeholders

Customers **81.6**
Best ever customer service score for South West Water⁽¹⁾

Investors **19%**
Earnings per share increased to 47.0p⁽²⁾

People **130**
Number of apprentices trained within the Group since 2011

Community **98.6%**
141 bathing waters out of 143 classified as 'sufficient' or better⁽³⁾

Environment **1.6m**
Tonnes of waste materials recycled

Efficiency in everything we do

We work smart, keep things simple and invest money wisely.

Progress through innovation

From the technology and science we use, through to the way we approach what we do – innovation drives us forward.

Sustainability matters

We take our responsibilities towards the environment seriously and aim to be sustainable in everything we do.

Strategic priorities

Our strategic objectives are set and monitored through a rolling long-term strategic planning process. This takes into account potential risks and our sustainability framework.

Long-term priorities

1 Leadership in UK water and waste

Near-term objectives

- Develop and fully maximise value from our infrastructure business through long-term, predictable, asset-backed, index-linked revenues
- Build on the strong track record of our water business by delivering and outperforming the K6 regulatory contract (2015-2020)
- Optimise our portfolio of Energy Recovery Facilities (ERFs) to ensure a high level of performance and availability is maintained
- Achieve the right balance between risk and reward by mitigating volatility through securing long-term cash flows
- Continue to drive returns from recycling 'self-help' measures that reduce the cost base and improve the utilisation of our assets
- Continue to develop a new model for proactive customer service that puts our customers at the heart of everything we do.

Progress in 2016/17

- Outperformance by South West Water against the K6 regulatory contract (2015-2020) continued in 2016/17, securing a net cumulative reward of £3.6 million
- South West Water's return on regulated equity (RoRE) continues to be sector-leading
- Innovative investment in new Mayflower Water Treatment Works in Plymouth – the first of its kind in the UK
- Delivery by Viridor of £107 million EBITDA from its ERF business, exceeding the target of c.£100 million
- Improved performance of Viridor's recycling business resulting from 'self-help' initiatives to reduce costs and improve asset utilisation
- Dividend per share increased by 7.1% reflecting strong performance of Pennon's water and waste management businesses.

2 Leadership in cost base efficiency

- Complete the organisation change programme coming out of our Shared Services Review and finalise the centralisation of key corporate and operational services
- Continue to maximise the benefits of the integration of Bournemouth Water operations into South West Water's business
- Ongoing initiatives to reduce central overheads, share best practice and deliver synergies.

- Good progress towards delivering K6 cost savings of £27 million from the Bournemouth Water integration
- South West Water cumulative totex efficiency of £129 million driven by continuing advantages from our strategic alliances
- £17 million per annum of cost savings to be delivered across the Group by 2019; £9 million per annum secured to date
- Cost efficient long-term financing in place – 3.4% interest rate on annual net debt.

3 Driving sustainable growth

- Continue to grow the ERF business, including the successful completion of construction projects at Glasgow, South London, Dunbar and Avonmouth ERFs
- Exploit the introduction of competition in the non-household retail market by building scale and efficiency through Pennon's water retail business, Pennon Water Services
- Identify and consider opportunities for further growth.

- £385 million invested in key infrastructure during the year
- Four ERFs now under construction
- New retail venture for business customers between Pennon Water Services, South Staffs and Cambridge Water – combined revenue of c.£170 million and entering the market with the fourth largest customer base
- Well positioned for regulatory and market developments – ongoing engagement with Ofwat reforms and prepared for the 2019 price review.

Strategic priorities linked to annual bonus targets, see pages 90 & 91

KPIs

>90%

average ERF availability

85%

customer satisfaction with overall service⁽¹⁾

(1) Average of the customer satisfaction scores achieved by South West Water, Bournemouth Water and Viridor for the year.

£17m

of cost savings per annum targeted across the Group by 2019

Group assets as at 31 March (£bn)

4.8	5.0	5.4	5.7	5.9
2013	2014	2015	2016	2017
				+3.5%

Sustainability drivers

- **Investing in people** – protecting the health, safety and wellbeing of our people to ensure we have a skilled, diverse, engaged and motivated workforce to deliver our strategy
- **Environmental protection** – integral to our water business's regulatory contract and the promotion of the circular economy by our waste management business
- **Waste prevention and resource efficiency** – delivering solutions for society is core to our strategy and helps to address the challenge of depleting natural resources.

- **Minimising disruption and inconvenience for our communities** – means that we also minimise the cost to the business
- **Energy efficiency** – the use of solar photovoltaics to power our facilities and other energy saving initiatives help us to reduce our own demand for electricity from the grid whilst maximising the energy generated from our core operations
- **Responsible sourcing** – value for money secured through robust procurement practices and sustainable supply chains.

- **Customer service and engagement** – increased focus to improve the customer experience and help expand our customer base whilst retaining existing customers
- **High standards of business conduct** – ensure that our people are incentivised appropriately and exhibit the right behaviours to enable us to achieve long-term and sustainable growth.

Risks and uncertainties

Our aspiration to be a leader in the sectors in which we operate could be affected by the occurrence of certain events, many of which have reputational consequences:

- An avoidable health and safety incident
- Legal, regulatory or tax non-compliance
- Poor customer service
- Failure to recruit, retain and develop people with the appropriate skills
- Business interruption (for example, as a result of a failure of our information technology systems) or operational failure
- Failure of a capital project
- Loss or corruption of data as a result of a cyber attack.

Risks that could impact our ability to deliver efficiencies include:

- Operational failures that result in rectification costs
- Changes in law or regulation that require additional expenditure to fund implementation and ongoing compliance
- An increase in customer bad debt resulting in additional debt collection costs
- Failure to recruit and retain people with the right skills, mindset and motivation to share best practice, deliver synergies and move the Group forward in the new 'shared services' structure.

Our ability to deliver sustainable growth could be impacted by:

- Unfavourable economic conditions
- Local authority austerity
- Poor customer service
- Loss of market share as a result of regulatory reform and increased competition
- Difficulties in recruiting, retaining and developing people with the necessary commercial acumen to help our businesses grow and prosper.

Our people

The talent, professionalism and commitment of our people is key to the delivery of our strategic objectives.

Our continued investment in our people is a cornerstone of the Group's ability to create shareholder value. In support of this, Pennon has started work on a new Group-wide people strategy and will roll this out before the end of the 2017/18 reporting year.

Health and safety

Our policy is to provide and maintain a safe working environment while preventing injury and ill health wherever possible. We continue to target improvement through training programmes focusing on behaviours and attitudes as well as risk awareness and risk control and the ability to learn from accidents or near misses. As the reporting of near misses has increased, RIDDOR* injury incidence rates have dropped across the Group. Viridor reported an improvement for 2016 and South West Water achieved a better performance on a like-for-like basis (excluding Bournemouth Water).

Earlier this year, Pennon announced a new vision and strategy for health and safety, designed to raise standards, prevent harm and create a culture of safety across its businesses. We call our new health and safety programme 'HomeSafe' and it represents a wide-ranging agenda of consolidation and improvement, which focuses on people, process and the physical environment.

* Reporting of Injuries, Diseases and Dangerous Occurrences Regulations.

We continue to invest in the skills and career progression of our staff.

Workplace strategy

Our goal is to attract and retain talented people with the knowledge, skills, values and behaviours required to deliver the Group's long term goals and objectives. Underpinning this, and in line with human rights principles, we have a range of policies covering health and safety, equal opportunities, diversity, ethics and employee relations. All elements of our workplace strategy apply to both our permanent and temporary workers and we expect suppliers and contractors to comply with relevant legislation and to hold similar principles.

“We believe fully engaged staff facilitate better safety, greater productivity and higher customer satisfaction.”

Code of Conduct

Our Code of Conduct sets out the principles we believe should guide our actions. These principles apply equally to permanent and temporary employees and we expect our suppliers and contractors to comply with equivalent guidance. Employee training courses have been developed around the Code of Conduct that focus on specific aspects relating to legal and ethical behaviour.

Employee engagement

We believe motivated and engaged people value their own health and safety and that of their colleagues, drive greater productivity, and aspire to deliver higher levels of customer satisfaction. Across the Group, over 3,800 of our people (78%) completed annual employment engagement surveys, in line with previous years. Importantly, for the first time, we brought together all of the leaders across the Group to discuss the results and agree key actions. These actions are focused on engaging our people in our strategy, supporting our people better as we evolve as an organisation, and providing more opportunities to engage in two-way communication.

Employee development

We continue to invest in the skills and career progression of our staff through a range of schemes and training opportunities, ranging from operational upskilling programmes to management training.

In the water business, this included specialist training for our call handlers in a range of skills including a programme with the mental health charity MIND, designed to help call handlers recognise if a customer is struggling to pay their bills owing to stress or depression. This has helped to improve our management of income recovery, which during 2016/17 was our best-ever.

In Viridor, we have continued to support 24 individuals undertaking a foundation degree specifically designed for the business, and launched a management development programme which 76 of our senior leaders completed during the year.

Community initiatives

Our employees are enthusiastic participants in the Group's volunteering programmes. Viridor employees volunteered 99 days, including activities with Somerset Wildlife Trust to transform a neglected area close to the River Tone in Taunton, Somerset. Throughout December, Viridor's Manchester Trafford Park team helped out Key 103's Cash for Kids Mission Christmas appeal, collecting donated toys from Greater Manchester residents.

South West Water staff took part in educational outreach programmes alongside the region's Wildlife Trusts and participated in Keep Britain Tidy's BeachCare programme. Since 2010, South West Water has supported 830 beach cleans which have collected more than 120 tonnes of rubbish.

Diversity and equal opportunities

The Board continues to promote equality of opportunity and diversity across the Group in all areas, including gender and ethnicity. Although some progress has been made on diversity in certain areas across the Group, this still remains a key area of focus and diversity specific actions are being reviewed as part of the wider sustainability agenda.

Gender diversity

In South West Water 27% of the workforce is female (an increase of 2% from last year). We do have some areas of under-representation for example in our craft and industrial group where the proportion of women is less than 1%. We are committed to focusing on this as an area for improvement in line with the industry.

The majority of Viridor's employees are male (85%), reflecting a traditionally male-dominated industry. The ratio is similar across senior management with 16% female. Of those employed directly by Pennon, 45% are women. We are committed to improving senior management gender ratios in time across the Group through initiatives such as informal mentoring programmes and family friendly policies.

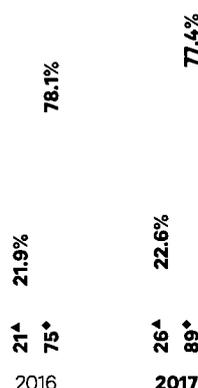
A working group is ensuring Pennon complies with new legislation on gender pay equality that requires certain companies to publish information on their gender pay gap and report this data to the UK Government.

Gender diversity as at 31 March

Employees



Senior Management



Board



▲ Women ◆ Men

The use of new technologies helps to improve both the performance and efficiency of our operational assets.

South West Water continues to invest in processes such as Granular Activated Carbon (GAC) and Ultraviolet Disinfection (UV), which is now used at 70 of our drinking water and wastewater treatment sites. In the drinking water side of the business these processes are designed to improve the taste and odour of customer supplies while securing long-term compliance with water quality standards.

70

drinking water and
wastewater sites using
UV treatment processes

Group performance

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Improving the
performance
and efficiency
of our assets

Review of the Chief Executive Officer

Our strategy is to lead in the UK's water and waste sectors, drive value through efficiency and invest for sustainable growth.

Chris Loughlin
Chief Executive Officer

Pennon Group achieved a strong performance in 2016/17. Our strategy is to lead in the UK's water and waste sectors, invest for growth and drive value through efficiency. I am pleased to say the Group is delivering against each of its strategic objectives while achieving a return for shareholders in a responsible and sustainable way.

Health and safety

During the year we were shocked and saddened by the death of Viridor worker Rafal Swiadek at the Materials Recycling Facility in Milton Keynes. No fatality is acceptable and I want to underline the Group's commitment to health and safety. In January 2017 we created the new role of director of Safety, Health, Quality and Sustainability (SHQS) and appointed Steve Holmes, who previously held the role of Health, Safety, Security and Environment director for Amec Foster Wheeler. He brings many years of senior experience in operations, health and safety from industries including oil and gas, nuclear, power and rail.

This appointment is an important development for Pennon because it reflects our commitment at the highest level to improve health and safety by utilising concepts and learnings from other high hazard industries. Steve has a mandate from the Board to implement an enhanced strategy that will raise the Group's performance and reinforce health and safety as core to Pennon's way of working. Our ambition is to be the health and safety leader in the UK water

and waste sectors and, to that end, we have launched our HomeSafe programme (see page 18). As we pursue our ambition, we can expect to see changes to how we evaluate and control risk, how we engage with our employees, and how we build greater leadership and accountability for health and safety.

Leadership in water and waste

We remain committed to delivering high quality services for the benefit of our customers, proactively seeking to understand their needs and priorities and making the most of new technologies and innovation to deliver appropriate improvements.

South West Water once again outperformed its regulatory contract to achieve a sector-leading RoRE (return on regulated equity) of 12.6%. In addition, South West Water once again achieved ODI outperformance which has secured a net reward of £3.6 million in the year.

In our waste operations, Viridor continues to be a leader following its significant investments in Energy Recovery Facilities (ERFs) in recent years. We delivered £107 million EBITDA, which is in excess of our target of c.£100 million, and now have a clear track record of constructing and commissioning ERFs, and delivering the operational and financial results.

We continued to drive returns from recycling through broader 'self-help' measures that are reducing the cost base and improving utilisation of assets. It is

£129m

Cumulative totex
outperformance

>90%

Average ERF availability

encouraging to see these initiatives supporting an increasing EBITDA. We are also making progress in commodity risk sharing with our recycling clients.

Investing for sustainable growth

Our decision in November 2016 to commit to a £252 million ERF at Avonmouth, near Bristol, has expanded our future portfolio to 12 plants. We expect demand for ERFs to continue to exceed capacity into the long term.

The Group is actively addressing opportunities arising from water industry deregulation. In preparation for the new non-household retail water market, which commenced 1 April 2017, we set up Pennon Water Services as a Pennon Group plc subsidiary, ringfenced from South West Water's business, to provide retail services to business customers. To achieve scale, Pennon Water Services formed a non-household retail venture with South Staffordshire Plc (incorporating South Staffs and Cambridge Water). Pennon Water Services entered the market with the fourth largest customer base in the deregulated market.

Driving value through efficiency

South West Water maintained its strong momentum in controlling total expenditure (Totex) with cumulative savings of £129 million and financing outperformance of £67 million in the first two years of K6 (2015-2020). South West Water is targeting to remain at the forefront of cost efficiency for the water sector.

During the year, we completed our Shared Services Review to drive value through efficiency, synergy and best practice. Reflecting the more integrated nature of our Group, we are taking advantage of the expertise our combined water and waste businesses have in terms of managing large asset bases, and in engineering, technology and innovation. The review resulted in a plan to centralise key corporate services and operational functions, including the introduction of a shared IT platform. This will achieve estimated savings of £17 million per year from 2019, up from the £11 million per year that we announced last year of which c.£9 million per annum has been secured to date.

Other efficiency successes include the Group's energy trading team which has developed a portfolio management strategy. This addresses the energy demands of the Group and ensures Pennon is buying energy at the right price while enhancing profitability from the energy we generate. With South West Water a net user of electricity, the Group has a natural energy hedging opportunity representing one third of Viridor's energy generation. We can now hedge our market position for up to five years ahead, further helping to protect revenues.

Balanced risk-reward profile across the Group

Part of our strategy as we build our ERFs, and in our recycling operations, is to ensure there is a balanced risk-reward profile that complements our water operations as closely as possible.

As a long-term infrastructure provider, we manage our risk profile by mitigating volatility through secure, long-term cash flows. We have made significant progress over the past two years in reducing risk and unpredictability across the Group by overlaying our long-term assets with long-term commercial arrangements, and supporting these with long-term financing.

At Viridor, for example, we have increased contracted volumes better aligning with the life cycle of our assets. By negotiating long-term 25-year index-linked contracts with stated volumes and prices, Viridor is building a similar risk-reward profile to the water side of the business. Prior to committing to Avonmouth, approximately 80% of our ERF portfolio volumes (and associated prices) were contracted long term.

Striking an appropriate balance between operational risk and reward is a key part of our strategy. This applies to any aspect of the Group's operations – developing our recycling business, our decision to build the Avonmouth ERF, or our entry into the non-household retail market. The starting point for achieving the right risk-reward balance is to ensure the Group fully understands the differences between its water and waste operations. This has given us a strong and effective framework for identifying risk.

Innovation and investment in Plymouth

South West Water's largest investment in its current five-year plan is the new £60 million state of the art Mayflower Water Treatment Works in North Plymouth. Due for completion by March 2018, Mayflower uses the innovative treatment processes of suspended ion exchange, inline coagulation and ceramic membrane filtration. This is the first time that this combined technology has been used in the UK. Mayflower will provide a secure, high-quality drinking water supply for the Plymouth area for generations to come.

Review of the Chief Executive Officer

continued

New branding

As we begin to work more closely as an integrated business, it is important that the Pennon, South West Water and Viridor brands also work together visually. The new branding underlines our commitment to environmental infrastructure, unifying us as a group but still reflecting the strengths of each business. A cost effective three-year programme for roll-out of the new branding for vehicles, sites and uniforms was in progress by year end.

We also ensure senior management are fully aware of how we are managing risk and how we can mitigate adverse impacts. At the same time, we identify appropriate business opportunities, especially as our strategy is to invest for growth in both water and waste over the longer term.

Sustainability is core to our business

Sustainability is core to the Group both in terms of ensuring its long-term commercial viability and of operating in an environmentally and socially responsible manner. The Group has a long track record in partnership and innovation across a range of sustainability issues. Our operations are deeply embedded into local communities and we believe this is one of the reasons Ofwat responded so positively to South West Water's latest business plan.

Sustainability is carefully integrated into our strategic thinking given the nature of our business as a provider of key water and waste services and the close relationship our operations have with environmental issues. Furthermore, we recognise that making responsible and sustainable business decisions is critical to achieving long-term investor confidence.

Our decision-making on capital investment integrates many sustainability factors including social, community and environmental impacts. We use a range of tools to ensure we make decisions that involve more than purely economic or financial criteria. In the case of capital expenditure on our network infrastructure, for example, an ideal solution is always one that combines not just the lowest cost base but also a favourable sustainability score.

There was clear evidence of the importance of sustainability within the Group during the year. In early 2017 Pennon completed its first Group submission to Business in the Community's Corporate Responsibility Index and received a score of 90% (a three-star rating). Pennon is also included in the FTSE4Good Index. In addition, we achieved a score of B (Management) for the annual CDP submission (formerly the Carbon Disclosure Project) for Climate Change and Water, and we continue to take steps to effectively reduce our impacts.

Our gross greenhouse gas emissions increased by 14%, primarily as a result of Viridor's newly commissioned ERFs reaching full operating capacity. The ERFs burn waste that would otherwise have gone to landfill. This has the double benefit of extracting more of the energy embedded in the waste and substituting energy generated from other, predominantly fossil fuel, sources.

Our environmental performance is an area of focus and further progress is needed in aspects such as reducing the risk of pollutions and flooding. In recognition of the shared importance of our environmental responsibilities across the Group, we have created the new role of director of Environment and, in April 2017, appointed Ed Mitchell to the role. Ed brings with him a wealth of experience, having spent eight years at the Environment Agency. Prior to this Ed held senior positions at Thames Water and the Department of Environment, Food and Rural Affairs.

Our people

Across the Group we look to attract, develop and retain a highly skilled and customer-centric workforce. At the end of the year, Pennon had a workforce of around 5,000 people and we continue to be a large employer in the south west of England.

Our multi-award winning apprenticeship programme, which started in 2011, continues to go from strength to strength. This year South West Water recruited its 100th apprentice since the programme began. Viridor is actively committed to expanding the number of apprentices it employs.

The Group also contributes to local efforts to develop skills for the future, an example being South West Water's role as a leading partner in a University Technical College for South Devon, which places a unique focus on engineering, water and the environment.

Our employees supported communities through 359 days of volunteering during the year and both South West Water and Viridor continue with a broad community education programme. Viridor has been shortlisted for The UBS Award for Education as part of Business in the Community's Responsible Business Awards 2017.

At executive level, the creation of the position of Group director of Human Resources is an important step in the Group's evolution. The responsibilities of the role include developing and implementing the Group's people strategy and assessing how we evolve the human resources model across the Group.

The success we achieved in 2016/17 owes much to our employees and I would like to thank all of them for their hard work, loyalty and dedication.

Outlook

The Group's outlook is encouraging. In our waste business, our ERF portfolio is a significant investment in the UK's environmental infrastructure and key to Pennon's growth agenda. Construction of our ERFs at Dunbar and South London is progressing well and construction on Avonmouth is now underway. In November 2016 we announced that we had taken positive action to terminate Interserve Construction Limited as EPC contractor for our ERF in Glasgow following their continued underperformance on the project. Good progress has been made since this date in engaging sub-contractors and progressing construction which is expected to be complete within a revised timetable agreed with our customer, Glasgow City Council.

Once all facilities are fully operational, we are confident they will add to the already strong contribution these assets are making to the Group's financial performance. We continue to work hard to create a balanced risk profile across our waste and recovery operations.

“We remain well positioned to play our part in the development of future regulatory reform.”

The Greater Manchester Waste Disposal Authority (GMWDA) has confirmed that it is seeking to exit and re-negotiate the Greater Manchester Waste private finance initiative (PFI) contract with Viridor Laing Greater Manchester. The PFI contract, which was entered into in 2009, was the UK's largest waste and energy project. Diversion of waste from landfill remains ahead of contractual commitments and we are keen to ensure this progress is able to continue. Viridor and its joint venture partner John Laing have been actively engaging with GMWDA as they consider their options. There are provisions in the PFI contract for compensation to be paid to Viridor and John Laing on termination.

Our water business is well prepared for the future. South West Water is fully engaged in Ofwat's programme for future water and wastewater services regulation as the Group prepares for the PR19 five-year review of pricing and investment requirements. We remain well positioned to play our part in the development of future regulatory reform and are working to ensure our voice is heard in shaping the industry's future.

South West Water will publish its 25-year strategic plan during 2017/18, setting out our evolving strategic priorities and our path to continued strong operational performance. We will make every effort to maintain a first-class, innovative and efficient service that is characterised by reliability, responsiveness and resilience. At the same time, we will ensure our operations and investments enhance the communities we serve and that we continue our commitment to understanding the needs of vulnerable customers and offering appropriate support.

Avonmouth ERF: investing for growth

Viridor, with its joint venture partners, is already one of the largest independent power generators from waste. When Avonmouth begins operation early in the next decade, it will place us in the leading position in UK energy recovery with 20% market share. Avonmouth will serve around 3.5 million people in the West of England and supply the national grid with enough electricity to power over 30,000 homes.

The waste supply in the Avonmouth ERF catchment area substantially exceeds the plant's own capacity as well as available capacity nearby. Supporting contracts we already have, an additional volume of some 800,000 tonnes is available from local municipal, commercial and industrial sources. Combustible waste market under-capacity in the west of England extends to 2030 and beyond, matching the UK trend. Viridor's market projections are supported by independent third party analysis.

Looking ahead, our strong operational and financial performance shows we are delivering on our strategy and providing a firm foundation for further growth. Our immediate priority is to optimise our current assets and operations so that we can continue fulfilling our strategic objectives. In the longer term, we believe there is additional opportunity for consolidation in wholesale water.

Meanwhile, we have a clearly articulated core strategy focusing on water and waste operations in the UK and we believe both business streams provide excellent opportunities. With our sector-leading dividend policy, our growth profile and our strong balance sheet, Pennon Group is well positioned to deliver further value to customers, communities and shareholders.

Chris Loughlin
Chief Executive Officer
Pennon Group plc

Our operations

Water and wastewater

In our water and wastewater business we are focused on providing services in the most efficient 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.

www.pennon-group.co.uk/water

- Reservoir
- Key water mains

South West Water

1.7
million total
population served

15,300
km of drinking water
mains network

900
wastewater pumping stations

0.8
million customers

682
treatment works with
66 ultraviolet (UV)
treatment facilities

144
bathing waters and
24 shellfish waters

21
raw water reservoirs

15,600
km wastewater
mains network

Bournemouth Water

0.5
million total
population served

2,831
km of drinking water
mains network

0.2
million customers

7
treatment works with
4 ultraviolet (UV)
treatment facilities

2
raw water reservoirs

Stephen Bird

Managing Director,
South West Water

We continued to deliver strong performance in 2016/17, providing high quality drinking water, achieving our best result to date in leakage and delivering a significant improvement in wastewater compliance. We were well prepared for the opening of the non-household retail market and are well-placed as preparations get underway ahead of the next Price Review (PR19).

Our operations

Water and wastewater continued

Continuing outperformance

The merged water business of South West Water and Bournemouth Water performed well during the year. South West Water's Return on Regulated Equity (RoRE) performance continues to be sector leading and is outperforming its business plan with a RoRE of 12.6%. This arises from base, financing and operational returns with 6% as the base return, 3.2% reflecting total expenditure savings and efficiencies, 0.3% reflecting a net reward on Outcome Delivery Incentives (ODIs) and 3.1% reflecting the difference between actual and assumed financing costs. This is consistent with the approach to our WaterShare mechanism.

A key highlight for the year is our significant capital investment of £191 million in our drinking water and wastewater operations. This reflects our focus on enhancing our environmental performance and we are pleased with the progress seen during the year.

During the year Ofwat updated its guidance to companies which requires financing outperformance to be calculated using an in-year average RPI rate. This approach reflects a financing outperformance of 2.4% and a total RoRE of 11.9% for 2016/17 (10.1% for 2015/16). South West Water's RoRE would remain sector leading and by the end of K6 period overall performance will converge.

Total expenditure savings

South West Water continued to focus on driving value through efficiency. It achieved cumulative total expenditure (Totex) savings of £129 million and financing outperformance of £67 million in the first two years of K6 (2015-2020).

The business expects to remain at the forefront of cost efficiency for the water sector.

These savings were driven by continuing advantages from our strategic alliances, including a new water distribution framework and the H₂O capital alliance, which is now delivering efficient schemes within the Bournemouth region.

We are also ensuring efficient capital investment, promoting off-site build techniques and changing the way we work through our iOPS programme focussed on innovation and new technology to deliver cost efficiency and customer service improvements.

We continued to deliver synergies from our acquisition of and merger with Bournemouth Water, focusing on front-line functions, having completed integration of back-office and support services at the end of the prior year. The targeted c.£27 million of net synergies over K6 are on track.

ODI rewards

South West Water had 22 ODIs and Bournemouth Water 10 ODIs, which have potential financial rewards or penalties. These ODIs include the Service Incentive Mechanism (SIM).

Operational performance for the year continued to improve and there was a net ODI reward of £36 million (£5.5 million cumulatively over two years) reflecting 0.3% RoRE outperformance to date.

South West Water maintained good reliability and serviceability across all four areas of operations and bathing water quality, water restrictions, interruptions to supply and leakage all resulted in rewards for the year. Disappointingly, performance in wastewater pollutions and external flooding fell below our targeted commitment and resulted in a penalty, however, performance did improve overall compared with the prior year.

The cumulative net reward of £5.5 million comprises £7.5 million of net rewards recognised at the end of the regulatory period and £2.0 million of net penalty which could be adjusted during the regulatory period.

Drinking water

Drinking water quality is a key priority and we maintained the high standards set previously. South West Water achieved 99.96% and Bournemouth Water achieved 99.98%.

The improved performance in managing our network led to our best ever leakage result of 82ML per day, exceeding our original target and delivering an ODI reward. This reflects innovative approaches to network management including investment in real-time pressure management, detection, repairs and network monitoring.

This was our 20th consecutive year of unrestricted water supplies and the Bournemouth water region maintained its record of zero water restrictions since privatisation.

The average duration of supply interruptions per property was lower in both regions compared with the previous year. In the South West Water region this performance delivered a small reward compared to the penalty incurred in 2015/16.

RoRE (2016/17)

1	Base	6.0%
2	Totex outperformance	3.2%
3	ODI outperformance	0.3%
4	Financing outperformance ⁽¹⁾	3.1%

(1) Interest outperformance is based on the outturn effective real interest rate on net debt using the forecast K6 average RPI, notional gearing of 62.5% and an actual effective tax rate of 18.2%.

Mayflower will be one of only two plants in the world to use transformational ceramic membrane filter technology.

Investment and innovation

We continued to invest in our assets to deliver drinking water improvements. The new £60 million state-of-the-art Mayflower Water Treatment Works in Plymouth is the largest single item of capital expenditure in our current five-year plan.

Serving Plymouth and South Devon, this is a major construction and engineering project with the facility scheduled to open in 2018. During the year, we reached the halfway point in the build on time and on budget. Mayflower will be one of only two plants in the world to use transformational ceramic membrane filter technology.

Construction is also progressing well at three other modern drinking water treatment works – at Tamar Lakes, Tottiford and Northcombe. Each will use Granulated Activated Carbon (GAC), a sophisticated filter technology for improved water treatment.

There was continued investment in our award-winning Upstream Thinking programme of catchment management involving a range of stakeholders including wildlife trusts and river authorities. During the year we worked with 1,056 farms and improved 7,568 acres of upstream land.

Wastewater

South West Water aims to ensure the safe and efficient removal and disposal of wastewater, while minimising the possibility of sewer flooding and pollution. We continued to implement a programme of wastewater treatment improvements and increased monitoring to prevent potential failure.

Upstream Thinking for sustainable solutions

Upstream Thinking is a good example of our aim to examine long-term costs as well as environmental factors when assessing capital expenditure on our network infrastructure. By delivering landscape-based solutions sympathetic to the environment rather than harder engineering solutions, we are addressing water quality and flooding risk in the most sustainable manner. Our strategy is to improve the quality of drinking water before it reaches treatment works, making it more cost effective to treat water. We also look to reduce flooding risk and retain water in catchments.

We could look solely at costly end-of-pipe solutions that might have had less preferable environmental impacts. But by co-operating with farmers and other stakeholders, we avoid the financial costs of hard engineering solutions and deliver solutions with a favourable sustainability score.

This delivered a significant improvement in numeric compliance (the percentage of wastewater treatment works deemed compliant). Performance for works with numeric consents was 98.4% compared to 95.8% in the previous year. Our performance at our smaller (descriptive) sites was 99.4% compared to 99.1% last year.

We delivered record bathing water quality results

Protecting the environment

Significant incidents (Categories 1 to 2) continued to fall, however the number of minor incidents increased marginally to 246 (2015 222). Unfortunately, the number of significant incidents at four is higher than target and, although lower than the seven reported last year, will result in a penalty for the year. We are prioritising further improvement in this area of our wastewater operations.

We delivered record bathing water quality results against more stringent EU standards during the year. Of the 143 bathing waters tested in the South West Water Region, 141 (98.6%) were classified as 'sufficient' or better. 116 beaches (81.1%) were classified as 'excellent'. All of Cornwall's beaches passed and only two beaches in Devon failed with neither of these due to any failure on the part of South West Water's own assets. These bathing water results are critically important given the importance of the coastal environment to the region's economy.

Our operations

Water and wastewater continued

Wastewater investment

Highlights of our investments and activity in wastewater during the year include process improvements and upgrades at four key sites and improvements in the sewage network to reduce the impact of saline infiltration (the impact of salt water). We also invested in increased capacity at our wastewater treatment works at Fluxton in Devon and Hayle in Cornwall.

Our continued investment in sustainability includes £5 million as part of our Downstream Thinking programme, which seeks to reduce sewer flooding by improving urban drainage, and £20 million for improvements in bathing waters and shellfish waters around Plymouth.

We also invested over £1 million to support the Exeter Flood Defence Scheme at Countess Wear Wastewater Treatment works. This is a welcome opportunity to work with partners in the region to enhance sustainability and deliver more resilient services.

Think Sink!

We continue to target a reduction in sewer flooding and pollution through the promotion of responsible sewer usage with our customers.

Following the success of our award-winning 'Love Your Loo' campaign, which targeted communities in areas with a history of sewer blockages, we launched a new 'Think Sink' campaign in December 2016.

This encourages customers to 'take the pledge' and avoid disposing of fat, oil and grease (among the major contributors to blockages) down the drain.

Customer service and engagement

There was a significant improvement in our customer service performance during the year.

South West Water scored 81.6 under the SIM used by Ofwat to compare water company performance.

The score for 2016/17 continues the improving trend of recent years and compares well with the previous year's score of 78.6. This reflects good progress in how we deal with service issues as well as call centre investments in data analytics.

Bournemouth Water's SIM score was 86.3 in 2016/17, one of the highest in the industry.

The improved SIM score owes much to the approximately 30% reduction in written complaints received at South West Water and Bournemouth Water. The customer experience quality scores also improved across both regions during the year. In addition, our overall customer satisfaction was 89%, in line with last year, with value-for-money satisfaction at an all-time high, with customer bills reducing in real terms over 2015-2020 regulatory period.

Support for those who need it

There was also good progress in helping vulnerable customers, including developing affordability schemes. South West Water was one of the first companies to introduce a social tariff to help customers experiencing temporary or long-term problems in paying their water bills.

We implemented a new employee training and development programme during the year that extends the support for vulnerable customers. We have also brought Bournemouth Water in line with South West Water's approach by rolling out a social tariff for the first time in 2017/18.

WaterShare

Our unique WaterShare scheme identified £4.0 million of benefits to customers during the year under review.

This is in addition to the £31 million shared in 2015/16. Following discussions with the independent WaterShare panel, it was decided to invest the £31 million in key areas of customer service.

How the benefit in 2016/17 is to be applied will again be considered by the WaterShare panel.

Non-household market opening

Since 1 April 2017, up to 1.2 million businesses and other non-household customers across the country have been able to choose which retailer they buy water and wastewater services from. Wholesale services, providing water to premises and taking wastewater away, are unaffected, but business customers can choose who provides their retail service.

During the year, the Group established Pennon Water Services, which will operate independently of South West Water and can secure services from any wholesaler in the United Kingdom. Equally, South West Water has the freedom to supply other business retailers around the UK.

MarketReady

In preparation for the opening of the non-household retail market on 1 April 2017, we carried out a company-wide training and awareness programme entitled MarketReady, designed to ensure recognition and compliance with the new market codes. A series of workshops were delivered to almost 2000 staff with messaging subsequently reinforced using an innovative web-based knowledge-testing application. The MarketReady campaign also featured heavily in all internal communications throughout the year.

98.6%

improved results for
bathing waters

£20m

investment in bathing and
shellfish water improvements

From September 2016 South West Water fully engaged in a period of 'shadow operation' to ensure that systems and processes were ready for market opening, operating as closely as possible to the market conditions and requirements whilst ensuring customer service levels were maintained.

Future market opportunities

Ofwat is promoting the development of a market for bio-resources (also referred to as sludge; a product from sewage which can be used for energy or as a fertiliser substitute) and a market for water resources.

We conducted preliminary work on these potential opportunities during the year and are actively engaged with Ofwat in developing the potential frameworks for these markets.

Ahead of PR19 we are also engaging with customers and stakeholders around their priorities for water and wastewater services over the short and long-term. The initial findings have helped inform our updated 25-year strategic plan which is being published during the summer.

Our community

Regional economy

South West Water is one of the largest companies in its region. The services it provides are essential for the area's economic sustainability and the company supports the employment of around 5000 staff directly and indirectly through the supply chain.

The company works closely with Local Enterprise Partnerships (LEPs), the Environment Agency and other stakeholders and regulators on projects and initiatives to ensure a sustainable and resilient future for the region.

Charitable partnerships

In 2016/17 South West Water provided almost £75,000 of community sponsorship as part of its business plan. Using the Business in the Community framework as a guide, which marries core business purpose with identified community and social needs, South West Water's main sponsorships were with:

- Devon and Cornwall Wildlife Trusts – in support of their community engagement and educational outreach programmes. Activities included a 2-day Wildlife Celebration at Trebah Gardens in Cornwall and 55 school visits to Wembury Marine Centre in Devon
- Surf Life Saving GB – in support of the Nippers & Youth Championships and a three-year Graduate Lifeguard Project programme for young people who will be able to gain a National Vocational Qualification and become a Level 1 Coach at age 16
- The South West Coast Path Association, which takes care of the 630-mile coast path, one of the region's main tourist attractions
- British elite windsurfer and Olympic hopeful Izzy Hamilton, from Bude, who learned to windsurf at Roadford Lake.

Access and recreation

The South West Lakes Trust, an independent charity, manages over 14,000 acres of land on South West Water's behalf. The Trust is the region's largest combined environmental and recreational charity, taking care of 50 inland water sites which attracted more than 1.9 million visits during 2016/17.

Conservation, access and recreation activities in the Bournemouth Water area, including management of fisheries and moorings, are now also being managed by South West Lakes Trust on South West Water's behalf.

Our operations

Waste management

Viridor is at the forefront of the resource sector in the UK, transforming waste into energy, high quality recyclates and raw materials.

www.pennon-group.co.uk/waste

Key facts

8

energy recovery facilities in operation and four more due to be operational by 2020

300

recycling, energy recovery and waste management facilities

380,000

potential homes powered by energy produced by our portfolio

650

waste collection vehicles securing materials for our network of assets

150

local authority and major corporate clients

7.6

million tonnes of waste materials input each year

32,000

customers across the UK

1.6

million tonnes of recyclate traded

Phil Piddington

Managing Director,
Viridor

Viridor has delivered a strong performance across its recycling and energy asset base. Our ERF portfolio is performing well and we have started construction of a new facility in Avonmouth, for which we have already secured half of the inputs. Our focus on self-help measures has reduced the risks in the recycling business and delivered significant financial benefit.

**Material recycling
facility**

**Energy recovery
facility**

Our operations

Waste management continued

Strong momentum

Our energy recovery and waste recycling business enjoyed strong momentum in 2016/17. Through our energy recovery facility (ERF) portfolio we are delivering on the Group's strategy to invest for growth. Our announcement of a new ERF at Avonmouth near Bristol takes our total portfolio to 12 plants. Of the three other ERFs currently under construction, Dunbar and South London ERFs are progressing well. Following the termination in the year of Interserve as our main contractor for Glasgow ERF, the project is now progressing to our revised plan with commissioning expected in 2017.

To date, the Group has invested more than £1 billion into its ERF asset base. This significant investment in environmental infrastructure is helping us to transform our business model with an increasing focus on ERFs and recycling.

In coming years, we expect our growing ERF business to be the largest contributor to Viridor, followed by recycling, with these operations together already successfully delivering new revenues that can replace our legacy landfill business.

'Self-help' measures during the year improved efficiency in our recycling operations while there was continued progress in commodity risk sharing with our customers.

We took further steps to evolve our approach to health and safety. The Group's new director of Safety, Health, Quality and Sustainability (SHQS) will work closely with Viridor to deliver a major transformation in our health and safety outlook that will benefit personal wellbeing and enhance business performance.

Viridor's total energy capacity has continued to grow and with our joint venture partners, we are already one of the largest independent power generators from waste in the UK. We had 280MW of operating capacity from ERFs, anaerobic digestion (AD), solar and landfill gas (including joint ventures) at 31 March 2017 and exported 1.5 terawatt hours (TWh) of power during the year.

Customer experience

During the year, we completed our first customer service survey to seek the views of over 1,000 clients. Viridor will use the findings to strengthen customer relationships and support the Group's wider growth strategy. By improving the quality of our products and services we enhance the customer experience, and this in turn supports customer retention and creates long-term business partnerships.

76% of Viridor customers said they were satisfied or very satisfied with the service

The key requirement from the perspective of our customers is for a seamless service providing safe, reliable collection. We continue to develop a fully integrated service of waste management, recycling and recovery recognising that customers are keen to avoid landfill. Our aim is to maximise the amount of waste that goes into recycling and to divert the balance to our ERFs or landfill as appropriate. By doing this, we are supporting development of a circular economy with greater resource productivity leading to reduced waste and pollution.

Energy recovery facilities

Viridor reported a good operational and financial performance for 2016/17.

Our ERF portfolio is a significant asset base comprising eight plants in operation with four under construction, including Avonmouth. This is the UK's largest network of modern low-carbon energy recovery facilities and produces much-needed energy. At year end, our ERFs provided 178MW of generating capacity. Once the total committed ERF portfolio is completed in 2020/21 our ERFs alone will provide 276MW of energy generation capacity.

Long-term waste contracts provide a secure fuel source for the ERFs and strategically agreed energy offtake contracts provide assured earnings from the energy generated.

£1.1bn

invested to date in our ERF portfolio

1.5TWh

power exported in 2016/17

Bringing new solutions to plastics recycling

Viridor is continually working on solutions to align next-generation recycling resources with the needs of UK industry. Our £12.5m advanced plastics recycling facility at Rochester is capable of processing 75,000 tonnes of mixed plastics each year. The Rochester team has partnered with packaging specialists (Nextek, funded by WRAP) to help find a solution to the 1.3 billion black plastic ready-meal trays sold by UK supermarkets that are not currently recyclable.

Viridor plays a vital part in the displacement of virgin materials in manufacturing supply chains, with recycled material that significantly reduces embodied carbon across product lifecycles.

Plant optimisation

We are maintaining a high level of performance in these facilities and demonstrating we can deliver long-term stable earnings. This helped us exceed our target contribution of some £100 million of EBITDA from our ERF portfolio for 2016/17.

For the operational plants, our focus was on optimisation and during 2016/17 we achieved average availability in excess of 90%. Our operational ERFs have a design capacity of 2.1 million tonnes of waste inputs, including joint ventures. Our forecasts are for this to increase to 3.2 million tonnes of waste by 2020.

ERF growth

Two of our ERFs under construction, at Dunbar and Beddington, are progressing well and to budget. Delays at Glasgow's Recycling and Renewable Energy Centre led Viridor to terminate the construction contract with Interserve. The project will be finished by an experienced team assembled by Viridor while contractual remedies will also support completion. The client (Glasgow City Council) is supportive and commissioning of the plant is now expected in 2017.

We are building a strong operational team using power industry best practice. We have demonstrated that we can build these facilities safely, on time and to budget and during the year we achieved upper quartile availability and reliability. Maintaining this high level of performance in our ERFs contributed to fulfilling our commitment to achieve c.£100 million EBITDA during the year.

The £252 million Avonmouth ERF near Bristol is scheduled for completion in 2020/21. The plant will have a capacity of 320,000 tonnes per annum and will deliver 34MW of electricity. Viridor expects to fill the plant's capacity on opening and by year end 50% of the fuel had already been agreed. This includes some 35% of total capacity secured through a long-term contract with Somerset Waste Partnership. This aligns with our strategy to achieve a balanced risk-reward profile across the Group. We are implementing that strategy by increasing long-term contracted revenue to match the life cycle of our assets. There are further contracts for Avonmouth ERF in the pipeline.

Impact on carbon emissions

41% of the Group's 2016/17 emissions were attributable to our ERFs. This part of the business will continue to contribute a significant proportion of our carbon footprint as more plants come on stream however there are clear environmental benefits due to the reduction of waste going to landfill. Viridor is in the process of establishing energy efficiency projects at key sites although, in the long term, we believe our energy recovery activities and their related combined heat and power schemes will help to deliver a distinct improvement over landfill. In addition, the displacement of virgin materials in manufacturing with recycled material contributes to significant reductions in embodied carbon across product life cycles. However, this offset falls outside current greenhouse gas reporting scopes.

Ardley ERF achieves best-in-class delivery

Viridor's ERF at Ardley, north of Oxford, delivered world-class safety performance in construction and was built on-time and on-budget. It completed its first year of operations in 2016/17 and achieved upper quartile availability (between 90% and 96%). This high level of performance is normally associated with a mature asset and it would be reasonable to expect a lower level of 80%-90% availability from a new plant. The achievement at Ardley of upper quartile performance in the first year with a completely new team is the result of Viridor's record of investing in quality people, training and development and its commitment to effective operational processes and procedures.

Innovative use of by-products

Viridor's ERFs are moving closer to becoming a fully 'zero waste to landfill' solution using innovative technology to treat the by-products of the energy recovery process. Incinerator Bottom Ash (IBA), the ash left behind after burning the waste and Air Pollution Control Residue (APCr), the by-product of the filtering process to clean exhaust gases before they exit the facility, are now being transformed into valuable construction products. Our IBA is recovered for processing from all ERF sites and after the removal of metals, is recycled into an aggregate that is used as capping layers, sub-bases, trenches and binding concrete to structures. The aggregate is now widely recognised and used in nationally important construction projects such as the M25 widening. Contracts are also in place for recycling APCr that includes an innovative technology that transforms the APCr into a carbon negative aggregate. The Environment Agency considers the aggregate to be a product in its own right, having been assessed as an 'end of waste' material that can be used in exactly the same way as virgin aggregates and with no worse environmental impact than virgin aggregate.

Our operations

Energy recovery and waste recycling continued

Recycling

Our recycling operations had a satisfactory year with Viridor retaining its position as one of the largest recycling businesses in the UK. Recycling volumes traded in 2016/17 were slightly lower than previous years at 1.6 million tonnes. We were active in many areas, including mixed material recycling, glass and plastics recycling, paper recycling, transforming food waste into organic and energy resources. As one of the UK's largest glass-recycling companies, our recycling plants in Sheffield and Glasgow processed over 245,000 tonnes of glass in 2016/17.

Self-help measures

Recyclate prices were mainly flat but under pressure, with fluctuations across different commodities. While the outlook for recyclate prices is relatively stable over the short term, we are not relying on a near-term recovery. In addition, local authority austerity in the face of central government cuts has made the market environment more difficult. We therefore focused in 2016/17 on 'self-help' optimisation measures. These initiatives drove improved margins with EBITDA increasing by £6 per tonne, from £8 per tonne in 2015/16 to £14 per tonne in 2016/17.

As part of the 'self-help' initiative, Viridor intensified its optimisation programme and, combined with other ongoing efficiency initiatives, this saw costs reduced by £1 per tonne for the year despite an increase in shipping costs.

Sharing commodity risk and opportunity

In line with the Group's strategy of achieving a balanced risk profile, we continue to work with stakeholders where we can share commodity risk and opportunity. There are further opportunities for risk sharing arrangements as contracts expire and are renegotiated.

Local authority contracts

Performance in 2016/17 across our key local authority contracts, including Greater Manchester, Glasgow, Lancashire, Somerset and West Sussex, as well as the Thames Water contract, remains broadly in line with 2015/16. We began operating our 25-year contracted service for Tomorrow's Valley in Wales (where four local authorities are collaborating in a £190 million residual waste contract) that is securing fuel for Trident Park ERF. In May 2016, we announced a significant multi-authority recycling project in Scotland's Clyde Valley. This is expected to be worth around £700 million over the 25-year contract period and will secure fuel for the Dunbar ERF.

Joint ventures

The Lakeside ERF (a 50/50 joint venture with Grondon Waste Management) continued to operate efficiently while Viridor Laing Greater Manchester (a joint venture between Viridor and John Laing Infrastructure) is delivering the 25-year Greater Manchester Waste private finance initiative (PFI) contract, which was the UK's largest waste and energy project entered into in 2009. Solid recovered fuel produced from Greater Manchester's residual waste is used to generate heat and power at Runcorn 1 ERF (TPSCo, a joint venture between Viridor, John Laing Infrastructure and Inovyn).

The Greater Manchester Waste Disposal Authority (GMWDA) continues to face financial challenges and in April 2017 confirmed it is seeking an exit and re-negotiation of the PFI contract. Diversion of waste from landfill remains ahead of contractual commitments and Viridor and its partners are keen to ensure this progress is able to continue. Viridor and John Laing have been actively engaging with GMWDA as they consider their options.

There are provisions in the PFI Contract for compensation to be paid to Viridor and John Laing on termination.

Crayford MRF underlines benefits of 'self-help' asset optimisation

Viridor has one of Europe's largest mixed-waste recycling facilities at Crayford in Kent. Crayford MRF applies advanced technology to sort and recover co-mingled recyclable materials from local councils and businesses outside London.

This plant serves as a good example of our boosting productivity through asset optimisation and self-help measures that saw inputs into Crayford reduce marginally from the previous year, but delivered a significantly increased EBITDA.

Investment in dust control

A key facet of our operations is managing the dust caused by our activities, to minimise the impact on our staff as well as on the external environment. The primary focus for dust control is elimination at source, through localised extraction and dust filtration systems at key locations within the process. Water suppression (the dampening down of yard areas or haul roads) is also used and we have invested in vacuum suction systems at a number of plants for use in cleaning and maintenance activities. These measures, as well as general standards of good housekeeping within our plants, help us to keep dust levels under control.

Energy efficiency programmes and reorganised operations have made our recycling facilities more efficient and productive.

Along with our JV partners, Viridor is already one of the largest independent power generators from waste in the UK.

Landfill

In 2016/17 we continued to manage our landfill energy business to maximise the value of landfill gas power generation, optimise opportunities for waste disposal where it is not suitable for recycling or sending to ERFs, whilst exploring alternative commercial development opportunities and other energy uses.

We operate a network of landfill gas power generation sites that contributed 99MW of capacity in 2016/17. We are continuing our strategy of delivering cash flow from landfill sites and anticipate continued reduction of capacity. However, we believe there will be an ongoing requirement for some landfill capacity in the UK as some waste is not suitable for recycling nor for sending to ERFs. Careful consideration will be given to selecting suitable sites for this opportunity, our intention being to retain only a small number of strategic sites by 2020. Viridor closed four sites during the year, bringing the total number of operational sites to 11.

Landfill restoration and biodiversity

Viridor continues to manage 31 closed landfill sites across the UK in accordance with biodiversity plans and using our experience in restoration. Sites have been restored to heathland, grassland, woodland, agriculture, amenity parkland or a combination of these. Viridor currently has eight sites that have

achieved The Wildlife Trust's Biodiversity Benchmark, which includes two heathland restorations (Tatchells and Warmwell in Dorset) and a grassland restoration that has national significance for birdlife (Beddingham in Sussex).

Community engagement

Investing in educational programmes and supporting initiatives local to our operational facilities is a key element of our community engagement. Our 11 educational facilities have received 19,327 visitors over the year and helped deliver 122 outreach events to 6,848 people.

The education facility at Ardley ERF has been shortlisted for the UBS Award for Education, as part of Business in the Community's Responsible Business Awards 2017 which recognised our Business Class Partnership with The Bicester School, Industrial Cadet Programme, Go4Set and Engineering Trust projects.

During 2016/17 Viridor has provided £8.0 million in community support, sponsorship and charitable donations, of which £7.7 million was paid to Viridor Credits for distribution via the Landfill Communities Fund.⁽¹⁾

We operate active community liaison groups to ensure effective dialogue with the local community and as part of our major construction projects we work hard to ensure maximum benefit is achieved for local communities in the surrounding area.

(1) Viridor Credits is an independent, not-for-profit organisation that administers Viridor's contributions to the Landfill Communities Fund.

Investment in Leachate Management

A number of operational projects have been launched aimed at reducing leachate generation including accelerated capping and restoration initiatives. A dedicated leachate management team has been created to focus on driving down long-term management and disposal costs, improving treatment plants and achieving the best environmental outcome.

Household Waste Recycling Centres

Viridor manages a network of Household Waste Recycling Centres (HWRCs) in partnership with local authorities across the UK. HWRCs complement kerbside collections by giving residents access to safe and modern facilities where they can bring along items that are not routinely collected from their home to maximise recycling.

Our HWRCs have won awards for site design and excellent customer services. In areas serviced by our HWRCs recycling rates significantly exceed national averages, often achieving recycling rates of more than 75%.

Report of the Chief Financial Officer

Financial review

Susan Davy
Chief Financial Officer

Overview

Pennon Group achieved a strong financial performance in 2016/17. We delivered against our strategic objectives to lead in the UK's water and waste sectors, invest for growth and drive value through efficiency.

The Group had the sector leading water company in the UK (as measured by Return on Regulated Equity (RoRE)) during the year. South West Water's RoRE has led the sector since the start of the current regulatory period and is outperforming with a RoRE 12.6%.

South West Water continued its significant investment programme with the £60 million water treatment works in Plymouth, the largest capital expenditure item in its current five-year plan. The Group also established Pennon Water Services (PWS) to compete in the newly opened non-household retail sector. To build scale, it was announced during the year that South Staffordshire Plc's non-household retail business would transfer to PWS in return for a 20% shareholding in PWS.

There was strong momentum in the energy recovery and waste recycling business in 2016/17. Our energy recovery facility (ERF) portfolio provides an excellent example of how the Group is executing its strategy to invest for growth. Our announcement during the year, of a new ERF at Avonmouth takes our total portfolio to 12 plants and our overall investment in ERFs to £1.5 billion. This major participation in UK environmental infrastructure is helping us transform our business model with an increasing focus on ERFs and recycling. The high level of performance of our ERFs

*»» Growth in
Pennon's profit is
driven by delivery
of ERF earnings
and continued
outperformance
in water. »»*

enabled us to exceed our c.£100 million EBITDA target from our ERF portfolio in 2016/17, delivering £107 million of EBITDA.

Both our water and waste operations implemented our strategy to drive value through efficiency. We completed our Shared Services Review during the year, an initiative involving planned centralisation of key corporate services and operational functions, reflecting the more integrated nature of our Group. This initiative will increase expected Group cost savings from c.£11 million previously announced to c.£17 million p.a. from 2019, of which c.£9 million p.a. has been secured to date. South West Water maintained its strong record of controlling total expenditure and remains at the forefront of cost efficiency in the water sector. These efficiency initiatives support the Board's pledge in water to reduce bills in real terms over the 2015-2020 regulatory period.

Other efficiency successes include the Group's energy trading team that is ensuring Pennon is buying energy at the right price and enhancing profitability from energy we generate. In addition our 'self-help' measures during the year improved efficiency in our recycling operations.

Part of our strategy as we build our ERFs, and in our recycling operations, is to ensure we achieve a balanced risk-reward profile. We are successfully reducing Group risk by overlaying our long-term assets with long-term commercial arrangements, and supporting these with long-term financing.

In February 2017 we unwound a derivative position entered into in 2011 that had become uneconomic, at a break cost of £44 million.

One of our key financial objectives is to ensure we maintain strong liquidity and have access to the most efficient and effective funding to support our capital investment programme. During the year our interest rate on average net debt remained low at 3.4% and at 31 March 2017 the Group continued to have a strong funding position with £1,383 million of cash and facilities.

Performance overview

EBITDA (£m)

289.9 [▲]	394.8 [◆]	433.0 [■]	401.6 [▲]	407.3 [◆]	456.9 [■]	421.6 [▲]	411.0 [◆]	465.9 [■]	438.2 [▲]	448.4 [◆]	508.4 [■]	475.3 [▲]	486.0 [◆]	546.2 [■]
2012/13	2013/14	2014/15	2015/16	2016/17										

▲ Statutory ◆ Underlying ■ Adjusted⁽¹⁾

Earnings per share (pence)

40.3 [▲]	38.8 [▲]	42.6 [◆]	32.3 [▲]	39.8 [◆]	37.0 [▲]	39.5 [◆]	39.8 [▲]	47.0 [◆]
2012/13	2013/14	2014/15	2015/16	2016/17				

▲ Statutory ◆ Before non-underlying items and deferred tax

Profit before tax (£m)

13.6 [▲]	190.0 [◆]	158.7 [▲]	207.3 [◆]	197.0 [▲]	210.7 [◆]	206.3 [▲]	211.3 [◆]	210.5 [▲]	250.0 [◆]
2012/13	2013/14	2014/15	2015/16	2016/17					

▲ Statutory ◆ Underlying

Dividend per share (pence)

28.46	30.31	31.80	33.58	35.96
2012/13	2013/14	2014/15	2015/16	2016/17

Underlying earnings reconciliation 2017

£m	Non-underlying items					Statutory results	Earnings per share (p)
	Underlying results	Restructuring costs	Unwind of derivative	Derivative fair value movements	Change in tax rate		
EBITDA	486.0	(10.7)	-	-	-	475.3	
Operating profit	304.6	(10.7)	-	-	-	293.9	
Profit before tax	250.0	(10.7)	(44.8)	16.0	-	210.5	
Taxation	(58.4)	2.3	8.0	(3.2)	21.3	(30.0)	
Profit after tax (PAT)	191.6	(8.4)	(36.8)	12.8	21.3	180.5	
PAT attributable to perpetual capital holders						16.2	
PAT attributable to shareholders						164.3	39.8
Deferred tax before non-underlying items						18.9	4.5
Non-underlying items post tax						11.1	2.7
Earnings before non-underlying items and deferred tax						194.3	47.0

Underlying earnings reconciliation 2016

£m	Non-underlying items					Statutory results	Earnings per share (p)
	Underlying results	Restructuring costs	Derivative fair value movements	Change in tax rate	Statutory results		
EBITDA	448.4	(10.2)	-	-	438.2		
Operating profit	261.8	(10.2)	-	-	251.6		
Profit before tax	211.3	(10.2)	5.2	-	206.3		
Taxation	(72.1)	2.0	(1.0)	331	(38.0)		
Profit after tax (PAT)	139.2	(8.2)	4.2	331	168.3		
PAT attributable to perpetual capital holders					16.2		
PAT attributable to shareholders					152.1	37.0	
Deferred tax before non-underlying items					39.2	9.5	
Non-underlying items post tax					(29.1)	(7.0)	
Earnings before non-underlying items and deferred tax					162.2	39.5	

(1) See reconciliation on page 40.

Report of the Chief Financial Officer

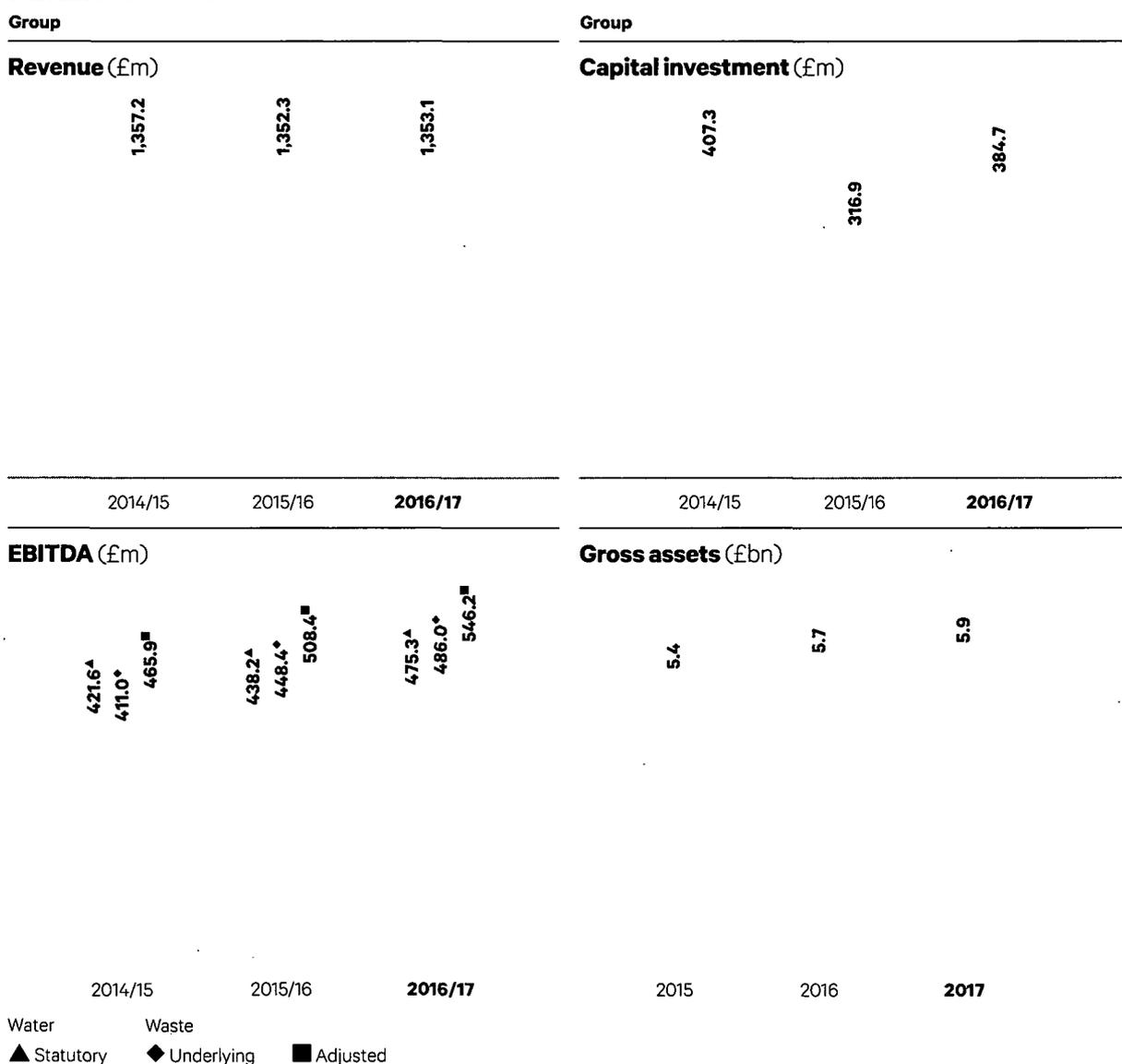
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Adjusted EBITDA reconciliation

£m	2017	2016
Statutory EBITDA	475.3	438.2
Non-underlying items	10.7	10.2
Underlying EBITDA	486.0	448.4
IFRIC 12 interest receivable ⁽¹⁾	16.1	16.7
JV EBITDA ⁽¹⁾	32.9	31.6
JV IFRIC 12 interest receivable ⁽¹⁾	11.2	11.7
Adjusted EBITDA	546.2	508.4

(1) These adjustments relate to the waste management business, resulting in adjusted waste management EBITDA of £198.5 million (2015/16 £176.5 million).

Financial KPIs



Statutory financial performance

The Groups statutory results showed growth in both profit before tax to £210.5 million (2015/16 £206.3 million) and earnings per share to 39.8p (2015/16 37.0p). This reflects strong earnings from both South West Water and Viridor, supported by sector leading efficiencies in the water business and a full year increase in Viridor's ERF operational capacity. The performance of the underlying business is set out in more detail below in the financial performance section.

The statutory results include the impact of non-underlying items totalling a charge after tax of £11.1 million (2015/16 £29.1 million credit). The Directors believe excluding non-underlying items and deferred tax provides a more useful comparison on business trends and performance.

The net non-underlying charge of £11.1 million is a result of:

- restructuring costs – £10.7 million charge
- derivative movements – £28.8 million charge
- taxation on the non-underlying items above totalling a credit of £7.1 million
- taxation – £21.3 million credit arising from the enacted reduction in the UK rate of corporation tax from 18% to 17% in 2020.

Financial performance

(before non-underlying items)

Revenue

Group revenue was marginally ahead of last year at £1,353.1 million (2015/16 £1,352.3 million). Revenue from the water business was up by 2.6% to £561.0 million (2015/16 £547.0 million) as a result of 2.5% higher demand due to drier weather, tariff increases of 1.4% (with RPI of 1.1%) and increased new connections. This increase in revenue, primarily linked to drier weather, is above the regulatory tolerance levels and will result in a small penalty of £0.2 million. Viridor's revenue decreased by 1.6% to £793.5 million (2015/16 £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 growing contribution of operational ERFs. Excluding the impact of construction revenue, Group revenue would have increased in the year by £20 million (1.5%).

Adjusted EBITDA

Group underlying EBITDA and adjusted EBITDA were ahead of 2015/16 up 8.4% at £486.0 million (2015/16 £448.4 million) and 7.4% to £546.2 million (2015/16 £508.4 million) respectively. Underlying operating profit increased by 16.3% to £304.6 million (2015/16 £261.8 million) and underlying profit before tax increased by 18.3% to £250.0 million (2015/16 £211.3 million). This has been achieved through an increase in profits from Viridor, together with continuing strong South West Water financial performance and efficient ongoing finance costs across the Group.

Following the merger of Bourne Mouth Water into South West Water the water business recorded strong performances against the K6 regulatory contracts, outperforming regulatory assumptions. The water business profit before tax increased by 4.9% to £173.9 million (2015/16 £165.7 million) reflecting higher revenue from tariff increases and increased demand, with operating costs of £211.9 million (2015/16 £211.8 million) broadly in line with last year. With the highest potential returns in the sector for K6, South West Water is outperforming its business plan, resulting in a cumulative ROPE of 12.6%. More detail on ROPE performance is set out on page 28. During the year Orwat updated its guidance for calculating the financing RPI over the regulatory period. South West Water's ROPE remains sector RPI over the regulatory period and the cumulative forecast performance over K6 is the same under both approaches.

South West Water's EBITDA increased during the year due to higher revenue and cost efficiencies along with other cost reductions. While average RPI has been increasing (2.9% as at March 2017), total operating costs in 2016/17 were in line with last year, with savings arising from operational maintenance synergies from the company mergers as well as targeted efficiencies contributing to cost performance. Operating costs also include a fine for £1.8 million issued in April 2017 relating to a

HSE prosecution following the tragic fatality of an employee at a wastewater treatment works in December 2013. In addition, South West

Waters bad debt charge continues to fall, down by over a quarter since the end of K5, to 11% as a percentage of revenues (1.7% at the end of K5). This was driven by strong collections as we work with our customers to manage their debt with the operations continually updating their approaches in targeting those customers with the means to pay whilst supporting those who have genuine affordability challenges.

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. As a result, Viridor's EBITDA increased by 18.7% to £138.3 million (2015/16 £116.5 million) whilst 2016/17 adjusted EBITDA increased 12.5% to £198.5 million (2015/16 £176.5 million). Viridor has four further ERFs under construction, including Avonmouth which we committed to during the year. Dunbar and Beddington (South London) are progressing well and to budget with steps being taken to ensure construction of Glasgow ERF is completed successfully.

Viridor's EBITDA was ahead of last year due to the ramping up of the existing ERF portfolio and recycling self-help measures, where significant progress has been made in reducing the cost base and improving the utilisation of assets, net of anticipated declines in landfill earnings primarily due to expected lower volumes. Our ERF activities contributed EBITDA of £106.9 million (2015/16 £99.7 million) delivering our target of £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 slightly to £44.1 million (2015/16 £43.3 million), with strong EBITDA from all three joint ventures. This resulted in a share of joint venture profit after tax of £4.2 million (2015/16 £3.6 million). During the year ERF earnings included contractual compensation^o of £12.7 million, a similar level to previous years.

Recycling and resources EBITDA, comprising recycling collection and contracts and other, increased by 14.5% to £56.8 million (2015/16 £49.6 million). Recycling revenue at £96 per tonne (2015/16 £85 per tonne) has increased £5 per tonne reflecting renegotiated input contracts and recycle prices. Average operating costs fell by £2 per tonne to £77 per tonne (2015/16 £74 per tonne) as a result of targeted efficiencies. This has been offset by an increase in shipping costs of £1 per tonne. As a result the recycling EBITDA margin increased by £6 per tonne to £14 per tonne (2015/16 £8 per tonne). 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 and to look to share commodity risk/opportunity with our clients.

Landfill EBITDA from power generation and waste disposal are down compared to last year by £3.7 million. The decrease in earnings is primarily due to lower power prices and volumes.

Net finance costs

Underlying net finance costs of £58.8 million were £4.7 million higher than last year, predominantly reflecting higher RPI, higher net debt from continuing capital investments and lower finance income following the unwind of the 2011 Peninsula MIB derivative, which reduces finance income by £8 million pa, going forward.

We have secured funding at a cost that is efficient and effective. The Group interest rate on average net debt for 2016/17 has slightly increased to 3.4% (2015/16 3.3%) reflecting increases in RPI.

The Group's interest rate on average net debt for the year to 31 March 2017 is 3.4% (after adjusting for capitalised interest of £12.9 million, notional interest items totalling £5.8 million and interest received from shareholder loans to joint ventures of £10.2 million). For South West Water this figure was 3.2%.

During the year underlying net finance costs (excluding pensions net interest cost £1.2 million, discount unwind on provisions £91 million and IFRIC 12 contract interest receivable £16.1 million) were £64.6 million (2015/16 £59.6 million), covered 4.7 times (2015/16 4.4 times) by Group operating profit.

(1) Primarily relates to liquidated damages received/receivable when construction completed post the original contractual completion date.

Report of the Chief Financial Officer continued

Profit before tax

Group underlying profit before tax was £2500 million, an increase of 18.3%, compared with the prior year (2015/16 £2113 million). On a statutory basis, profit before tax was £210.5 million (2015/16 £206.3 million) reflecting non-underlying charges before tax of £39.5 million (2015/16 £5.0 million).

Taxation

The Group's underlying mainstream UK corporation current tax charge for the year (before prior year credits) was £41.3 million, the £7.0 million increase on last year is primarily driven by higher profits, reflecting an effective tax rate of 16.5% (2015/16 £34.3 million, 16.2%). There was a prior year credit of £1.8 million recognised for the year (2015/16 credit of £1.4 million). In addition there is a non-underlying £9.4 million current tax credit relating to non-underlying items (2015/16 £1.7 million credit).

Underlying deferred tax for the year (before prior year charges) was a charge of £17.8 million (2015/16 £23.3 million). The charge for 2016/17 primarily reflects capital allowances, including on ERFs, in excess of depreciation charge. There was a prior year deferred tax charge of £11 million recognised for the year (2015/16 £15.9 million charge). In addition there is a non-underlying £21.3 million deferred tax credit relating to the enacted reduction in the UK rate of corporation tax to 17% in 2020 and a £2.3 million deferred tax charge relating to other non-underlying items.

This resulted in a total tax charge for the year of £300 million (2015/16 £380 million).

We have recently concluded discussions with HMRC resolving the treatment of certain uncertain tax items. Provisions for these uncertain tax items had been recognised in previous years, no further amounts are required to be recognised in relation to these items.

Non-underlying items

The net non-underlying charge of £11.1 million is a result of:

- restructuring costs – £10.7 million charge relating to restructuring costs from the Group wide Shared Services Review and migration to a Group IT platform (including a £9.5 million non-cash de-recognition of an existing IT asset)
- derivative movements – £28.8 million charge reflecting the unwind of the 2011 Peninsula MB Limited (PMB) derivative (charge £44.8 million) offset by market movements on our long-dated floating rate vanilla swaps
- taxation on the non-underlying items above totalling a credit of £7.1 million
- taxation – £21.3 million credit arising from the enacted reduction in the UK rate of corporation tax from 18% to 17% in 2020.

Unwind of the 2011 PMB derivative

Since 2011 Pennon has received a fixed interest rate on a £200 million financial asset and paid an index-linked interest rate on a £200 million loan, designed to improve the Group's overall interest rate performance. The counterparty to both instruments was PMB. In combination, these instruments were accounted for by Pennon as a derivative, with a net interest income of £8 million p.a., c.£7 million in 2016/17, cash settled.

In periods of index underperformance, losses arose in PMB which were group relieved with Pennon.

Following a change in legislation, which saw the value of the derivative to Pennon moving from a liability of £4 million to a liability of c.£40 million, Pennon made the decision to exit the transaction.

The break cost due to Nomura in respect of the termination was £44 million, with an agreed payment date of June 2018. The impact for the Group is a net cost of £35 million post tax.

The group relief claimed by Pennon has been treated as an uncertain tax item and has been substantially provided for over recent years. Following the conclusion of discussions with HMRC, no further amounts are required to be recognised by Pennon.

Post the unwind of the transaction the Group's interest will no longer include the c.£8 million p.a. income, c£7 million in 2016/17, and the underlying tax charge will reduce by a similar amount.

Earnings per share

Earnings per share on both a statutory and underlying basis before deferred tax were ahead of last year, up 7.6% at 39.8p (2015/16 37.0p) and up 19.0% at 47.0p (2015/16 39.5p) respectively, reflecting higher profits.

Net assets per share at book value at 31 March 2017 were 365p, up 11% on last year.

Dividends and retained earnings

The statutory net profit attributable to ordinary shareholders of £164.3 million has been transferred to reserves.

The Directors recommend the payment of a final dividend of 24.87p per share for the year ended 31 March 2017. With the interim dividend of 11.09p per share paid on 4 April 2017 this gives a total dividend for the year of 35.96p, an increase of 7.1% over 2015/16 and maintaining our long-standing sector-leading dividend policy of RPI + 4% year-on-year growth. We set that policy in the 2010-2015 regulatory period and confirmed its continuation through to 2020. The net effect of this policy is that dividends per share will have almost doubled over the 10 years to 2020.

This 4% real growth above RPI per annum is driven by continued outperformance of our water business and by the significant investments we are making in Viridor which is successfully delivering on its targeted contribution to Group earnings. We are actively seeking further opportunities for growth beyond 2020 with the aim of sustaining a sector-leading dividend policy over the longer term.

Proposed dividends totalling £149.5 million are covered 1.3 times by net profit (before non-underlying items and deferred tax) (2015/16 1.1 times). Dividends are charged against retained earnings in the year in which they are paid.

Operating costs (before non-underlying items)

Operating costs for the year totalled £1,049 million. The most significant areas of expenditure were:

Expenditure	£m
Employment costs	180
Depreciation	178
Landfill tax	141
Raw materials and consumables*	91
Transport	58
Power	41
Business rates	39
Abstraction and discharge consents	9

* Excludes transport costs.

Group capital investment

Group capital investment was £384.7 million in 2016/17 compared to £316.9 million in 2015/16. This peak level of investment is expected to continue in to 2017/18, reflecting the profile of investment in Viridor's ERFs.

South West Water's capital expenditure was £190.9 million compared to £134.1 million in 2015/16. The beginning of the new regulatory period reflects a change in the nature and extent of capital activity and an increase in activity in year two.

As anticipated the largest single project in South West Water's spending is the development of the innovative Mayflower water treatment works at North Plymouth. Construction works are well advanced and the formation of the process elements is underway with over 5km of water pipeline and effluent pipes already installed. Advanced techniques have been used to limit the impact on the surrounding area including micro tunnelling under a major road into Plymouth. In addition investment has been targeted to improve wastewater compliance with process upgrades and improvements at six sites.

Viridor's capital investment of £193.8 million was ahead of 2015/16 (£182.8 million). The majority of expenditure this year reflects the ongoing ERF programme, with significant expenditure at South London, Dunbar and Glasgow ERFs.

The infrastructure at Dunbar is nearing completion with a significant element of the process plant having been delivered to site prior to installation. The plant is expected to be operational in H2 2017/18. Construction at Beddington is progressing to plan with access routes to the site being improved and the core infrastructure under construction. Operations are expected to commence in H1 2018/19.

Glasgow's Recycling and Renewable Energy Centre is receiving waste and generating energy. New construction contracts with Doosan Babcock are progressing well with commissioning expected in 2017.

The major categories of expenditure were:

1	ERF	£158m
2	Water	£91m
3	Wastewater	£100m
4	Recycling	£3m
5	Landfill energy	£12m
6	Other	£21m

Cash flow

The Group's operational cash inflows in 2016/17 at £456 million were £38 million higher than last year (2015/16 £418 million). These funds have been put to use in efficiently financing the Group's capital structure and investing in future growth, through our substantial continuing capital investment programme. This investment has resulted in higher Group net debt.

Summarised cash flow	2016/17 £m	2015/16 £m
Cash inflow from operations ⁽¹⁾	456	418
Net interest paid	(62)	(64)
Tax paid	(36)	(45)
Dividends paid (net of scrip)	(132)	(123)
Hybrid periodic return	(20)	(20)
Capital investment ⁽²⁾	(363)	(291)
Dividends and loan repayments received from joint ventures	5	34
Pension contributions	(11)	(34)
Equity placing and other share issues	2	102
Acquisitions (net of cash acquired)	-	(91)
Net cash outflow	(161)	(114)
Fair value of debt acquired from Bournemouth Water	-	(160)
Debt indexation/interest accruals	(20)	(13)
Increase in net borrowings	(181)	(287)

(1) Before construction spend on service concession arrangements of £13 million (2015/16 £14 million) and pension contributions of £11 million (2015/16 £33 million)

(2) Including construction spend on service concession arrangements and proceeds from sale of property, plant and equipment

Major components of the Group's debt finance at 31 March 2017

1	Finance leasing	£1,384m
2	Bank bilateral debt	£404m
3	Index-linked bonds	£416m
4	European Investment Bank (EIB) loans	£364m
5	Private placements	£562m
6	Bond 2040	£133m

Liquidity and debt profile

The Group has a strong liquidity and funding position with £1,383 million cash and facilities at 31 March 2017. This includes cash and deposits of £598 million (including £224 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £785 million. At 31 March 2017 the Group's loans and finance lease obligations totalled £3,263 million. After the £598 million held in cash, this gives a net debt figure of £2,665 million, an increase of £181 million during the year.

During the year the Group has drawn the South West Water EIB funding of £130 million signed in 2015/16.

Since the year end the Group has signed £50 million of new and renewed revolving credit facilities to provide pre-funding for future cash flows.

Report of the Chief Financial Officer continued

The Group has agreed £110 million of funding from the EIB into Pennon Group plc, in relation to the capital investment in Cardiff's Trident Park Energy Recovery Facility. This funding is anticipated to be signed later in 2017 when the EIB expects to have clarity over the implications of Article 50 being triggered. Negotiations are continuing with the EIB to secure additional funding for South West Water, so this can be delivered in a timely manner following the clarity noted above.

The investment in Avonmouth ERF will be corporately financed and options are being considered, including a new hybrid, to continue the Group's diversified funding position.

The Group has a diversified funding mix of fixed, floating and index-linked borrowings. The Group's debt has a maturity of up to 40 years with a weighted average maturity of 20 years matching the asset base. Much of the Group's debt is floating rate, with derivatives being 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, in line with the Group's policy to have hedging in place before the start of a regulatory period. £486.3 million of South West Water's debt is index-linked at an overall real rate of under 2.0%. As a result of the aforementioned initiatives, South West Water's cost of finance is among the lowest in the industry. Two-thirds of South West Water's net debt is from finance leases, providing a long maturity profile to its debt. Interest payable on them benefits from the fixed credit margins, which were secured at the inception of each lease. Bournemouth Water was successfully integrated into South West Water on 1 April 2016 and as a result a quarter of the gross funding for the water business is RPI linked consistent with Ofwat's notional level.

At 31 March 2017 the fair value of the Group's non-current borrowings was £28 million more than its book value (2016 less than £114 million) as detailed in note 28 to the financial statements. This reflects the benefit of securing interest rates below the current market rate, offset by volatility in inflation markets.

Capital structure – overall position

The Group's net debt has increased by £181 million to £2,665 million, with the increase reflecting significant capital investment. The Group's gearing ratio at 31 March 2017, being the ratio of net debt to (equity plus net debt) was 63.8% (31 March 2016 62.5%), reflecting continuing capital investment.

Group net debt includes £1,132 million of investment in wholly-owned ERFs (Runcorn II, Oxford, Exeter, Cardiff, Glasgow, Dunbar and South London) and £87 million of funding for investments in joint ventures through shareholder loans (which together represents 46% of Group net debt). In addition the joint ventures have non-recourse net debt from third parties (excluding shareholder loans) of which Pennon's share is £194 million. c.85% of ERF and joint venture funding is from corporate finance.

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. £6.9 million (2015/16 £6.3 million) of potential cash dividend was retained in the business and resulted in the issuance of 771,563 shares.

The combined South West Water and Bournemouth Water debt to RCV ratio is 61.8% (31 March 2016 59.7%), which aligns with Ofwat's K6 target for efficient gearing of 62.5%.

Regulatory capital value as at 31 March (£m)

	2,916	2,959	2,928	3,150	3,291
					+4.5%
	2013	2014	2015	2016	2017

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. 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 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 2016/17 – collected/paid

The Group made a net payment of £36.4 million (of UK corporation tax) in the year (2015/16 £45.0 million). The main elements of the payment were £19.8 million in relation to 2016/17 instalment payments and £16.6 million in relation to earlier years.

The total tax charge for the year of £30.0 million is less than the charge that would have arisen had the accounting profit before tax 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 £41.3 million results in an effective rate of 16.5%, which is lower than the statutory rate of 20.0% mainly due to capital allowances received on ERF capital expenditure.

1	Landfill tax	£147m
2	Employment taxes	£57m
3	Business rates	£39m
4	UK corporation tax	£36m
5	Environmental payments	£11m
6	Fuel Excise Duty	£7m
7	VAT	£5m
8	Carbon Reduction Commitment	£3m
9	Other	£5m

The Group's total tax contribution extends significantly beyond the UK corporation tax payments.

Total taxes amounted to £310 million (2015/16 £342 million) of which a net amount of £45 million (2015/16 £47 million) was collected on behalf of the authorities for employee payroll taxes and VAT.

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

Landfill tax of £145 million (2015/16 £166 million) collected and paid on waste material deposited at our landfill sites. This amount includes £6 million (2015/16 £11 million) paid to local environmental bodies via the Landfill Tax Credits Scheme. Landfill tax is an operating cost which is recovered from customers and is recognised in revenue. In addition the Group incurred landfill tax of £2 million (2015/16 £1 million) on the disposal of waste to third parties. 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 13% of the total landfill receipts of HMRC in the year.

Value Added Tax (VAT) of £5 million paid (2015/16 £8 million) by the Group to HMRC. VAT has no material impact on profit before tax

Business rates of £39 million (2014/15 £42 million) paid to local authorities. This is a direct cost to the Group and reduces profit before tax.

Employment taxes of £57 million (2015/16 £54 million) including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs). Employer NICs of £16 million (2015/16 £15 million) were charged approximately 93% to operating costs with 7% capitalised to property, plant and equipment. The total amount of £50 million includes PAYE of £3 million (2014/15 £2 million) on pension payments made by the Group pension scheme.

Fuel Excise Duty of £7 million, (2015/16 £8 million) related to transport costs. This reduces profit before tax

Payments to Environment Agency and other regulatory bodies total £11 million, (2015/16 – £11 million) This reduces profit before tax

Carbon Reduction Commitment (CRC) payment for the Group of £3 million, (2015/16 £4 million). This reduces profit before tax.

The corporation tax rate for 2016/17 used to calculate the current year's tax is 20% and will reduce to 19% for the year to 31 March 2018 and 17% for the year ending 31 March 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 2017 the Group's pension schemes showed an aggregate deficit (before deferred tax) of £68.0 million (March 2016 £40.9 million). The deficit has increased due to the post-Brexit fall in bond yields, increasing the valuation of liabilities. However, over half of the increase in the valuation of liabilities has been offset by increases in asset values.

The net aggregate liabilities of £56 million (after deferred tax) represented around 2% of the Group's market capitalisation at 31 March 2017.

The 31 March 2016 actuarial valuation of the main scheme has been finalised, the outcome is in line with the 2013 valuation and schedule of contributions, which is consistent with Final Determination (FD) allowances for K6 (2015-2020).

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

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 in line with the Group's agreed risk appetite, and mitigated.

A Group Risk Forum provides a 'top down' assessment of Group risks, that supplements 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 reviewed on an ongoing basis as part of a robust assessment of key risks, mitigations, controls and assurance activities 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 and challenge principal risks, where management justify their 'bottom-up' risk assessments through formal reports and presentations
- Principal risks of each subsidiary are reviewed and confirmed on a quarterly basis by the subsidiary executive management teams, 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 Pennon Executive before consideration by the Audit Committee and then formal presentation to the Board for approval
- The impact of risks on the three long-term strategic priorities is included in the following table of principal risks and uncertainties.

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 the agreed risk appetite of the Board.

Robust risk assessment

The Directors confirm that they have carried out a robust assessment of risks facing the Group, including assessing the impacts on its business model, future performance, solvency and liquidity. 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 51.

Principal risks and uncertainties

Strategic impact

1	2	3
Leadership in UK water and waste	Leadership in cost base efficiency	Driving sustainable growth

Long-term priorities affected.

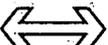
Risk level

Low	Medium	High	 Increasing	 Stable	 Decreasing
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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.

Current assessment of direction of travel of risk level.

Law, regulation and finance

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Compliance with law, regulation or decisions by Government and regulators, including water industry reform	<p>Long-term priorities affected:</p> <p>1 2</p> <p>Non-compliance could lead to financial penalties and other additional costs which could undermine our efforts to maximise cost base efficiency. Damage to reputation could affect shareholder value.</p> <p>Regulatory reform could lead to inefficiencies and have a consequential affect on customer affordability.</p> <p>The June 2017 General Election could lead to a changed regulatory environment.</p>	<p>Robust regulatory framework ensures compliance with Ofwat, Environment Agency and other requirements.</p> <p>Full engagement in consultations on reform of policy and legislation, helps influence change through effective stakeholder relationships.</p> <p>Clear and accessible guidance for employees is in place and training programmes have been rolled out and are ongoing.</p> <p>Good progress has been made in preparing for regulatory reform and we entered the non-household retail market on 1 April 2017. We are fully engaged in the programme for the next regulatory price review. External reviews support the assurance provided by the water business to its regulators.</p>	Low		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	<p>Long-term priorities affected:</p> <p>1 3</p> <p>Failure to maintain funding requirements could lead to additional finance costs and put our growth agenda at risk.</p>	<p>Clear treasury and funding policies and an effective Group Treasury team.</p> <p>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.</p>	Low		Ensure funding requirements are fully met by maintaining prudent headroom.
Non-compliance or occurrence of avoidable health and safety incident	<p>Long-term priorities affected:</p> <p>1 2 3</p> <p>Breach of health and safety laws and regulations could lead to financial penalties, significant legal costs, damage to reputation and loss of shareholder value.</p>	<p>Risk is reduced through health and safety compliance systems, policies and procedures, which are currently being reviewed and enhanced, supported by a programme of capital investment.</p>	Medium		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	<p>Long-term priorities affected:</p> <p>2</p> <p>Censure for non-compliance with HMRC requirements could lead to financial penalties, significant legal costs, damage to reputation and loss of shareholder value.</p>	<p>Professionally qualified and experienced in-house tax team, supported by external specialists.</p> <p>Significant progress made during 2016/17 to agree outstanding tax items with HMRC.</p>	Low		Full compliance with HMRC requirements.

Risk report continued

Law, regulation and finance continued

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Increase in defined benefit pension scheme deficit	<p>Long-term priorities affected:</p> <p>2</p> <p>The Group could be called upon to increase funding to reduce the deficit, impacting our cost base.</p>	<p>Use of professional advisers to manage the pension scheme's investment strategy to ensure the scheme can pay its obligations as they fall due.</p> <p>Risk increased post-Brexit vote due to market uncertainties. The situation has since stabilised, as evidenced by the outcome of the recent triennial evaluation, which demonstrates the recovery plan from 2013 is still on track.</p>	Low		Expectation that pension benefits can be paid in full without increased costs to the Company.

Market and economic conditions

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Non-recovery of customer debt	<p>Long-term priorities affected:</p> <p>1 2</p> <p>Potential impact on customer debt collection, particularly with regard to vulnerable customers and affordability.</p>	<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, FreshStart) help to reduce bad debt exposure for customers struggling to pay.</p> <p>Viridor's debt collection risk is lower due to the high proportion of public sector accounts.</p>	Medium		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 commodity and power prices	<p>Long-term priorities affected:</p> <p>3</p> <p>The economic climate and falling commodity and energy prices have a direct impact on the revenues generated by our recycling business.</p>	<p>Viridor is well positioned across the waste hierarchy, with long-term contracts supporting the ERF segment. The recycling self help measures focus on 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 South West Water and Viridor, offsetting any drop in power prices. Existing investments that qualified for Renewable Obligation Certificates are protected by the 'grandfathering' principle.</p>	Medium		Taking well-judged risks and having response plans in place to mitigate external macro-economic risk factors down to an acceptable level.

Operating performance

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Poor operating performance due to extreme weather or climate change	<p>Long-term priorities affected:</p> <p>1</p> <p>Failure of our assets to cope with extreme weather conditions may lead to an inability to meet our customers' needs, environmental damage, additional costs and loss of reputation.</p>	<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 drought plans every three years, which are both reviewed annually for a range of climate change and demand scenarios, with schemes promoted to maintain water resources (eg. pumped storage for reservoirs), conservation and customer water efficiency measures.</p> <p>While no water restrictions are envisaged, the risk is rising due to the recent prolonged period of dry weather.</p> <p>Viridor has in place a regional adverse weather management strategy, aimed at reducing disruption to site operations and transport logistics.</p>	Low		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>Long-term priorities affected:</p> <p>1 3</p> <p>Poor customer service has a direct impact on South West Water's delivery of the PR14 business plan and Viridor's ability to retain and grow market share.</p> <p>The opening up of the non-household retail market to competition means that we must ensure we understand and meet the needs of our business customers if we are to deliver growth in this area.</p>	<p>Targeted improvements made to improve customer service including South West Water's relative industry standing during the K6 period.</p> <p>Viridor's strategy to diversify into energy recovery has offset the decline in landfill and current challenges in recycling.</p> <p>Viridor is exploring alternative uses for its landfill assets.</p>	Medium		<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>Long-term priorities affected:</p> <p>1</p> <p>Operational failure in our Water business could mean that we are not able to supply clean water to our customers or provide safe wastewater services. This has a direct impact on successful delivery of the PR14 business plan.</p> <p>Business interruption caused by defects, outages or fire could impact the availability and optimisation of our ERFs and recycling facilities.</p>	<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>	Medium		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.

Risk report continued

Operating performance continued

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Difficulty in recruitment, retention and development of appropriate skills, which are required to deliver the Group's strategy	<p>Long-term priorities affected:</p> <p>1 2 3</p> <p>Ensuring we have a workforce of skilled and motivated individuals is key to delivery of all our strategic priorities.</p> <p>We need the right people in place to share best practice, deliver synergies and move the Group forward in the new 'shared services' structure.</p> <p>We need a team with the necessary commercial acumen to help our businesses grow and prosper.</p>	<p>Succession plans are in place. The recent Group restructure, Viridor transformation and integration of Bournemouth Water have strengthened the executive team, but in turn has the potential to impact morale across the Group.</p> <p>With reliance on EU nationals, uncertainties across the Group following the Brexit vote mean the current assessment of the direction of travel of the risk is increasing.</p>	Medium		Appropriate skills and experience in place, with good succession plans to mitigate impact on strategic plan.

Business systems and capital investment

Principal risks	Strategic impact	Mitigation	Net risk	Direction	Risk appetite
Failure or increased cost of capital projects/exposure to contract failures	<p>Long-term priorities affected:</p> <p>1 3</p> <p>The success of our capital programme and long-term contracts is key to our ability to provide top class customer service, the delivery of our growth agenda and our aspirations to grow market share in our waste recycling and recovery business.</p>	<p>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.</p> <p>Regular reporting of performance on major contracts and post project appraisals.</p> <p>The Greater Manchester Waste Disposal Authority has publicly stated it is seeking an exit from the Greater Manchester Waste PFI. Pennon/Viridor is working closely with its JV partners to secure a mutually acceptable outcome.</p>	Medium		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	<p>Long-term priorities affected:</p> <p>1</p> <p>Failure of our systems due to inadequate cyber security could lead to significant business interruption. Corruption or loss of data could result in detriment to our customers, financial penalties and reputational damage.</p>	<p>Major systems implementation is supported by a formal programme governance framework, supplemented by specialist consultants. Viridor systems are in the process of migrating to a Group shared service platform.</p> <p>Cyber risks are mitigated by a strong information security framework, cyber security awareness campaigns, plus internal and external testing and formal ISO accreditation. Ensure all possible measures are in place, aligned to guidance issued by the National Cyber Security Centre (NCSC), commensurate with the fast changing cyber risk landscape.</p>	Medium		Robust systems in place to support business activity, with strong cyber protection to minimise a growing risk.

Britain's exit from the European Union

As with all major decisions and changes that affect our business, Pennon conducted a thorough analysis of the possible implications of a vote to leave the European Union. Pennon did not take a public stance on the referendum in June 2016 as the Board believed that the vote was a personal decision.

It is too early to know the implications of the vote to leave; this will only become clear when negotiations following the March 2017 triggering of Article 50 are complete. In the meantime, we are tracking Brexit implications in assessing every risk.

Ofwat's principles for holding companies – Board leadership, transparency and governance

Ofwat requires that holding companies manage their risks in such a way that the regulated company is protected from risk elsewhere in the Group. The principal risks and uncertainties disclosed above include the Group-level risks that could materially impact on South West Water.

Pennon's risk management and internal control frameworks ensure that it does not take any action that would cause South West Water to breach its licence obligations. Further, the Group's governance and management structures mean that there is full understanding and consideration of South West Water's duties and obligations under its licence, as well as an appropriate level of information sharing and disclosure to give South West Water assurance that it is not exposed as a result of activities elsewhere in the Group.

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 47 to 50 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 the Group's viability. Over the course of the year the Audit Committee has considered a deep-dive review of the following principal risks to enable a thorough assessment of the impact of these risks on ongoing viability:

Principal risk	Matters considered by the Audit Committee
Cyber security	Review of the cyber security framework in place
Financial markets	Ability to manage external shocks or potential market dislocations that could impact on financing strategy
Brexit	Initial assessment of Brexit implications and mitigations
Wholesale energy risk	Review of Group energy risk strategy to mitigate volatility in the wholesale energy market
Drinking water contamination	Review the risk to drinking water quality in the event of significant water contamination
Legislative and regulatory compliance	Management of changes in EU and UK legislation and regulation, including the impact of Brexit
ERF – business interruption and continuity management	Review of business continuity planning in place across all ERF facilities
Water Business – debt collection	Non-recovery of household debt risks and mitigations

Principal risk	Matters considered by the Audit Committee
Recycling and commodity market volatility	Management and de-risking of recycling and commodity market volatility
Recruitment and retention	Review of people risks including the ability to attract and retain the right skills to deliver the Group strategy
Water resources, flooding and resilience	Consider the impact of climate change and drought risks on water resources and ongoing flood-related resilience

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. The five-year period was chosen for consistency with the length of the Water business's regulatory contract and the associated business planning cycle, and the longer-term nature of the business.

In making the assessment, the Directors have taken account of the Group's robust capital 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 assessment is subject to uncertainty, the level of which depends on the proximity of the time horizon. 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 1 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 1 to 51 was approved by the Board on 23 May 2017.

By Order of the Board



Helen Barrett-Hague
Group Company Secretary
23 May 2017

The annual performance evaluation is an important tool for assessing the Board's effectiveness in overseeing the use of shareholders' funds and ensuring the Pennon Executive implements the Group's strategy.

This year's evaluation concluded that the balance of skills, knowledge and experience on the Board helped it to demonstrate a high degree of effectiveness, with a broad understanding of Pennon's businesses, the opportunities available to them and the threats they face.

Read more page 62

Two of our Directors have a background in industry, three in finance and one in governance.

Three of our Directors have held office for less than three years, reflecting our commitment to continually refresh the Board and bring in new ideas.

Committed to operating
**to the highest standards
of corporate governance**

**Governance and
remuneration**

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Chairman's letter to shareholders

Sir John Parker
Chairman

Good governance provides the framework for effective delivery of our strategy, the creation of shareholder value and the ongoing development of our sustainable business.

Dear Shareholder

I am pleased to introduce the corporate governance report for 2017 on behalf of the Board. This 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.

Strong governance is central to the successful management of any company. At Pennon it provides the framework for effective delivery of our strategy, the creation of shareholder value and the ongoing development of our sustainable business. In my second year as Chairman of Pennon I remain committed to ensuring that we continue to operate to the highest standards of corporate governance.

During the year we monitored the operation of the revised governance structures that were put in place in April 2016 and a review was carried out by our Senior Independent Director, Gill Rider, alongside an independent external evaluation of the Board's structure, operation and performance. Based on these assessments, the Board has concluded that the governance framework, which comprises the operation of the Board, its Committees, executive management and the board of South West Water, as well as the risk management and internal control environment described on pages 46 and 62, is robust and effective, and is operating smoothly. It provides a strong foundation for efficient and transparent decision-making while preserving the degree of regulatory independence that Ofwat requires for the water business.

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 each of 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.

103

meetings and calls in
our comprehensive
IR programme

16

city conferences, salesforce
briefings and roadshows

The revised governance structure implemented in April 2016 has reinforced the good governance already in place and has helped us to operate effectively and cohesively as a Board. It is my responsibility to act on the results of the annual performance evaluation of the Board and its Committees via an action plan approved by the Board. 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 the Directors in maintaining up-to-date knowledge and understanding of our total business as we pursue our 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 103 meetings and conference calls were held. Pennon attended eight city conferences and sales force briefings and eight roadshows, including in the US and mainland Europe. 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. In addition, this year we held a site visit to Viridor's Ardley Energy Recovery Facility near Oxford.

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 corporate 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 2017 AGM on 6 July all of our Directors intend to be present together with a number of other senior executives of our businesses to meet with shareholders to further explain developments at Pennon.

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. 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 September 2014 version of the Code, which is effective for reporting periods commencing on or after 1 October 2014 and before 17 June 2016.

In addition, as the holding company of South West Water Limited, the Company has complied with Ofwat's principles for holding companies in respect of Board leadership, transparency and governance.

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 103 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
23 May 2017

Board of Directors

Sir John Parker

Chairman

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.

Skills and experience

Sir John is a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He won the lifetime achievement award at The Sunday Times 2015 Non-Executive Director Awards and is widely recognised for his policy work on corporate governance, including the value of diversity in the boardroom. He has chaired five FTSE100 companies and 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. He was also president of the Royal Academy of Engineering from 2011 to 2014.

Since his appointment as Chairman, Sir John has brought the Group together under a revised governance framework that features a new role of Group Chief Executive Officer and other senior positions. The new team is working together collaboratively to drive forward the Group's strategy.

External appointments

Sir John is the chairman of Anglo American plc and of Advanced Plasma Power Limited. He is also a non-executive director of Carnival Corporation and Airbus Group, and is a Visiting Fellow of the University of Oxford. Sir John's commitments are expected to reduce in 2017, when he retires from the board of Anglo American plc.

Christopher Loughlin

Chief Executive Officer

BSc Hons, MICE, CEng, MBA

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

Skills and experience

Chris has extensive experience of the regulated business environment and the management of major engineering and infrastructure services. He started his career as a chartered engineer working in both the consulting and contracting sectors and, after holding a number of senior positions with British Nuclear Fuels plc, joined its board as an executive director. Prior to joining Pennon he was chief operating officer with Lloyds Register and before that executive chairman of Magnox Electric plc. He was also a senior diplomat in the British Embassy, Tokyo.

Chris has a comprehensive understanding of the water industry. He was previously a board member (and, for a period, president) of the Institute of Water, and between April 2008 and March 2012 was chairman of Water UK.

Since his appointment as Group Chief Executive Officer, Chris has set Pennon on a path of closer collaboration in pursuit of delivery of its strategy, with the constituent parts of the Group now working together to identify synergies, reduce costs and exploit opportunities for growth.

External appointments

Chris is currently chairman of British Water, a director of Water UK and a trustee of the charity WaterAid. An enthusiastic advocate of local business, Chris is also vice chairman of the Cornwall Local Enterprise Partnership.

Susan Davy

Chief Financial Officer

BSc Hons, ACA

Susan joined the Board on 1 February 2015. She is a member of the Pennon Executive.

Skills and experience

Susan is a graduate qualified chartered accountant with 20 years' experience in the utility sector.

Prior to her current appointment Susan was Finance Director at South West Water between 2007 and 2015, during which time she was responsible for the company's Business Plan to 2020. She has also held a number of other senior finance roles in the water sector, including as Head of Regulation and Head of Finance (Wastewater) at Yorkshire Water.

Susan's knowledge of the industry coupled with her financial and regulatory expertise has supported the development of Pennon's strategy and her input has been invaluable to the Board in its deliberations. Susan is highly respected in the City and has been instrumental in building Pennon's reputation.

External appointments

Susan is a member of the A4S (Accounting for Sustainability) CFO leadership network and a council member of CBI South West.

Gill Rider

Senior Independent Director (Non-Executive)

CB, PhD, CCIPD

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.

Skills and experience

Gill has a wealth of experience in leadership, governance and remuneration across a broad range of sectors including professional services, education and government.

Formerly, she 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.

As chairman of the Sustainability Committee, Gill has encouraged and supported executive management in the development of a sustainability programme that underpins the delivery of Pennon's strategy. At Accenture she chaired the global corporate responsibility and Foundation giving programme and was instrumental in building sustainability objectives into Accenture's worldwide human capital strategies.

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.

Martin Angle

Independent Non-Executive Director

BSc Hons, FCA, MCSI

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.

Skills and experience

Martin is an experienced non-executive director, bringing a wide range of knowledge and experience from a career in investment banking, private equity and industry.

Over a 20-year executive career in investment banking, Martin held senior roles with SG Warburg & Co. Ltd, Morgan Stanley and Dresdner Kleinwort Benson, before becoming the group finance director of TI Group plc, then a FTSE 100 company. He subsequently joined Terra Firma Capital Partners where he held various senior roles in its portfolio companies, including the executive chairmanship of the Waste Recycling Group Limited, then a major participant in the UK waste sector, and Le Meridien Hotel Group where he was executive deputy chairman.

Martin has also served as a non-executive director on a number of boards including Savills plc, where he was the senior independent director; National Exhibition Group, where he was chairman; Severstal; and Dubai International Capital.

As chairman of the Remuneration Committee, Martin has steered Pennon's approach on executive remuneration, ensuring that it is aligned with and supports the Group's strategy.

External appointments

Martin is currently vice chairman and non-executive director of the FIA Foundation, the adviser to the Board of the Commercial Bank of Dubai and the adviser to NGP, a private group based in the USA, which is building out a major platform in renewable energy in emerging markets.

Neil Cooper

Independent Non-Executive Director

BSc Hons, FCMA

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

Skills and experience

Neil brings to the Board extensive experience in a wide variety of corporate and financial matters. Most recently, he was group finance director of Barratt Developments plc and, before that, group finance director of William Hill plc and Bovis Homes plc. He also held senior finance positions at Whitbread plc, worked for PricewaterhouseCoopers as a management consultant and held a number of roles with Reckitt & Colman plc.

As chairman of the Audit Committee, Neil has been influential in directing Pennon's approach on a number of significant matters including internal control, governance and financial reporting.

External appointments

None.

Helen Barrett-Hague

Group General Counsel & Company Secretary

Solicitor, LLB Hons

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

Skills and experience

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

Helen is responsible for the provision of legal and company secretarial services to the Group, for statutory and regulatory compliance in terms of business conduct, and for supporting the Chairman and the Board in ensuring that Pennon's high standards of governance continue to be met. She is also chairman of the board of trustees of the Pennon Group Defined Contribution Pension Scheme.

External appointments

None.

The Board and its governance framework

The Board of Pennon Group plc and its governance framework is set out below.

The Board acts as the main governing body for the purpose of oversight of Viridor's business. For regulatory reasons, South West Water's business continues to be overseen by the board of South West Water Limited. The boards and committees of Pennon Group plc and South West Water Limited usually meet sequentially on the same day or days, facilitated by the dual directorships held by a number of the Directors.

Read more pages 61 and 62

Viridor Executive Meeting
Chaired by the Viridor Managing Director and consisting of principal executives of Viridor

Pennon Executive Meeting
Chaired by the Group CEO and consisting of principal executives of the Group

South West Water Executive Meeting
Chaired by the South West Water Managing Director and consisting of principal executives of South West Water

The Pennon Board

Consisting of the Chairman, the Group CEO, the CFO and three independent Non-Executive Directors

The South West Water Board

Consisting of the Chairman, the Group CEO, the Managing Director, the Finance Director, three Pennon Non-Executive Directors and three South West Water non-executive directors*

Audit Committee

Members: three independent Non-Executive Directors and two South West Water non-executive directors for South West Water matters

Sustainability Committee

Members: two independent Non-Executive Directors, two South West Water non-executive directors (of which one is a vacancy) for South West Water matters, and the Group CEO

Remuneration Committee

Members: three independent Non-Executive Directors and two South West Water non-executive directors (of which one is a vacancy) for South West Water matters

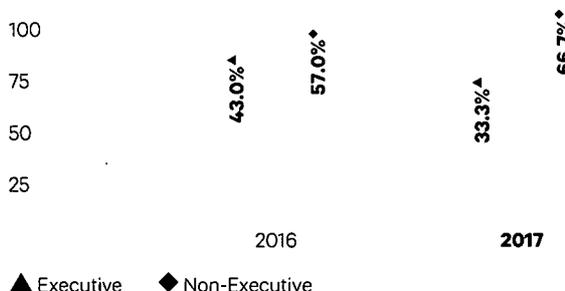
Nomination Committee

Members: the Chairman, three independent Non-Executive Directors and three South West Water non-executive directors (of which one is a vacancy) for South West Water matters

Pennon Board composition, independence and experience

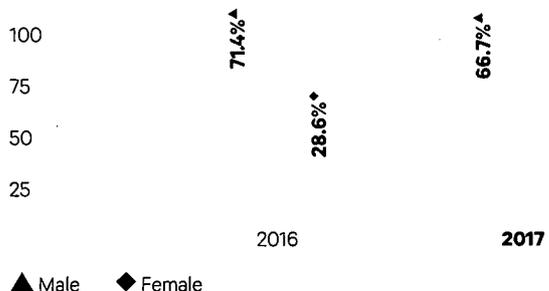
Composition

as at 31 March



Diversity

as at 31 March



At the end of the year the Board of Directors comprised the Chairman, two Executive Directors and three Non-Executive Directors.

The Board continued to exceed its target of 25% female representation throughout the year and at the year end it was 33.3%.

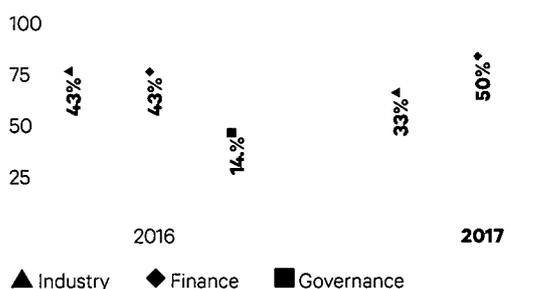
Tenure

as at 31 March



Experience

as at 31 March



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 Non-Executive Directors listed on the following page. In December 2017 Martin Angle will reach the ninth anniversary of his appointment. The Board is satisfied that Martin continues to demonstrate independence of character and judgement in the performance of his role as a Director and therefore has determined that he remains independent.

Sir John Parker 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.

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

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 on pages 56 and 57 and the experience chart above demonstrates collectively a broad range of business, financial and other relevant experience.

Directors' roles

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 57). Martin Angle is also a member of the Audit Committee and he has relevant financial experience as set out in his biography on page 57.

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

The Board and its governance framework continued

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 CEO Representing the Group and being available to shareholders Discussing separately with the Non-Executive Directors performance and strategic issues
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 exploiting 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
Chief Financial Officer	Susan Davy	<ul style="list-style-type: none"> Supporting the CEO in providing executive leadership and developing Group strategy Reporting to the Board on performance and developments across the business Implementing decisions of the Board Managing 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
South West Water non-executive directors	Martin Hagen Matthew Taylor Vacancy	<ul style="list-style-type: none"> As for the Pennon Non-Executive Directors above, but only in respect of South West Water matters

Board meetings and attendance

The Directors and their attendance at the nine scheduled meetings of the Board during 2016/17 are shown below:

Members	Appointment date	Attendance
Chairman		
Sir John Parker	April 2015	9/9
Non-Executive Directors		
Martin Angle	December 2008	9/9
Neil Cooper	September 2014	9/9
Gill Rider	September 2012	9/9
South West Water non-executive directors⁽¹⁾		
Martin Hagen	-	9/9
Steve Johnson ⁽²⁾	-	1/1
Matthew Taylor	-	9/9
Executive Directors		
Susan Davy	February 2015	9/9
Christopher Loughlin	August 2006	9/9
Ian McAulay ⁽³⁾	September 2013	4/4

In 2016 the number of scheduled Board meetings was reduced from ten to nine per year (plus an annual strategy day) and the number of scheduled Committee meetings was reduced to four per year to coincide with Board meetings. Board and Committee meetings are arranged over a session lasting a day and a half, which includes a working dinner for the Directors. Additional meetings of Committees are arranged as and when necessary. This approach allows for longer agendas and in depth review and discussion around complex matters.

Managing the Group and its subsidiaries

The Board's responsibilities include overall leadership of the Group, setting the Group's values, policies and standards, approving Pennon's strategy and objectives and providing oversight of the Group's operations and its performance. The Board makes decisions in relation to Group and Viridor business in accordance with its schedule of matters reserved. The South West Water board continues to operate as a separate independent board in accordance with its own schedule of matters reserved to ensure compliance with Ofwat's principles on board leadership, transparency and governance.

(1) Representing South West Water interests.

(2) Until 28 April 2016.

(3) Until 31 August 2016.

Detailed consideration of certain matters is delegated to Board Committees, to the Executive Directors and to the Group General Counsel & Company Secretary, as appropriate. In addition to the matters the Directors are required to decide by statute or regulation, the matters reserved to the Board in relation to Pennon Group plc and Viridor Limited include:

- 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 Board also ratifies certain decisions taken by the South West Water board, including major capital projects and investments, long-term objectives and commercial strategy, the five-year regulatory plan, annual budgets and certain decisions relating to financing. This

approach is compatible with Ofwat's principles for holding companies in respect of Board leadership, transparency and governance.

Operation of the Board

The Board operates by receiving written reports circulated 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.

The Pennon Board and the South West Water board usually meet sequentially, which allows a more holistic and cohesive approach to decision-making and communication across the Group. This is facilitated by the dual directorships held by a number of the Directors.

Pennon Board composition

Chairman	Group CEO	CFO
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3 independent Non-Executive Directors of Pennon	In attendance 3 independent non-executive directors of South West Water*
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*Recruitment is underway to fill the one vacancy

South West Water board composition

Chairman	Group CEO	Managing Director, South West Water	Finance Director, South West Water
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3 independent non-executive directors of both South West Water and Pennon	3 independent non-executive directors of South West Water*	In attendance Group CFO
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Pennon Executive management

The role of the Pennon Executive is to define and drive the business priorities that will achieve delivery of the strategy. It is responsible for ensuring, to the extent of the authority delegated by the Board, the proper and prudent management of Group resources to create and maximise shareholder value.

Chaired by the Chief Executive Officer, the Pennon Executive meets formally on a monthly basis to review and refine recommendations to be presented to the Board.

Members of the Pennon Executive

Chris Loughlin	Chief Executive Officer
Susan Davy	Chief Financial Officer
Adele Barker	Interim Group director of Human Resources
Helen Barrett-Hague	Group General Counsel & Company Secretary
Stephen Bird	Managing Director, South West Water
Sarah Heald	Director of Corporate Affairs & Investor Relations
Steve Holmes	Director of Safety, Health, Quality & Sustainability (SHQS)
Ed Mitchell	Director of Environment and interim Operations director (Wastewater Services), South West Water
Phil Piddington	Managing Director, Viridor
Paul Ringham	Commercial director, Viridor
Bob Taylor	Operations director (Drinking Water Services), South West Water

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, including environmental, social and governance (ESG) risks), 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.

The Board and its governance framework continued

Performance evaluation

The Board undertakes a formal and rigorous review of its performance and that of its Committees and Directors each year. This year, Armstrong Bonham Carter LLP, who are independent board performance consultants with no other connection with the Company, facilitated the evaluation of the Board's and the Committees' performance. The exercise was conducted in March 2017 by way of a series of structured interviews with all the Directors, various members of the senior executive team, the Internal Audit Manager and the External Audit Partner.

The agenda for these interviews was circulated to each participant prior to the meetings and was designed to assess:

- whether the Directors had thoroughly discussed and agreed the use of shareholders' funds to ensure the Company was successful whilst managing the risks inherent in the strategy, plans and the operating environment
- the effectiveness of the Board in ensuring that the executive team had implemented the strategy and plans, and had managed all the other activities of the Company well.

Armstrong Bonham Carter collated and analysed the results from each interview and prepared separate reports on the performance of the Board as a whole and one for each Committee, all of which were reviewed and discussed by the Board.

The Senior Independent Director separately conducted a review of the individual directors' performance and the Chairman's performance was evaluated separately by the Non-Executive Directors, led by the Senior Independent Director.

The review concluded that the Board, its Committees and its individual Directors had demonstrated a high degree of effectiveness. The new Board structure was viewed most positively and had helped the Non-Executive Directors to achieve a broader knowledge of both businesses. Consequently, the Board had a good understanding of opportunities for growth and the threats facing the business. The Board's commitment to health and safety was widely noted and all Directors commented on the need to improve performance following three fatalities since 2013. The appointment of a new Group director of Safety, Health, Quality and Sustainability, who will work to embed a strong health and safety culture throughout the Group, was welcomed. In addition, the Board agreed to adopt actions relating to the development of Group strategy, the shaping of Pennon's corporate values and increased focus on employee engagement. Subsequently the Board agreed and implemented an action plan which it will monitor regularly.

Conclusions and recommendations in respect of the composition of the Board were considered by the Nomination Committee and are covered on page 70.

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 63 to 73 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 and are also available from the Group Company Secretary upon request.

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. This has operated effectively during the year.

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 2016/17 and up to the date of the approval of this annual report and accounts.

The Group's system of internal control is consistent with the FRC's new 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' (FRC Internal Control Guidance).

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 46 in the strategic report provides for the identification of key risks including 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, which were reviewed and refreshed during the year. 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 47 to 50.

Board Committees' reports

The Audit Committee report

Neil Cooper

Audit Committee Chairman

“The role of the Audit Committee is to ensure that robust systems are in place for financial reporting, internal control and risk management.”

Dear Shareholder

I am pleased to introduce the Audit Committee's report on its activities during the year.

As in previous years, the principal responsibilities of the Committee continue to be focused in a number of key areas: firstly, on ensuring the appropriateness of the Group's financial reporting; an activity which includes the testing of accounting judgements made in preparing reporting and in assessing whether the presentation of the Group's activities is fair, balanced and understandable. Secondly, on reviewing and challenging the ongoing effectiveness of the internal control environment and thirdly, on the scope of risk management processes across the Group, including monitoring the Group's risk appetite as well as acting as a forum in which to carry out more detailed reviews of higher risk areas of the operation.

Monitoring and reviewing the effectiveness of the external auditor and the internal audit function is an important ongoing 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. In this context, the Committee notes that the Financial Reporting Council (FRC) Audit Quality Review team assessed the audit of the Group's 2016 report and accounts during the year and the Committee has received and discussed a report from the Company's external auditor with regards to the findings, as set out on page 66.

Following the establishment last year of a new Group executive risk management forum to assess risk appetite and monitor key risks and their mitigation, the Committee has received detailed 'deep dive' presentations from senior management on individual principal risks including, for example, drinking water contamination risk, wholesale energy market risk, ERF business interruption and continuity management, EU/UK regulatory and legislative change, non-recoverable debt in South West Water and Viridor recycling and commodity activities. More detail on our risk management processes, principal risks and their associated mitigation can be found on pages 46 to 51. Aligned with this we continue to assess 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 51.

As part of the half-year and year-end reporting review process, we reviewed and challenged the key financial reporting judgements of management as set out on page 65. Significant matters considered by the Committee both during the year and in relation to the year-end financial statements are laid out in this report.

Neil Cooper

Audit Committee Chairman

The Audit Committee report continued

Audit Committee composition and meetings

	Date of appointment to Pennon Audit Committee	Attendance	South West Water audit committee member
Committee chairman			
Neil Cooper	September 2014	5/5	✓
Committee members			
Martin Angle	December 2008	5/5	✓
Gill Rider	September 2012	5/5	✓
South West Water non-executive directors⁽¹⁾			
Martin Hagen	-	5/5	✓
Matthew Taylor	-	5/5	✓

(1) Representing South West Water interests.

The Pennon Audit Committee and the South West Water audit committee meet sequentially on the same day. The responsibilities of the South West Water audit committee mirror those of the Pennon Audit Committee but only in respect of South West Water.

Other regular attendees to Committee meetings during the year included: Chief Executive Officer; Chief Financial Officer; Managing Directors of South West Water and Viridor; Group General Counsel & Company Secretary; Finance Directors of South West Water and Viridor; Group Financial Contoller; Group Audit Manager; and external auditor.

In addition, the Board Chairman has an open invitation to attend the Committee meetings. In the last year he attended those meetings at which the Committee 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 7.11R of the FCA's Disclosure Guidance and Transparency Rules, have competence in accounting or auditing. Details of each Director's significant current and prior appointments are set out on pages 56 and 57.

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 sets in place 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 and opposite.

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 presentation of 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"> Review of internal audit reports on core systems and processes across the Group, for example, Group treasury, contract management and Recycling & Recovery Approved updated policies in relation to treasury and going concern assessment Reviewed an external quality assessment on the effectiveness of the Internal Audit function Monitored the effectiveness of key strategic projects including Viridor's Enterprise transformation and South West Water's market ready programme
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 Considered the findings of the FRC's review of the 2016 external audit
Risk management	<ul style="list-style-type: none"> Reviewed the Group's 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 Management of information security across the Group in mitigating key IT risks Received as part of the risk management review the annual report on any whistleblowing Carried out regular 'deep dives' at Committee meetings on principal risk areas

- Governance
- Discussed the results of independent performance evaluation of the Committee, conducted by Armstrong Bonham Carter LLP
 - 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 updated Group policies covering treasury and foreign exchange
 - 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

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 2017 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 106 to 113. In addition to the significant matters set out in the table below, the Committee considered a range of other matters. These include presentational matters, in particular relating to the non-underlying disclosure format and ensuring a fair presentation of statutory and non-statutory performance and financial measures.

During the year, the Group has seen substantial impact from movements in derivatives, both as a result of market movements and as a result of changes in our expectations of economic benefits. This has led to the early unwind of a derivative through Peninsula MB Limited, giving rise to a substantial non-underlying charge. The Committee and Board have received several updates and reports from the Chief Financial Officer in regard to these movements, deeming management's approach to the accounting recognition and disclosure of these items, as non-underlying, to be appropriate.

Area of focus by the Committee	How the matter was addressed by the Committee
Revenue recognition	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 closely considered the work in respect of these areas at year end by the external auditor as well as reviewing disclosures around revenue recognition accounting policies.
Non-current asset impairment review and provisions	Recognising that the value of certain non-current assets and long-term environmental provisions within Viridor can be 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. The Committee noted the substantial headroom in the mandatory review of goodwill for impairment, resulting in this area being deemed less judgemental. Following a detailed review of the analysis undertaken, and consideration of management assumptions in relation to both the value of environmental provisions and the assessment of indicators for potential impairment of non-current assets, the Committee was satisfied that a robust and consistent approach had been followed and that the management's assertion that the carrying value of these assets and liabilities remained reasonable, and therefore the Committee were able to approve the disclosures in the financial statements. This key area was also closely reviewed as part of the year-end audit by the external auditor.
South West Water 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, enabled the Committee to conclude that management's assessment of the year-end position was reasonable.
Provisions for uncertain tax positions	It 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 a report to the Board setting out the resolution of a number of uncertain tax items, 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 on resolution of these matters the level of judgement required in assessing the year end tax creditor was consequently reduced. Where appropriate expert external legal and accounting advice and other specialist taxation advice had been sought which assisted the Committee in forming a view on the appropriateness of the provisions for remaining 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 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 on a periodic basis. Rolling five-year strategy projections and the resultant headroom relative to borrowings is also regularly reviewed by the Board, including scenarios to better enable the committee to understand the potential range of outcomes. At the end of each six month period 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 51.

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, Ernst & Young LLP, was appointed following a comprehensive audit tender process and approval by shareholders at the Company's 2014 AGM. Their reappointment was approved at the 2016 Annual General Meeting. Debbie O'Hanlon is the audit partner and has been in that role since Ernst & Young's appointment.

The Audit Committee report continued

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 and which was shared with, and discussed by, the Committee in advance.

The effectiveness review of the external auditor is undertaken as part of the Committee's annual performance evaluation, which was carried out by independent external consultants, Armstrong Bonham Carter LLP. Further details of the performance evaluation are provided on page 62. No issues were raised during that review and the Committee concluded that the auditor was effective during the year. In addition, during the year the FRC's Audit Quality Review team reviewed the audit of the Group's 31 March 2016 financial statements, focussing on the audit of impairment, taxation and revenue. The FRC categorised the audit as 'good or limited improvements required', with no significant areas for improvement identified. Following the review and discussion of the findings by the Committee, changes were made to the auditor's approach to the audit of revenue in the waste business. 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 during the year and again since the year end, confirming 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

In line with the requirements of the EU Audit Directive and Regulation which came into force on 17 June 2016, the Committee continues to have a robust policy for the engagement of the external auditor's firm for non-audit work. The Committee receives a regular report covering the auditor's fees including details of non-audit fees incurred. Recurrent fees relate to agreed procedures in relation to annual regulatory reporting obligations to Ofwat, work most efficiently and effectively performed by the statutory auditor. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work. The Committee carefully reviews non-audit work proposed for the statutory auditor, taking into consideration 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 11.3% 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 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 regularly 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.

During the year an external assessment of the internal function was performed by KPMG LLP, concluding that the Company's internal audit function conforms to IIA standards issued by the Institute of Internal Auditors. The review highlighted both areas of good practice and some areas for improvement which would improve the delivery of the Company's internal audit function.

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 103, 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 106 to 113.

In preparing and finalising the 2017 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.

The Sustainability Committee report

Gill Rider
Sustainability Committee
Chairman

Our approach to sustainability helps us to draw together the needs of society with the delivery of commercial success.

Dear Shareholder

I am pleased to introduce the Sustainability Committee's report on its activities during the year. Sustainability remains an integral part of Pennon's strategy, and the Group continues to take this responsibility 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 promote the highest standards of corporate responsibility by bringing together and reviewing initiatives that drive sustainability, approving targets and monitoring the progress made in achieving Pennon's strategic sustainability objectives. Those objectives are set out on page 69.

We are well equipped to oversee performance from the perspective of the Group and that of the individual businesses, with additional attendees Lord Matthew Taylor (South West Water non-executive director), Stephen Bird (Managing Director, South West Water) and Phil Piddington (Managing Director, Viridor) contributing to the Committee's discussions. We are delighted with the strengthening of the executive team and envisage that director of Safety, Health, Quality and Sustainability, the director of Environment and the interim director of Human Resources, all recently recruited to Group-level roles, will play a central role in supporting the Committee as we continue to guide the business and advise the Board on sustainability which we believe is material to delivery of the Group's strategy.

Pennon's business model and its strategic priorities on pages 14 to 17 show how a thorough approach to sustainability helps us to draw together the needs of society with the delivery of commercial success. The Group's long-term strategic priorities are designed to create value for all our stakeholders – our customers, our communities and our people, as well as our investors – and details of how we are implementing this strategy are provided throughout the annual report. 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

The Sustainability Committee report

continued

Sustainability Committee composition and meetings

	Date of appointment to Pennon Sustainability Committee	Attendance	South West Water sustainability committee member
Committee chairman			
Gill Rider	September 2012	5/5	✓
Committee members			
Martin Angle	December 2008	5/5	✓
Chris Loughlin	November 2006	5/5	✓
Ian McAulay ⁽¹⁾	September 2013	2/2	n/a
South West Water non-executive directors⁽²⁾			
Steve Johnson ⁽³⁾	-	1/1	✓
Matthew Taylor	-	5/5	✓

(1) Until 31 August 2016.

(2) Representing South West Water interests.

(3) Until 28 April 2016.

The Pennon Sustainability Committee and the South West Water sustainability committee meet sequentially on the same day. Senior executives also attend meetings to support discussions on their specific areas of expertise.

Neil Cooper stood down from the Committee on 1 April 2016 and Steve Johnson, who was a member of the South West Water sustainability committee, resigned on 28 April 2016 as a non-executive director of South West Water. Recruitment for a replacement is underway.

The responsibilities of the South West Water sustainability committee mirror those of the Pennon Sustainability Committee but only in respect of South West Water. In addition, the South West Water sustainability committee continues to provide oversight of South West Water's performance against its sustainability targets and the sustainability activities that are core to the successful delivery of South West Water's K6 Business Plan 2015-2020. This is consistent with Ofwat's requirement for independent governance of our regulatory business.

During the year the Committee continued to apply the best practice framework published by Business in the Community (BitC), a leading business-led charity that promotes responsible business. The structure provided through BitC's key areas of sustainability (marketplace, workplace, community and environment) is reflected in Pennon's sustainability objectives and supports the development of a range of targets by South West Water and Viridor as part of their business planning processes.

We aim to set stretching targets and as at 31 March 2017 South West Water had achieved eight of its 12 targets for the year and Viridor had completed eight out of 16 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 June 2017 and July 2017 respectively.

The Sustainability Committee balances the requirement to conduct 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.

Since last year's report, the Committee has considered a wide range of matters in the course of fulfilling its duties in accordance with its terms of reference:

- the Group's health and safety performance (including a health and safety 'deep dive') and the effectiveness of health and safety policies and procedures
- environmental strategy and performance
- performance in respect of customer service and engagement
- the Group's approach to community relations 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 2016 and the associated verifier's reports and recommendations
- progress against the sustainability targets for 2016/17 and sustainability targets for 2017/18.

In addition, the Committee considered:

- the development of Pennon's new Code of Conduct, which sets out the principles that should guide our employees' actions and support everyday decision making
- the establishment of a Group-wide compliance and ethics programme
- the results of Business in the Community's 2016 benchmarking assessment of South West Water and Viridor, with both organisations awarded two and a half stars out of five
- the results of Committee's independent performance evaluation conducted by Armstrong Bonham Carter LLP
- modifications to the Committee's terms of reference.

Strategic sustainability objectives

The Sustainability Committee has defined the following strategic objectives, which drive the sustainability targets set by South West Water and Viridor. Commentary on our performance against our objectives is integrated throughout the strategic report.

- Manage Pennon Group as a sustainable and successful business for the benefit of our customers, shareholders and other stakeholders
- Aim to ensure that all our business activities have a positive economic, social and environmental impact on the communities in which we operate
- Engage with our customers and other stakeholders and foster good relationships with them
- Strive for the highest standards of health and safety in the workplace so as to minimise accidents, incidents and lost time
- Develop and motivate our employees, treat them fairly and ensure that they are fully engaged in all aspects of Pennon Group's objectives and follow the highest standards of business conduct
- Aspire to leadership in minimising emissions that contribute to climate change, and develop climate change adaptation strategies
- Aspire to leadership in all aspects of waste prevention and resource efficiency by delivering solutions for society to address the environmental challenge of depleting natural resources.

Reporting and verification

In reporting on sustainability, the Company has sought to comply with the Investment Association Guidelines on Responsible Investment Disclosure.

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. Certain disclosures within this annual report that relate to the sustainability performance of South West Water and Bournemouth Water have been verified by SMC against the output of an independent audit of regulatory data conducted by CH2M.

Benchmarking

Pennon is a constituent of the FTSE4Good Index, 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:

- Chairman's statement (page 8)
- Business model (page 14)
- Strategic priorities (page 16)
- Our people (page 18)
- Review of the Chief Executive Officer (page 20)
- Our operations (pages 26 to 37)

South West Water and Viridor sustainability reports

The sustainability report for Viridor will be published in June 2017, and South West Water will incorporate its sustainability reporting in its company annual performance report and regulatory accounts, which will be published in July 2017. 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 2016/17, and their performance against them, are given in their respective reports.

The Nomination Committee report

“ We are pleased to report that, at the year end, 36% of Pennon Executive members were women. ”

Sir John Parker
Nomination Committee Chairman

The Nomination Committee met four times during the year to fulfil the duties set out in its terms of reference.

Matters considered by the Committee during the year included:

- The recruitment for a non-executive director of South West Water, to fill the vacancy arising from the resignation of Steve Johnson in April 2016
- The appointment of the Group director of Safety, Health, Quality and Sustainability, the interim Group director of Human Resources and the Group director of Environment
- The recruitment of a director of Wastewater Services, South West Water
- A review of succession plans, the leadership needs of the Group and the Group's approach to succession planning, resulting in the instigation of a project to be undertaken by the interim Group director of Human Resources
- the structure, size and composition of the Board, including the skills, knowledge, independence, diversity and experience of the Directors, taking into account the findings of the independent performance evaluation conducted by Armstrong Bonham Carter LLP
- a review of the time spent by Non-Executive Directors in fulfilling their duties and the other directorships they hold
- the steps to be taken to bring further skills and experience in environmental management into the executive team resulting in the appointment of Ed Mitchell to the new role of director of Environment, after the year end
- the Group's performance against its diversity and equality policies.

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. Buchanan Harvey & Co, who have no other connection with the Company, were engaged to assist with the recruitment of a non-executive director for the South West Water board, the process for which is still underway.

Nomination Committee composition and meetings

	Date of appointment to Pennon Nomination Committee	Attendance	South West Water nomination committee member
Committee chairman			
Sir John Parker	April 2015	4/4	✓
Committee members			
Martin Angle	December 2008	4/4	✓
Neil Cooper	September 2014	4/4	✓
Gill Rider	September 2012	4/4	✓
South West Water non-executive directors⁽¹⁾			
Martin Hagen		2/2	✓
Steve Johnson ⁽²⁾		0/0	✓
Matthew Taylor		2/2	✓

(1) Representing South West Water's interests.

(2) Until 28 April 2016.

The Pennon Audit Committee and the South West Water audit committee meet sequentially on the same day. The responsibilities of the South West Water nomination committee mirror those of the Pennon Nomination Committee but only in respect of South West Water.

The CEO also attends meetings when invited.

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 2017 and, as disclosed on page 59, one third of the Board's Directors are women and as such the Group has exceeded 25% female representation at Board level.

We are pleased to report that, at the year end, 36% of Pennon Executive members were women compared to the reported 22% at 31 March 2016. 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 19.

The Committee and the Board will continue to monitor and promote diversity across the Group with the aim of ensuring women are appropriately represented on the Pennon Executive.

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 18, together with information regarding the gender breakdown of the workforce on page 19.

The Remuneration Committee report

Our remuneration policy must help us to attract and retain high calibre people who are able to contribute to the success of the Group.

Martin Angle

Remuneration Committee Chairman

The Committee met seven times during the year to fulfil the duties set out in its terms of reference. In particular, the Committee 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, in every third year, reviewing the remuneration policy and considering any changes necessary to ensure it remains appropriate and fulfils its purpose of attracting and retaining 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 executives of the Group.

The Committee's activities during the financial year

The Committee engaged in the following activities during the year:

- Annual executive salary review
- Annual review of the Chairman's fee
- Determining performance targets in respect of the Annual Incentive Bonus Plan for 2016/17
- Reviewing drafts of the Directors' remuneration report for 2015/16 and recommending it to the Board for approval for inclusion in the 2016 annual report
- Determining bonuses and deferred bonus awards pursuant to the Company's Annual Incentive Bonus Plan in respect of the year 2015/16
- Approving the Performance and Co-investment Plan awards for the year

- Approving the remuneration arrangements for the new Finance Director, Viridor
- Approving the release of the 2013 deferred bonus share awards and the vesting of executive share options pursuant to the Annual Incentive Bonus Plan
- Determining the outcome of the 2013 Performance and Co-investment Plan awards
- Considering and debating issues relating to the review of the remuneration policy and future arrangements for the annual bonus and long-term incentive plan (LTIP), with a particular focus on performance metrics and incentive levels to ensure these are aligned with the new management structure and strategic objectives
- Reviewing and agreeing to recommend the removal of the co-investment obligation under the Performance and Co-investment Plan, and an increase in our shareholding guidelines
- The results of independent performance evaluation of the Committee, conducted by Armstrong Bonham Carter LLP.

The Committee's focus for 2017/18

- Complete the design of the new simplified LTIP and oversee its implementation
- Ensure that targets are stretching but also fair and achievable, so that they act to retain, motivate and incentivise management to deliver the Group's strategic goals and to create long-term value for shareholders
- Improve the process around, and disclosure of, personal bonus targets
- Conduct a shareholder consultation process in preparation for its submission to shareholders for approval at the AGM
- Monitor on an ongoing basis the alignment of executive pay and benefits with the strategic direction of the Group.

Remuneration Committee composition and meetings

	Date of appointment to Pennon Remuneration Committee	Attendance	South West Water remuneration committee member
Committee chairman			
Martin Angle	December 2008	7/7	✓
Committee members			
Neil Cooper	September 2014	6/7	✓
Gill Rider	September 2012	7/7	✓
South West Water non-executive directors⁽¹⁾			
Martin Hagen	-	7/7	✓
Steve Johnson ⁽²⁾	-	1/1	✓

(1) Representing South West Water interests.

(2) Until 28 April 2016.

The Pennon Remuneration Committee and the South West Water remuneration committee meet sequentially on the same day. The responsibilities of the South West Water remuneration committee mirror those of the Pennon Remuneration Committee but only in respect of South West Water.

Steve Johnson, who was a member of the South West Water remuneration committee, resigned as a non-executive director of South West Water on 28 April 2016

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 attends from time to time but is not a member of the Committee. The CEO also attends meetings when invited except for such part of a meeting when matters concerning his own remuneration are to be discussed.

Directors' remuneration report

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Directors' remuneration at a glance

Key components of Executive Directors' remuneration

Base salary

Set at a competitive level to attract and retain high calibre candidates to meet Company's strategic objectives in an increasingly complex business environment.

Benefits

Benefits provided are consistent with the market and level of seniority and to aid retention of key skills to assist in meeting strategic objectives.

Annual bonus

Incentivises the achievement of key performance objectives aligned to the strategy of the Company.

Long-term incentive plan

Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.

Shareholding guidelines

Create alignment between executives and shareholders and promote long-term stewardship.

Pension

Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.

All-employee share plans

Align the interests of all employees with Company share performance.

Summary of Directors' remuneration 2016/17

	Base salary/fees (£000)	Benefits (including Sharesave) (£000)	Annual bonus (cash and deferred shares) (£000)	Long term incentive plan (£000)	Pension (£000)	Total remuneration (£000)
Executive Directors						
Chris Loughlin	510	27	429	199	153	1,318
Susan Davy	390	18	332	73	109	922
Non-Executive directors						
Sir John Parker	266	-	-	-	-	266
Neil Cooper	66	-	-	-	-	66
Martin Angle	67	-	-	-	-	67
Gill Rider	72	-	-	-	-	72

See the full single total figure of remuneration tables on page 89

Key proposed changes in policy and implementation

Performance measurement

Re-shaping our performance measurement framework to align with the strategic priorities of the Group – for both the annual bonus and the LTIP.

Holding period

Formalising our existing two year holding period.

LTIP opportunity

A proposed increase to our LTIP opportunity to align it better with the market, aiding retention and recruitment – the first increase to incentive quantum we have made for 10 years.

Shareholding guidelines

Increasing our shareholding guidelines for the Executive Directors, to provide stronger alignment with shareholders and long term strategy.

Read more about the changes to our remuneration policy on pages 76 to 79

Annual Statement from the Chairman of the Remuneration Committee

Our remuneration arrangements ensure the commitment of our Executive Directors to our long-term strategic objectives and to the creation of shareholder value.

Read more about our strategic objectives on page 16

Dear Shareholder

Introduction

I am pleased to present, on behalf of our Board, the Remuneration Committee's Directors' Remuneration Report for the year ended 31 March 2017.

We are submitting a revised Directors' Remuneration Policy (Policy) for a binding shareholder vote at the 2017 AGM, following the expiration of a three year period. As explained below, the revised Policy follows the first comprehensive review of our executive remuneration arrangements for 10 years and reflects the major changes Pennon has made to its strategy, management structure and governance in the last year. This includes the appointment of Chris Loughlin to the newly created role of Group CEO, leading a new, restructured Pennon Executive team. It also reflects the challenges we face in the recruitment and retention of executive talent.

We have always sought to take a responsible approach to executive remuneration and are mindful of the views of shareholders and wider stakeholders. We have therefore consulted with the shareholder base and, taking on board feedback, have aligned our proposals accordingly.

On pages 88 to 99 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2016/17 including the 'single remuneration figure' table. It also provides details on how our policy will be applied for 2017/18. 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 97% of shareholders who voted approved the annual report on remuneration. The Committee appreciates the support of its shareholders.

Policy review

Over the last year we have undertaken a comprehensive review of all aspects of our executive remuneration arrangements. A particular focus was given to looking at our performance measurement framework afresh against our new Group structure, and to ensure its continued relevance and alignment with strategy and consistency with best practice. Throughout the process, the Committee has received advice from its remuneration advisers, Deloitte LLP, and from the Board Chairman.

This has been the first review of incentive levels for 10 years and, while a number of best practice features have been adopted in recent years, our review has also sought to address recent challenges that Pennon has faced in recruiting talent in a changing talent pool and business environment. Over the last ten years, the complexity of our business has increased, and we are now one of the largest environmental infrastructure groups in the UK.

Our objective continues to be to have remuneration arrangements that ensure the commitment of our Executive Directors to our long-term strategic objectives and to the creation of shareholder value, whilst ensuring their behaviours reflect the values of the organisation and actions are taken in accordance with our high standards of governance.

Remuneration review – the key principles we followed

- Align executive targets with the Company's key strategic objectives
- Ensure a transparent, simple and quitable approach to pay
- Incentivise the delivery of sustainable long-term value to shareholders
- Attract and retain high calibre executives in an increasingly competitive talent market
- Drive the right behaviours at all times from executives
- Support the underlying strategic priorities of operating safely, with an engaged workforce and focus on customer service
- Improve transparency and line of sight under the performance measurement framework
- Apply similar remuneration principles to members of the Pennon Executive
- Seek feedback and input on our proposals from shareholders.

Proposed modifications

As a result of our review, and following input and feedback from shareholders, we are proposing some modifications to our remuneration policy, including a refreshed approach to our performance measurement framework, with metrics which are strongly aligned to our Group strategy and targets which are regarded as stretching.

- **Long-term incentive plan (LTIP) performance measures** – introduction of new performance metrics under our LTIP, aligned with our key strategic objectives. It is proposed, for 2017/18, that LTIP awards will be based on a combination of EPS growth, dividend growth/dividend cover, and return on capital employed (ROCE). These metrics align executives with the delivery of sustainable earnings and related cash flows, as well as our sector-leading dividend policy. We also took account of shareholder feedback and included a portion of the award linked to the long-term capital returns generated by our business. This moves away from our historic approach of using only Total Shareholder Return (TSR). Our review highlighted that it has become increasingly difficult to formulate a robust sector comparator group, and a FTSE 250 group is often counter cyclical to our sector.
- **LTIP opportunity** – a proposed increase to our LTIP opportunity – the first increase to incentive quantum we have made for 10 years. Under the proposed new policy, the maximum opportunity for executive directors will be increased from 100% to 150% of salary. Our recent experience in recruitment has led us to believe that we are not sufficiently competitive in the market. While careful consideration was given to the current climate, the Committee strongly believes that it is in shareholders' interests to enable Pennon to compete for talent on a level playing field, securing an executive team who can deliver long-term business success. Our incentive levels will continue to be positioned conservatively against the market. As a Committee we also recognise the importance of stretching performance metrics in circumstances where we are seeking a higher maximum award.

- **LTIP simplification and performance alignment** – simplification of our long-term incentive framework with the removal of the co-investment element under the new LTIP. In addition, vesting for threshold performance will be reduced from 30% to 25%.
- **Annual bonus performance measures** – an increase in the combined weighting on Group financial metrics and the key operational measures on which performance is assessed by our regulator, customers, communities and wider stakeholders. We are not proposing any change to the existing maximum award or policy that 50% of any bonus is deferred into shares which are normally released after three years.
- **Shareholding guidelines and long-term stewardship** – the size of the shareholding expected to be held by the Executive Directors will be significantly increased from 100% of salary to 200% of salary for both the CEO and CFO. This is to enhance the focus on long-term stewardship and to provide stronger alignment with shareholders.
- **Holding periods** – we introduced two-year holding periods in 2015. We are retaining this feature and are formalising it as part of our policy.

Further details on the remuneration policy are set out on pages 79 to 87.

Overall performance achieved during the year

The Group achieved a strong performance in 2016/17 across its water and waste businesses, delivering against its strategic objectives. Group underlying profit before tax was £250.0 million, an increase of 18.3% compared to 2015/16. Earnings per share (before deferred tax and non-underlying items) was up 19.0% at 47.0p reflecting higher profits.

South West Water's return on regulated equity (RoRE) at 12.6% continues to lead the sector and Viridor generated EBITDA of £107 million during the year, ahead of the target of c.£100 million.

Key remuneration decisions

For 2017/18, salaries for executive directors were increased by 1.5%, consistent with increases awarded to the wider employee population.

The bonus outturns for the Executive Directors for 2016/17 reflect the strong 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 90 and 91.

As regards the Company's long-term incentive plan, the overall estimated outturn for awards vesting in 2017 at the end of the three year period is 43.7% of the maximum 100%. This reflects that the Company's total shareholder return is estimated to exceed both the comparator index performance and the FTSE 250 group.

Board changes

Ian McAulay (CEO of Viridor) stepped down from the Board on 31 August 2016 and left the Group on 31 December 2016. Details of his leaving arrangements are set out on page 92.

Looking forward

We will continue to review our remuneration arrangements and performance measures to ensure they are aligned with our strategy. In conclusion, I hope you find our report this year informative and that we can rely on your vote in favour of the remuneration policy and our annual report on remuneration.

Martin D Angle

Remuneration Committee chairman

Directors' remuneration policy

Introduction

The remuneration policy described in this part of the report is intended to apply to the Company, subject to a binding shareholder vote, following the date of the Company's 2017 AGM which is scheduled to be held on 6 July 2017.

Shareholders will also be asked to approve a revised long-term incentive plan (LTIP). This will replace the current Performance and Co-investment Plan (PCP), which will expire in July 2017.

The Directors' remuneration policy will be displayed on the Company's website at www.pennon-group.co.uk/about-us/governance-and-remuneration, immediately after the 2017 AGM and will be available upon request from the Group Company Secretary.

www.pennon-group.co.uk/about-us/governance-and-remuneration

Changes to the remuneration policy

The Remuneration Committee undertook a comprehensive review of the remuneration policy following the end of a three year period, as well as the expiry of our long-term incentive plan (the existing PCP will expire in July 2017). Following this review, which included a consultation process with our largest shareholders, the key changes to the policy include:

- Re-shaping our performance measurement framework to align with the strategic priorities of the Group
- A proposed increase to our LTIP opportunity to align it better with the market, aiding retention and recruitment – the first increase to incentive quantum we have made for 10 years
- Formalising our existing two year holding period
- Significant increase in our shareholding guidelines for Executive Directors.

Component	Existing policy	New policy	Rationale and link to strategy
Annual bonus	<i>Performance measures</i> Performance targets relate to corporate and personal objectives. Normally 70% relates to financial targets or quantitative measures.	<i>Performance measures</i> Increase in the portion of the award relating to financial and quantitative operational measures – amounting to 80% in 2017/18.	Improved focus on Group measures and reflects new Group management structure. Strong link to measurable financial and operational KPIs which underpin the delivery of our strategy and value to shareholders and our customers.
	<i>Maximum award</i> Maximum award of 100% of salary.	<i>Maximum award</i> No change to the Policy	Retain our current annual bonus maximum with alignment to annual KPIs.
	<i>Deferred element</i> A proportion (usually 50%) of any bonus is deferred into shares in the Company which are normally released after three years.	<i>Deferred element</i> No change to the Policy.	Alignment of executives and shareholders, with a significant portion of any bonus deferred into shares.
LTIP	<i>Performance measures</i> Total shareholder return (TSR) against the performance of a water/waste peer group index and constituents of the FTSE 250 index (excluding investment trusts).	<i>Performance measures</i> A combination of EPS growth, sustainable dividend growth and dividend cover, and return on capital.	Performance measurement framework more closely aligned to Pennon's strategy. Move away from TSR due to increasing challenge in forming robust and relevant comparator group due to sector consolidation and the FTSE 250 group which is often counter cyclical to our sector.
	<i>Co-investment requirement</i> Requirement to acquire co-investment shares equivalent to one-fifth of the value of the award.	<i>Co-investment requirement</i> No co-investment requirement under the new policy.	Simplification of our long-term incentive framework. Shareholdings requirements will significantly increase (see below) but are no longer linked to the LTIP.
	<i>Maximum award</i> Maximum award of 100% of salary.	<i>Maximum award</i> Maximum award of 150% of salary.	Ensure we can recruit and retain executive talent. Following the increase, Pennon will continue to be positioned conservatively against the market.

Component	Existing policy	New policy	Rationale and link to strategy
LTIP (continued)	<i>Threshold vesting</i> 30% of maximum award.	<i>Threshold vesting</i> 25% of maximum award.	Reduced threshold vesting to reflect best practice.
	<i>Holding periods</i> Two-year holding periods were introduced for awards made from 2015.	<i>Holding periods</i> Two-year holding periods will continue to apply (and will be formally included in Policy).	Extend time horizons to five years and enhance long-term focus of executives.
Shareholding requirements	100% of salary for executive directors	200% of salary for both the CEO and CFO.	Strengthen alignment of executives with shareholders and promote long-term stewardship.

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. Where it is intended that certain provisions of the 2014 remuneration policy will continue to apply, this is indicated in the future policy table below.

How the components support 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 and retain high calibre candidates to meet the Company's strategic objectives in an increasingly complex business environment. Base salary reflects the scope and responsibility of the role as well as the skills and experience of the individual.	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. However, the Committee reserves the right to make increases above those made to general employees, for example in circumstances including (but not limited to) an increase in the scope of the role.	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 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 provided are consistent with the market and level of seniority to 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 remain proportionate.	None.
Annual bonus			
Incentivises the achievement of key performance objectives aligned to the strategy of the Company.	Annual bonuses are calculated following finalisation of the financial results for the year to which they relate and are usually paid three months after the end of the financial year. 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. Malus and clawback provisions apply which 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.	The maximum bonus potential for each Director is 100% of base salary.	Performance targets relate to corporate and personal objectives which are reviewed each year. For 2017/18, in relation to the financial and operational measures of the annual bonus framework there will be an 80% overall weighting of which 50% will be profit before tax, 10% return on regulated equity and 20% operational measures. All of these measures will be subject to defined quantitative targets. The measures, weighting and threshold levels may be adjusted for future years. Following the financial year end the Committee, with advice from the Chairman of the Board 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 in exceptional circumstances may exercise its discretion and adjust the bonus to reflect any specific factors.

Directors' remuneration policy

continued

How the components support 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 (LTIP)			
<p>Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.</p>	<p>Annual grant of conditional shares (or equivalent). Share awards vest subject to the achievement of specific performance conditions measured over a performance period of no less than three years.</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>For grants made in 2015 and 2016 onwards under the PCP, as well as all grants made from 2017 under the LTIP, 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. The circumstances in which clawback may be applied are material misstatement or serious misconduct.</p> <p>In addition a 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>	<p>The maximum annual award is 150% of base salary.</p>	<p>The current performance measures for the LTIP are based on a combination of growth in earnings per share (EPS), sustainable dividend growth and dividend cover, and return on capital.</p> <p>For 2017/18 awards, performance measures will be weighted as follows:</p> <ul style="list-style-type: none"> • 40% based on EPS growth • 40% based on a combination of dividend growth and a dividend cover metric • 20% based on return on capital employed. <p>The 'underpin' evaluation includes consideration of safety, environmental, social and governance (ESG) factors as well as financial performance.</p> <p>No more than 25% of maximum vests for minimum performance.</p> <p>The Committee will keep the performance measures and weightings under review and may change the performance condition for future awards if this were considered to be aligned with the Company's interests and strategic objectives, as well as the impact of regulatory changes.</p> <p>However, the Committee would consult with major shareholders in advance of any proposed material change in performance measures.</p> <p>Commitments made under the 2014 policy</p> <p>Performance conditions set under the previous remuneration policy (approved at the 2014 AGM) will continue to apply to awards granted in 2014, 2015 and 2016. These awards are due to vest in 2017, 2018 and 2019 respectively. Previous performance conditions were based on total shareholder return (TSR) against the performance of a water/waste peer group index and constituents of the FTSE 250 index (excluding investment trusts).</p> <p>For awards granted under the 2014 remuneration policy, no more than 30% of the maximum vests for minimum performance.</p>

How the components support 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
Shareholding requirements			
Create alignment between executives and shareholders and promote long-term stewardship.	200% of salary for both the CEO and CFO.		
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. Whilst one Executive Director is a pension member there are no further prospective accruals in respect of defined benefit pension arrangements.	None.
All-employee share plans			
Align the 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.

Directors' remuneration policy continued

Notes to the policy table

Operation of executive share plans

The long-term incentive plan will be operated in accordance with the rules of the plan as approved by shareholders. The deferred bonus awards will be governed by the rules adopted by the Board from time to time. Awards under any of the Company's share plans referred to in this report may:

- Be granted as conditional share awards, nil-cost options or in such other form that the Committee determines has the same economic effect
- Have any performance conditions applicable to them amended or substituted by the Committee if an event occurs which causes the Committee to determine an amended or substituted performance condition would be more appropriate and not materially less difficult to satisfy
- Incorporate the right to receive an amount (in cash or additional shares) equal to the value of dividends which would have been paid on the shares under an award that vest up to the time of vesting (or where the award is subject to a holding period, release). This amount may be calculated assuming that the dividends have been reinvested in the Company's shares on a cumulative basis
- Be settled in cash at the Committee's discretion.

Pre-existing commitments

The Committee reserves the right to make any remuneration payments and/or payments for loss of office (including exercising any discretion available in connection with such payments) outside the policy set out above where the terms of the payment were agreed (i) before the 2014 AGM (the date the Company's first shareholder-approved directors' remuneration policy came into effect); (ii) before the policy set out above came into effect, provided that the terms of the payment were consistent with the shareholder-approved directors' remuneration policy in force at the time they were agreed; or (iii) at a time when the relevant individual was not a director of the Company and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a director of the Company. For these purposes 'payments' includes the Committee satisfying awards of variable remuneration and, in relation to an award over shares, the terms of the payment are 'agreed' at the time the award is granted.

The Executive Share Option Scheme (ESOS) which, under the 2014 remuneration policy, operated in conjunction with the deferred element of the annual bonus, has been removed. No ESOS options have been offered to Executive Directors since 2013.

Early vesting events

On a change of control or voluntary wind up of the Company, LTIP awards may vest to the extent determined by the Committee having regard to the performance of the Company and, unless the Committee determines otherwise, the period of time that has elapsed since grant. Deferred bonus awards may vest in full. Alternatively, participants may have the opportunity, or be required, to exchange their awards for equivalent awards in another company, although the Committee may decide in these circumstances to amend the performance conditions.

The Committee also has the discretion to treat any variation of the Company's share capital or any demerger, special dividend or other transaction that may affect the current or future value of awards as an early vesting event on the same basis as a change of control.

Amendments to the remuneration policy

The Committee may make minor amendments to the policy (for example for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining shareholder approval for that amendment.

Performance measures and targets

The performance conditions for the annual bonus plan are selected by the Committee each year to reflect key performance indicators for the Company and key metrics used by the Board to oversee the operation of the businesses.

In respect of the LTIP, performance conditions for 2017/18 awards will be EPS growth, a sustainable dividend metric (comprising dividend growth and dividend cover) and return on capital employed (ROCE). The Committee chose these measures as they are closely aligned with Pennon's strategic focus on the delivery of sustained earnings and related cash flows, as well as our sector-leading dividend policy. ROCE also measures the long-term capital returns generated by our businesses. The performance targets are set in the context of the Company's forecasts and market expectations, and are regarded as stretching targets.

The Committee may amend performance measures, weightings and targets, in the context of the Company's strategy, the impact of changes to the regulatory framework, accounting standards and any other relevant factors.

The measurement of performance against performance targets is at the Committee's discretion, which may include appropriate adjustments to financial or non-financial elements and/or consideration of overall performance in the round.

Performance conditions may also be replaced or varied if an event occurs or circumstances arise which cause the Committee to determine that the performance conditions have ceased to be appropriate. If the performance conditions are varied or replaced, the amended conditions must, in the opinion of the Committee, be fair, reasonable and materially no less difficult than the original condition when set.

The Committee would consult with major shareholders in advance of any proposed material change in performance measures.

Differences in remuneration policy for all employees

When setting remuneration for Executive Directors the Committee considers relevant information about pay and conditions in the Group. Senior executives and Executive Directors generally receive a higher proportion of their total pay in the form of variable remuneration and share awards. All administrative employees of the Group are entitled to base salary and pension provision including life assurance. In addition all administrative staff in Pennon Group and South West Water and all senior and middle management staff in the operations functions in Viridor are entitled to participate in annual bonus arrangements, the levels of which are based on the seniority and level of responsibility. Long-term incentive share awards are only available to senior executives and Executive Directors, and certain benefits are generally available only to more senior employees at management level and above.

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 components support 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 fees 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, consider the level of fees payable to Non-Executive Directors in other companies of similar scale and complexity.</p>	Total fees paid to Non-executive Directors will remain within the limits stated in the Articles of Association.
Benefits		
The benefits provided for the Chairman 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's benefits include the provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties.</p>	None.

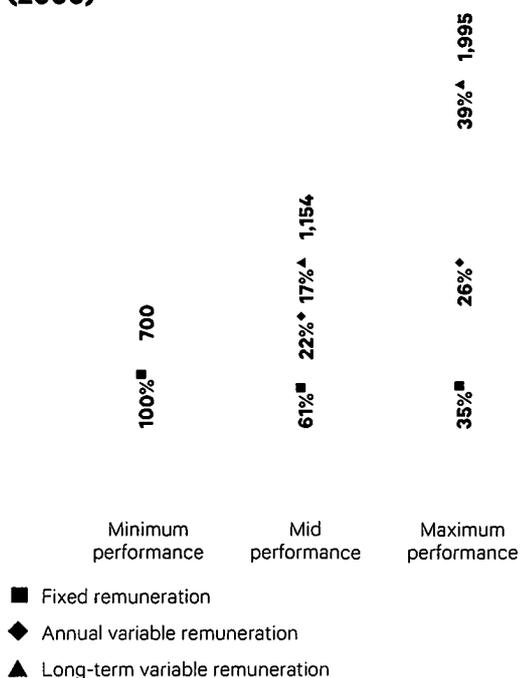
Directors' remuneration policy

continued

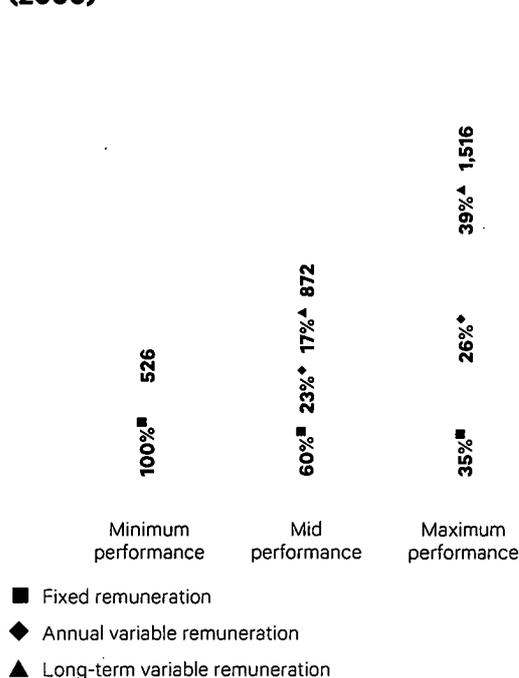
Illustrations of applications of remuneration policy

The total annual remuneration for the Executive Directors that could result from the proposed remuneration policy, based on salaries for 2017/18, is shown below.

Chris Loughlin – Chief Executive Officer (£000)



Susan Davy – Chief Financial Officer (£000)



Scenario	Assumptions
Fees	
Minimum performance	Fixed pay, which constitutes base salary, pension and benefits in kind. These values are made up of the salaries for 2017/18 (set out on page 88) and an estimate of the value of the benefits and pension.
Mid performance	Fixed pay and 50% of the maximum annual bonus and 25% of the maximum long term incentive award.
Maximum	Fixed pay and 100% vesting of the annual bonus and of long-term incentive awards.

No adjustments have been made for potential share price growth or payment of dividends. Benefits from all-employee schemes have also been excluded.

Approach to recruitment remuneration

When considering the appointment of Executive Directors the Committee seeks to balance the need to offer remuneration to attract candidates of sufficient calibre to deliver the Company's strategy whilst remaining mindful of the need to pay no more than is necessary.

The Committee will appoint new Executive Directors with a package that is in line with the remuneration policy that has been agreed by shareholders and is in place at the time. Base salary may be set at a higher or lower level than the previous incumbent.

Other elements of remuneration would be in line with the Company's policy set out in the in the future policy.

The maximum variable pay opportunity on recruitment (excluding 'buyouts') would be in line with the future policy table, being a maximum annual bonus award of 100% of salary and maximum award under the LTIP of 150% of salary.

The Committee may determine for the first year of appointment that any annual bonus will be subject to different weightings or objectives.

To facilitate recruitment it may be necessary to recompense a new Executive Director for the expected value of incentive rewards foregone with their previous employer ('buyout' awards). The

Committee may make buyout awards in accordance with LR9.4.2 of the Listing Rules. The Committee will ensure that any such award would at a maximum match the value of the awards granted by the previous employer and be made only where a Director is able to demonstrate that a loss has been incurred from leaving his or her previous employment. Any buyout would take into account the terms of the arrangement forfeited, including in particular any performance conditions and the time over which they vest. The award would have time horizons which are in line with or greater than the awards forfeited.

For interim positions a cash supplement may be paid rather than salary (for example a Non-executive Director taking on an executive function on a short-term basis).

Where an employee is promoted to the position of Executive Director (including if an Executive Director is appointed following an acquisition or merger), pre-existing awards and contractual commitments would be honoured in accordance with their established terms.

Non-executive Directors fees would be in line with the policy set out in the future policy table on page 83.

Dates of Directors' service contracts/letters of appointment

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

Executive Directors	Date of service contract	Expiry date of service contract
Chris Loughlin*	1 January 2016	At age 67 (20 August 2019)
Susan Davy*	1 February 2015	At age 67 (17 May 2036)
Ian McAulay*	2 August 2013	At age 65 (25 April 2030) Resigned on 31 August 2016

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

Non-Executive Directors	Date of initial letter of appointment	Expiry date of appointment
Sir John Parker	19 March 2015	31 March 2018
Martin Angle	28 November 2008	30 November 2017
Neil Cooper	17 July 2014	30 August 2017
Gill Rider	22 June 2012	30 August 2018

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

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

All Non-Executive Directors are subject to annual re-election and letters of appointment are for an initial three-year term.

Copies of Executive Directors' service contracts and Non-Executive Directors' letters of appointment are available for inspection at the Company's registered office.

Directors' remuneration policy continued

Policy on termination of service agreements and payment for loss of office

The Company's policy is that Executive Directors' service agreements normally continue until the Director's agreed retirement date or such other date as the parties agree. Otherwise they are terminable on one year's notice.

There are no liquidated damages provisions for compensation on termination within Executive Directors' service agreements. Taking into account the circumstances of any termination, the Committee may determine that a payment in lieu of notice should be made. Any such payments would be restricted to salary and benefits. In these circumstances consideration would be given to phasing of payments and an individual's duty and opportunity to mitigate losses.

The Committee reserves the right to make any other payments in connection with a director's cessation of office or employment where

the payments are made in good faith in discharge of an existing legal obligation (or by way of damages for breach of such an obligation) or by way of compromise or settlement of any claim arising in connection with the cessation of a director's office or employment. Any such payments may include but are not limited to paying any fees for outplacement assistance and/or the director's legal and/or professional advice fees in connection with his cessation of office or employment.

The Company may meet ancillary costs, such as outplacement consultancy and/or reasonable legal costs if the Company terminates the Executive Director's service contract.

Any compensation payable will be determined by reference to the terms of the service contract between the Company and the employee, as well as the rules of the various incentive plans as set out in the table below.

Annual bonus	<p>Normally no bonus is payable unless an Executive Director is employed on the date of payment.</p> <p>In certain good leaver circumstances (death, disability, redundancy, retirement and any other circumstance at the Committee's discretion) a bonus may be payable. Any such bonus would be based on performance and pro-rated to reflect the period of service with performance normally assessed at the same time as other employees. The Committee retains discretion to adjust the timing and pro-rating of any award to take account of any prevailing exceptional circumstances which they consider would be fair to the Company and to the employee. Share deferral would not normally apply.</p>
Deferred shares	<p>Unvested awards would normally lapse upon cessation. In certain good leaver circumstances, unless the Committee determines otherwise, the restricted period is not automatically terminated on cessation of employment; rather, the restricted period continues to apply as if the leaver was still in employment. However, awards may be released to participants on cessation of employment at the discretion of the Committee.</p> <p>Good leaver circumstances are death, injury, ill-health, disability, redundancy, retirement, the sale of the individual's employing business or company out of the Group and any other circumstance at the Committee's discretion.</p>
Long-term incentive plan	<p>Any unvested awards would normally lapse upon cessation of the individual's employment within the Group. In certain good leaver circumstances, awards vest to the extent determined by the Committee taking into account the extent to which the performance conditions have been satisfied, the period of time elapsed between grant and the cessation of employment and such other factors as the Committee may deem relevant. Awards would normally vest on the original normal vesting date and be released at the end of the two-year holding period (unless the Committee determines awards should be subject to earlier vesting and release dates).</p> <p>If a participant dies, an award will, unless the Committee determines otherwise, vest and be released at the time of the participant's death, taking into account the extent to which the performance conditions have been satisfied and the period of time elapsed since grant.</p> <p>Good leaver circumstances are death, ill health, injury, disability, redundancy, retirement, where the participant's employer is no longer a member of the Group, where the participant is employed in an undertaking which is transferred out of the Group, or for any other reason that the Committee determines.</p> <p>All awards would lapse if a participant was summarily dismissed.</p>
All-employee awards	Leavers will be treated in accordance with the HMRC approved rules.
Other awards	Where a buyout award is made on recruitment, leaver provisions would be determined at the time of award.

Statement of consideration of employment conditions elsewhere in the Company

In setting executive remuneration the Committee takes account of employment market conditions and the pay and benefits differentials across the Group. The Committee considers annual summary reports of employee remuneration and the terms and conditions of employment within each operating company and has regard to these in setting salary and other benefits for the Executive Directors and senior management. The reports of employee remuneration do not include comparison metrics.

The Committee does not consult with employees when drawing up the Directors' remuneration policy but does take account of the Group-wide policy as described above.

Statement of consideration of shareholder views

The Committee has taken into account general good governance, best practice and shareholder views when formulating the remuneration policy. As part of our recent remuneration review, we carried out an extensive consultation process and consulted our Top 30 shareholders, comprising 63% of the shareholder base. As a result of this process, a number of changes were made to our proposals, including the use of a ROCE metric under our new LTIP and a significant increase in our shareholding guideline, from 100% to 200%, for both the CEO and the CFO.

Annual report on remuneration

Introduction

This section sets out how the Company has applied its remuneration policy in the 2016/17 year, and details how the new policy will be implemented for the year 2017/18. 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 6 July 2017.

Operation of the remuneration policy for 2017/18

A summary of the specific remuneration arrangements for Executive Directors in 2017/18 is described below:

Base salary	<p>2017/18 salaries are:</p> <ul style="list-style-type: none"> Chris Loughlin: £517,650 Susan Davy: £395,850 <p>Salaries were increased by 1.5% in line with increases for all employees.</p>				
Pension and benefits	No changes. Salary supplement cash allowance of 30% for Chris Loughlin and 25% for Susan Davy, from which is deducted the employer's contribution to the defined benefit or defined contribution pension schemes for the Directors.				
Annual bonus	<p>No change to maximum opportunity of 100% of salary. No change to operation of deferral, with 50% of the bonus to be deferred into shares for three years. For 2017/18, the annual bonus will be based on the following performance measures:</p> <p>60% based on Group financial metrics (50% PBT, 10% RoRE).</p> <p>20% based on operational metrics, weighted equally between Waste and Water. These measures will be quantitative and measurable, and are key to meeting the needs of our customers, our regulator, and wider stakeholders.</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">Water metrics</th> <th style="text-align: left;">Waste metrics</th> </tr> </thead> <tbody> <tr> <td> <ul style="list-style-type: none"> Service Incentive Mechanism (SIM) Bathing quality Leakage Waste water pollution incidents Duration of interruptions to supply Waste water and waste asset reliability. </td> <td> <ul style="list-style-type: none"> ERF availability Delivery against recycling action plan Growth in customer base. </td> </tr> </tbody> </table> <p>20% based on personal strategic measures. These will be relevant to the individual, and will include health and safety, environmental performance, development and delivery of commercial priorities for the Group, PR19, and leveraging of synergies.</p> <p>For bonuses from 2014/15 both malus and clawback apply as described in the remuneration policy.</p>	Water metrics	Waste metrics	<ul style="list-style-type: none"> Service Incentive Mechanism (SIM) Bathing quality Leakage Waste water pollution incidents Duration of interruptions to supply Waste water and waste asset reliability. 	<ul style="list-style-type: none"> ERF availability Delivery against recycling action plan Growth in customer base.
Water metrics	Waste metrics				
<ul style="list-style-type: none"> Service Incentive Mechanism (SIM) Bathing quality Leakage Waste water pollution incidents Duration of interruptions to supply Waste water and waste asset reliability. 	<ul style="list-style-type: none"> ERF availability Delivery against recycling action plan Growth in customer base. 				

Long-term incentive plan	<p>Maximum award of 150% of base salary for both the Chief Executive Officer and the Chief Financial Officer.</p> <p>For 2017/18, performance measures will be EPS growth, a sustainable dividend measure and ROCE, with targets set as follows:</p> <p>EPS growth – 40% weighting</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center;">EPS growth pa</th> <th style="text-align: center;">Vesting</th> </tr> </thead> <tbody> <tr> <td>Threshold</td> <td style="text-align: center;">6%</td> <td style="text-align: center;">25%</td> </tr> <tr> <td>Maximum</td> <td style="text-align: center;">10%</td> <td style="text-align: center;">100%</td> </tr> </tbody> </table> <p>Straight-line vesting between threshold and maximum.</p> <p>Sustainable dividend measure (dividend growth and dividend cover) – 40% weighting</p> <p>The performance measure comprises two performance targets, both of which need to be achieved. There is a 'gateway' dividend growth target of RPI+4% per annum.</p> <p>There is then an EBITDA dividend cover target which operates as follows:</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center;">EBITDA dividend cover</th> <th style="text-align: center;">Vesting</th> </tr> </thead> <tbody> <tr> <td>Threshold</td> <td style="text-align: center;">2.6</td> <td style="text-align: center;">25%</td> </tr> <tr> <td>Maximum</td> <td style="text-align: center;">3.6</td> <td style="text-align: center;">100%</td> </tr> </tbody> </table> <p>Straight-line vesting between threshold and maximum.</p> <p>As an additional underpin the board must also be satisfied with the level of EPS dividend cover. EBITDA dividend cover will be based on adjusted EBITDA calculated as (underlying EBITDA + share of JV dividends & interest receivable + IFRIC12 interest receivable).</p> <p>For the purpose of the calculation, dividend cover would be based on the policy of 4% pa above RPI.</p>		EPS growth pa	Vesting	Threshold	6%	25%	Maximum	10%	100%		EBITDA dividend cover	Vesting	Threshold	2.6	25%	Maximum	3.6	100%
	EPS growth pa	Vesting																	
Threshold	6%	25%																	
Maximum	10%	100%																	
	EBITDA dividend cover	Vesting																	
Threshold	2.6	25%																	
Maximum	3.6	100%																	

Long-term
incentive plan
continued

Return on capital employed (ROCE)* – 20% weighting

	Average ROCE	Vesting
Threshold	8%	25%
Maximum	10%	100%

* ROCE is defined as: (operating profit + JV profit after tax + interest receivable) divided by capital employed (debt + equity including hybrid).

Straight-line vesting between threshold and maximum.

The LTIP award will be subject to an 'underpin' relating to overall Group performance including consideration of environmental, social and governance factors and safety performance, as well as financial performance.

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 remuneration policy report.

Performance is measured over three years and a two-year holding period applies.

Shareholding
guideline

200% of salary for both the CEO and CFO.

Non-Executive Director fees

Non-Executive Director fees for 2017/18 are set out below. They include an increase of 1.5% approved by the Board for the Chairman and for the Non-Executive Directors, effective from 1 April 2017.

Role	Fees £
Chairman	270,331
Basic Non-executive Director fee	47,198
Additional fees	
Senior Independent Director fee	7,000
Additional fee for chairman of the Audit Committee	14,210
Additional fee for chairman of the Remuneration Committee	10,150
Additional fee for chairman of the Sustainability Committee	10,150
Committee fee	5,075

Single total figure of remuneration tables (audited information)

	Basic salary/fees (£000)		Benefits ⁽ⁱ⁾ (including Sharesave) (£000)		Annual bonus (cash and deferred shares) (£000)		Long term incentive plan (£000)		Pension ⁽ⁱⁱ⁾ (£000)		Total remuneration (£000)	
	2016/17	2015/16	2016/17	2015/16	2016/17	2015/16	2016/17 ⁽ⁱⁱⁱ⁾	2015/16	2016/17	2015/16	2016/17	2015/16
Executive Directors												
Chris Loughlin ^(iv)	510	427	27	29	429	356	199	224	153	128	1,318	1,164
Susan Davy	390	325	18	18	332	238	73	83	109	91	922	755
Ian McAulay ^(v)	305	400	12	21	–	238	–	–	58	80	375	739
Non-executive directors												
Sir John Parker	266	219	–	–	–	–	–	–	–	–	266	219
Neil Cooper	66	65	–	–	–	–	–	–	–	–	66	65
Martin Angle	67	62	–	–	–	–	–	–	–	–	67	62
Gill Rider	72	65	–	–	–	–	–	–	–	–	72	65

(i) Benefits comprise a car allowance and medical insurance.

(ii) Based on an estimated 43.7% vesting as referred to on page 91 and based on the Company's share price of 836.64p (being the average share price over Q4 2016/17), together with an estimate of the accrued dividends payable on the vesting shares.

(iii) See page 92 for further information.

(iv) Appointed 1 January 2016 – previously Executive Director and Chief Executive, South West Water. For 2015/16, remuneration is aggregate total in the year in respect of both positions.

(v) Stepped down from the Board on 31 August 2016 and left the Group on 31 December 2016.

Annual report on remuneration continued

Annual bonus outturn for 2016/17

The performance targets set and the performance achieved in respect of the annual bonus for 2016/17 for both Executive Directors is set out below. In line with the Committee's policy, 50% of any bonus is payable in shares, the release of which is deferred for a three-year restricted period.

Chris Loughlin

Measure	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS (30% weighting)	37.53p	41.7p	47.96p	47.0p	24.83%
Average South West Water directors' performance (20% weighting)					
The average of the bonus earned by the executive directors of South West Water in respect of targets which related to:					
Operating profit	£224.6m	£229.2m	£233.8m	£237.2m	
Return on regulated equity	7.0%	9.0%	11%	12.6%	
Net debt*					17.56%
Totex outperformance*					
The achievement of a range of service improvements relating to bathing water quality, SIM, leakage, wastewater compliance, pollutions, resolution of operational contacts, duration of supply interruptions, asset reliability and employee engagement.					
Average Viridor directors' performance (20% weighting)					
The average of the bonus earned by the executive directors of Viridor in respect of targets which related to:					
EBITDA + JVs	£119.6m	£132.9m	£146.2m	£142.5m	
Budgeted restructuring savings	£56.1m	£59.0m	£62.0m	£58.7m	
Sales revenue	£731.9m	£770.4m	£808.9m	£785.0m	14.82%
Environmental compliance events	-	11	-	3	
Personal strategic objectives (30% weighting)*					
<ul style="list-style-type: none"> • Successful implementation of new governance arrangements across the Group to ensure these are effective and efficient, with improved processes, communications and development of common services and synergies • Refreshment of Group strategy, including identification of focus and growth areas, as well as agreement of appropriate business model for waste recycling. Establishment of 'Growth Forum' to consider and validate growth opportunities. Centralisation of the recycling business model. Implementation of 'self help' measures for margin (Viridor has improved from 3.2% to 4.7%) • Revision of succession planning process and structure for directors • Enhancement of Pennon's recognition, branding and reputation with internal and external stakeholders. Completion of a group wide rebranding exercise, which following board approval was rolled out throughout the organisation. Results of investor surveys on Pennon brand recognition at investor level • Delivery of strategic priorities around Group level processes, synergies and efficiencies. Achievement of £100 million EBITDA target for ERF, with improvement in recycling margins. Strong progression of Shared Services and establishment of a Group executive 					26.84%
Total outturn					84.05%

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

Susan Davy

Measure	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS (30% weighting)	37.53p	41.7p	47.96p	47.0p	24.83%
Average South West Water directors' performance (20% weighting)	The average of the bonus earned by the executive directors of South West Water in respect of targets which related to:				
Operating profit	£224.6m	£229.2m	£233.8m	£237.2m	
Return on regulated equity	7.0%	9.0%	11%	12.6%	17.56%
Net debt*					
Totex outperformance*	The achievement of a range of service improvements relating to bathing water quality, SIM, leakage, wastewater compliance, pollutions, resolution of operational contacts, duration of supply interruptions, asset reliability and employee engagement.				
Average Viridor directors' performance (20% weighting)	The average of the bonus earned by the executive directors of Viridor in respect of targets which related to:				
EBITDA + JVs	£1196m	£1329m	£146.2m	£142.5m	
Budgeted restructuring savings	£56.1m	£59.0m	£62.0m	£58.7m	14.82%
Sales revenue	£731.9m	£770.4m	£808.9m	£785.0m	
Environmental compliance events	-	11	-	3	
Personal strategic objectives (30% weighting)*	<ul style="list-style-type: none"> Review of the Group's funding strategy, in light of growth requirements and changes to the SWW regulatory framework Reviewing and optimising finance resources and support throughout the Group. Successful centralisation of procurement and property teams, and completion of the review of financial advisors leading to appointment of new brokers Successful delivery of plan to deliver reduction in overheads and cost base. Development of the Growth Board to review growth opportunities across the Group Successful completion of 2016 review of pension valuation and funding position, ensuring appropriate risk and funding exposure 				
Total outturn					85.03%

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

Ian McAulay

Ian McAulay stepped down from the Board on 31 August 2016 and left the Group on 31 December 2016. He did not receive a bonus for the year ended 31 March 2017.

Performance and Co-investment Plan outturn for 2016/17

The PCP awards made on 14 July 2014, which are due to vest on 14 July 2017, are the awards included in the single figure table. The extent to which the awards will vest is subject to the satisfaction of the performance conditions that were in place at the time the awards were made:

- 50% of the award vests subject to the Company's TSR performance measured against an index made up of the following six listed comparator companies:
 - National Grid Plc
 - Séché Environnement
 - Severn Trent
 - Shanks Group
 - Suez Environnement
 - United Utilities
- The remaining 50% of the award vests subject to the Company's ranked TSR performance against the constituents of the FTSE 250 (excluding investment trusts).

Currently it is estimated that the outturn will result in a 43.7% vesting as set out in the table below.

The calculation of TSR performance from the start of the performance period on 1 April 2014 to 10 May 2017 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 2017*	Vesting outturn*
Comparator index (50% of award)	Equal to index	15% above the index	4.87% above the index	26.4%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	52.0%	17.3%
TOTAL				43.7%

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 2017 to 30 June 2017) the achievement and the outturn is an estimate at the date of calculation (11 May 2017)

Vesting of an award is also subject to the 'underpin' described on page 80 which the Committee has determined to the date of this report would be satisfied.

Annual report on remuneration continued

Retirement benefits and entitlements (audited information)

Details of the Directors' pension entitlements and pension-related benefits during the year are as follows:

	Value of defined benefit pension ⁽ⁱ⁾ (£000)	Company contributions to defined contribution arrangements (£000)	Cash allowances in lieu of pension (£000)	Total value for the year (£000)	Normal retirement age and date (for pension purposes)	Accrued pension at 31 March 2017 (£000)
Chris Loughlin	–	–	153	153	67 (20 August 2019)	–
Susan Davy	25	–	84	109	65 (17 May 2034)	18 ⁽ⁱⁱ⁾
Ian McAulay ⁽ⁱⁱⁱ⁾	–	40	18	58	65 (25 April 2030)	–

(i) The value of the defined benefit pension accrued over the period comprises the total pension input amount (which has been calculated in line with regulatory requirements) less the pension contributions paid by the Director.

(ii) Accrued pension is based on service to the year end and final pensionable salary at that date.

(iii) Continued to receive pension benefits until cessation of employment on 31 December 2016.

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.

Susan Davy receives an overall pension benefit from the Company equivalent to 25% of her salary which, in 2016/17 comprised an employer's contribution of £13,554 and a cash sum of £83,946. 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% pa 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 was a member of Pennon Group's defined contribution arrangement and received an overall pension benefit from the Company equivalent to 20% of his salary until the cessation of his employment on 31 December 2016.

No additional benefits will become receivable by a Director in the event that the Director retires early.

Director changes – additional information

Payments in connection with leaving arrangements – Ian McAulay (audited information)

Ian McAulay, stepped down from the Board on 31 August 2016. He left the employment of Viridor Waste Management Limited, on 31 December 2016, at which point salary and benefits ceased to be paid. Mr McAulay did not receive an annual bonus award in respect of the year ended 31 March 2017.

The treatment of Ian McAulay's share awards was in line with the Company's remuneration policy (approved by shareholders at the 2014 AGM):

- Awards made to Mr McAulay in 2014, 2015 and 2016 under the Performance and Co-investment Plan were forfeited in accordance with the Rules of the Plan
- Deferred shares allocated to Mr McAulay in 2014, 2015 and 2016 pursuant to the Annual Incentive Bonus Plan, which related to previous performance periods, were released to him following cessation of his employment on 31 December 2016 at an aggregate value of £269,784. The 3,651 ESOS options granted in 2014 in association with Mr McAulay's 2014 deferred bonus share award lapsed upon his stepping down from the Board
- Deferred shares allocated to Mr McAulay as a buyout award upon his appointment as Chief Executive, Viridor, were released to him on 30 September 2016 (being the end of the three-year restricted period) together with additional shares in lieu of shares that could have been acquired with the amount of each cash dividend on the released shares during the restricted period. The total value was £149,579.

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.

Non-Executive Director fees and benefits

The Non-Executive Directors' fees were increased by the Board for 2016/17 by amounts ranging from 0.6% to 7.3%, 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%.

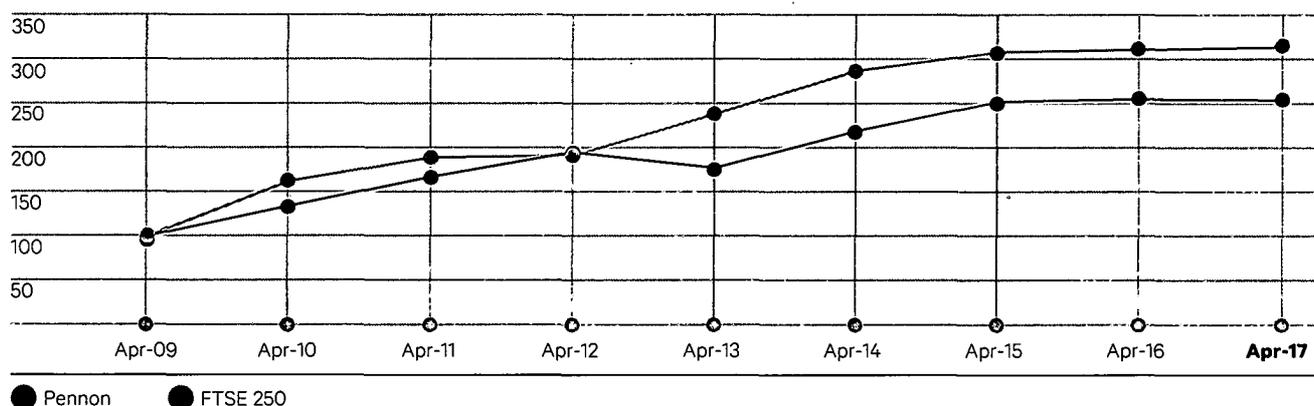
The Chairman's benefits comprise provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties. He is entitled to expenses on the same basis as for the other Non-Executive Directors.

All employee, performance and other contextual information

Historical TSR

The graph below shows the value, over the eight year period ended on 31 March 2017, 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.

Total shareholder return (TSR)



Equivalent chief executive officer remuneration

As the Company did not have a Group Chief Executive Officer until 1 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 CEO) and the Group CEO's remuneration for the year, as explained in footnotes (i) and (ii) below. For 2016/17, the Group CEO's remuneration for the year is shown.

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16 ⁽ⁱ⁾	2015/16 ⁽ⁱⁱ⁾	2016/17 ⁽ⁱⁱⁱ⁾
Average Executive Director single figure of remuneration (£000)	916	1,091	1,221	894	962	762	738	1,119	1,318
Annual bonus payout (% of maximum)	91.79	94.69	72.87	47.00	67.56	68.20	66.37	83.98	84.05
LTIP vesting (% of maximum) ^(iv)	67.30	50.00	79.30	50.00	30.20	0.00	37.90	37.90	43.70^(v)

(i) The average of the Executive Directors, excluding the Group CEO.

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

(iii) Group CEO - first complete year in role.

(iv) The long-term incentive plan (LTIP) vesting percentage excludes accrued dividends which are added on vesting.

(v) The LTIP vesting percentage is an estimate as at 11 May 2017.

Comparison of CEO remuneration to employee remuneration

The table below shows the percentage change between 2015/16 and 2016/17 in base salary, benefits and annual bonus for the Group CEO (from his appointment on 1 January 2016), and all employees.

The percentage increase in average remuneration for employees is calculated using wages and salaries (excluding share-based payments) of £157.1 million (2015/16 £158.0 million), analysed into the three components in the table and the average number of employees of 4,799 (2015/16 4,987) both as detailed in note 13 to the Group financial statements.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
CEO remuneration	n/a	n/a	n/a
All employees	3.31%	0.00%	0.00%

Prior to 1 January 2016 there was no CEO of Pennon Group. The increase in remuneration for Chris Loughlin, following promotion to Group Chief Executive Officer of Pennon from his previous position as Chief Executive, South West Water, is set out in the single total figure of remuneration table on page 89 and is not directly comparable with the general increases to all-employees across the Group. The increase in bonus outturn as a percentage of maximum was 0.1%. The salary increase for 2017/18 is 1.5%.

Annual report on remuneration continued

Relative importance of spend on pay

	2016/17 (£ million)	2015/16 (£ million)	Percentage change
Overall expenditure on pay ⁽¹⁾	179.9	180.0	-0.2%
Distributions to ordinary shareholders	138.5	129.5	6.9%
Distributions to perpetual capital security holders	20.3	20.3	0.0%
Purchase of property, plant and equipment (cash flow)	354.1	283.7	24.8%

(1) Excludes non-underlying items.

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 2016/17

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 /restricted period end date
Chris Loughlin			510		
Susan Davy	PCP	100% of salary	390	30% of maximum	31 March 2019
Ian McAulay			405 ⁽¹⁾		
Chris Loughlin			178		
Susan Davy	Deferred bonus	50% of bonus awarded	119	n/a	4 July 2019
Ian McAulay			119		

(1) This award lapsed when Ian McAulay stepped down from the Board on 31 August 2016.

PCP awards were calculated using the share price at close on 29 June 2016, which was £9.20 per share. The date of grant was 1 July 2016. Deferred bonus awards were calculated using the share price at which shares were purchased on the market on 1 July 2016 in order to satisfy the award, which was £9.5014.

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. For 2016/17, this guideline was 100% of salary for Executive Directors. From 2017/18 the Committee has significantly increased these guidelines to 200% of salary for both the CEO and CFO.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of the Company as at 31 March 2017 (or date of cessation, if earlier) and 31 March 2016 together with their shareholding guideline obligation (based on the 2016/17 guideline of 100% of salary) and interest are shown in the table below:

	Share interests (including connected parties) at 31 March 2017	Share interests (including connected parties) at 31 March 2016	Shareholding guideline	Shareholding guideline met?	Unvested awards			
					Performance shares (subject to performance conditions)	SAYE	Deferred bonus shares	ESOS ⁽ⁱ⁾
Chris Loughlin	290,323	247,745	100%	Yes	153,251	4,984	57,435	-
Susan Davy ⁽ⁱⁱ⁾	57,119	44,197	100%	Yes	100,382	2,635	29,876	-
Ian McAulay ⁽ⁱⁱⁱ⁾	18,748	18,748	-	No longer applicable	-	-	-	-

(i) Details of options that vested under the Executive Share Option Scheme (ESOS) and were exercised during the year are provided on page 97. No share options are held that are vested but have not been exercised.

(ii) 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.

(iii) In respect of Ian McAulay:

- Share interests shown are as at 31 August 2016, being the date he stepped down from the Board
- Unvested awards made to him under the Performance and Co-investment Plan (numbering 137,831 performance awards) have lapsed.
- 33,080 deferred bonus shares were released to him following cessation of his employment on 31 December 2016. His buyout award of 16,091 deferred shares was released following the end of the three-year restricted period, on 30 September 2016.
- His ESOS options, awarded to him on 27 August 2014, have lapsed.

Since 31 March 2017, 4,858 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 59 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 2017 and 22 May 2017.

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 2017	Shares held at 31 March 2016
Sir John Parker	10,000	10,000
Martin Angle	-	-
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 2017 and 22 May 2017.

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 22 May 2017 is as set out below:

	Awarded	Headroom	Total
Discretionary schemes	1.48%	3.52%	5%
All schemes	4.08%	5.92%	10%

Annual report on remuneration continued

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 2016	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 2017	Date of end of period for qualifying conditions to be fulfilled
Chris Loughlin							
02/07/13	57,810	-	653.00p	24,625	224	-	01/07/16
14/07/14	48,465	-	798.50p	-	-	48,465	13/07/17
01/07/15	49,352	-	810.50p	-	-	49,352	30/06/18
01/07/16	-	55,434	920.00p	-	-	55,434	30/06/19
Susan Davy⁽ⁱⁱ⁾							
02/07/13	21,347	-	653.00p	9,093	83	-	01/07/16
14/07/14	17,893	-	798.50p	-	-	17,893	13/07/17
01/07/15	40,098	-	810.50p	-	-	40,098	30/06/18
01/07/16	-	42,391	920.00p	-	-	42,391	30/06/19
Ian McAulay⁽ⁱⁱⁱ⁾							
14/07/14	44,458	-	798.50p	-	-	-	13/07/17
01/07/15	49,352	-	810.50p	-	-	-	30/06/18
01/07/16	-	44,021	920.00p	-	-	-	30/06/19

(i) 37.9% of the July 2013 award shares vested on 1 July 2016 at a market price of 911.24p per share. The total number of shares that vested included additional shares equivalent in value to such number of shares as could have been acquired by reinvesting the dividends which would otherwise have been received on the vested shares during the restricted period of three years. The balance 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.

(iii) Ian McAulay's share awards lapsed upon his stepping down from the Board on 31 August 2016.

Payments to past Directors

David Dupont, who retired as an Executive Director of the Company on 31 January 2015, remained entitled to a pro rata share of the PCP award made on 2 July 2013, his entitlement reflecting the proportion of the restricted period he was employed by the Company. 37.9% of the PCP award made on 2 July 2013 vested on 1 July 2016 and David Dupont received this award, together with additional shares to the value of accrued dividends on such shares, pro rated on the same basis as the award shares, amounting in total to 12,996 shares valued at £118,425 at the date of vesting. The award made to David Dupont on 14 July 2014 lapsed in its entirety, due to his retirement being before the financial year end of the year in which the award was made.

(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 2016	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 2017	Date of end of period for qualifying conditions to be fulfilled
Chris Loughlin							
05/08/13	16,978	–	693.00p	16,040 ⁽ⁱ⁾	141	–	04/08/16
27/08/14	19,552	–	821.50p	–	–	19,552	26/08/17
27/07/15	19,124	–	791.00p	–	–	19,124	26/07/18
04/07/16	–	18,759	950.14p	–	–	18,759	03/07/19
Susan Davy⁽ⁱ⁾							
05/08/13	7,555	–	693.00p	6,617 ⁽ⁱⁱ⁾	58	–	04/08/16
27/08/14	7,543	–	821.50p	–	–	7,543	26/08/17
27/07/15	9,809	–	791.00p	–	–	9,809	26/07/18
04/07/16	–	12,524	950.14p	–	–	12,524	03/07/19
Ian McAulay							
30/09/13	16,091	–	696.00p	18,087 ⁽ⁱⁱⁱ⁾	150	–	29/09/16
27/08/14	7,775	–	821.50p	7,775 ^(iv)	63	–	26/08/17
27/07/15	12,779	–	791.00p	12,779 ^(iv)	104	–	26/07/18
04/07/16	–	12,526	950.14p	12,526 ^(iv)	102	–	03/07/19

- (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 were released on 25 August 2016 at 882.01p per share. Executive share options granted in 2013 pursuant to the ESOS, in conjunction with the operation of the annual bonus plan, were exercised by the Directors on 18 August 2016. Further details are provided below. Deferred bonus shares equivalent in value to the gain on the ESOS options were forfeited.
- (iii) Ian McAulay's buyout award was released at the end of the three-year restricted period, on 30 September 2016, at 827.00p per share. In addition, 1,996 shares were issued, being the number of shares that could have been acquired with the amount of each cash dividend on the released shares during the restricted period.
- (iv) These shares were released on 6 January 2017 following cessation of Ian McAulay's employment on 31 December 2016, at 815.55p per share. ESOS options granted in conjunction with Ian McAulay's 2014 bonus award lapsed upon his stepping down from the Board on 31 August 2016.

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

Chris Loughlin £23,026*; Susan Davy £11,259; Ian McAulay £9,798.

* 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. 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 95.

(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. Under the Company's new remuneration policy, the ESOS has been removed and executive share options are no longer offered in conjunction with deferred bonus shares.

Date of award	Options held at 1 April 2016	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Options held at 31 March 2017	Maturity date
Chris Loughlin							
05/08/13	4,329	–	4,329	693.00p	884.5p	–	–
Susan Davy⁽ⁱ⁾							
05/08/13	4,329	–	4,329	693.00p	884.5p	–	–
Ian McAulay⁽ⁱⁱ⁾							
27/08/14	3,651	–	–	821.50p	–	–	–

- (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 retained an interest in her position as Chief Financial Officer.
- (ii) Ian McAulay's ESOS options lapsed following his stepping down from the Board on 31 August 2016.

Annual report on remuneration continued

(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 2016	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 2017	Options held at 31 March 2017	Exercise period/maturity date
Chris Loughlin								
03/07/13	2,788	-	-	538.00p	-	811.00p	2,788	01/09/18 - 28/02/19
24/06/15	2,196	-	-	683.00p	-	811.00p	2,196	01/09/20 - 28/02/21
Susan Davy								
24/06/15	2,635	-	-	683.00p	-	811.00p	2,635	01/09/18 - 28/02/19

The Remuneration Committee and its advisers

Martin Angle (Committee chairman), Neil Cooper and Gill Rider were members of the Committee throughout the year and at any time when the Committee considered any matter relating to Directors' remuneration during the year.

During the year the Committee received advice or services which materially assisted the Committee in the consideration of remuneration matters from Sir John Parker (Chairman of the Board), Helen Barrett-Hague (Group General Counsel and Company Secretary), Adele Barker (interim Group director of Human Resources), and from Deloitte LLP. Deloitte LLP was appointed directly by the Committee.

Deloitte LLP assisted in the remuneration policy review for Executive Directors and in calculating the Company's total shareholder return compared with two comparator groups for the Company's long-term incentive plan, as well as providing advice on remuneration trends and market practice. Deloitte LLP's fees in respect of advice which materially assisted the Committee during 2016/17 were £88,330 (arrived at from an hourly rate basis of charging). During the year, Deloitte LLP also provided tax, corporate finance and risk advisory services to the Group. 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.

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 1 July 2016, including votes for, against and withheld.

Annual report on remuneration (2016 AGM)	
For % (including votes at the Chairman's discretion)	97.49
Against %	2.51
Withheld number	218,770
Remuneration policy (2014 AGM)	
For % (including votes at the Chairman's discretion)	97.11
Against %	2.89
Withheld number	264,354

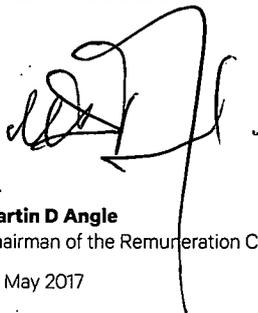
A vote withheld is not counted in the calculation of the proportion of votes 'for' and 'against' a resolution.

The Remuneration Committee is pleased to note that over 97% of shareholders who voted approved the 2015/16 Directors' remuneration report. The Committee appreciates the continuing support of its shareholders.

Directors' remuneration report compliance

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.

On behalf of the Board



Martin D Angle

Chairman of the Remuneration Committee

23 May 2017

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 54 to 73 and 100 to 103 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 46 of the strategic report)
- likely future developments of the Company (pages 24 and 25 of the strategic report)
- important post-balance sheet events (page 25 of the strategic report)
- certain employee matters (page 18 and 19 of the strategic report), as well as the disclosures below.

In addition, there are a number of disclosures which are included in the Directors' report by reference, including:

- financial risk management (note 3 of the notes to the financial statements)
- financial instruments (page 42 of the strategic report and 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 56 and 57. In addition, Ian McAulay, who was Chief Executive, Viridor, and an Executive Director of Pennon Group plc, served during the year until his resignation from the Board on 31 August 2016.

Financial results and dividend

The Directors recommend a final dividend of 24.87 pence per ordinary share to be paid on 1 September 2017 to shareholders on the register on 7 July 2017, making a total dividend for the year of 35.96 pence, the cost of which will be £14.95 million, resulting in a transfer to reserves of £14.8 million. The strategic report on pages 38 to 45 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 18.

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 71, and information regarding the diversity of the workforce is provided on page 19.

Employees are consulted regularly about changes which may affect them either through their trade union-appointed representatives, through consultation groups 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 18 and 19 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 2017 around 41% of the Group's employees were participating in these plans.

Greenhouse gas emissions

Change in emissions

Gross greenhouse gas emissions for the Group this year increased by 14%, primarily as a result of Viridor's newly commissioned energy recovery facilities reaching their full operating capacity.

Viridor's energy recovery facilities burn waste that would otherwise have gone to landfill. This has the double benefit of extracting more of the energy embedded in the waste and substituting energy generated from other, predominantly fossil fuel, sources. There has been a 4% reduction year-on-year in emissions from the Group's landfill sites and a similar percentage increase in renewable energy generation across the Group.

All Group companies benefitted from a reduction in the UK's average electricity grid emissions conversion factor which fell sharply by 11% between 2015/16 and 2016/17. This resulted in an overall reduction in the Group's Scope 2 emissions over the year and saw both South West Water and Bournemouth Water record lower overall emissions than in the previous year.

South West Water recorded an increase in emissions from energy usage associated with the provision of drinking water services driven by an unusually dry year. The company's water resources models signalled the need to protect water resources that would normally be topped-up naturally from rainfall. As a result additional raw water was pumped into reservoirs over the winter period to ensure sufficient water supplies would be available for the subsequent summer period. A corresponding reduction in emissions from energy usage was seen in the waste water side of the business as the lack of rainfall meant less surface water run-off ended up in the sewer system and needed to be pumped.

For the second year in succession the Group's gross Scope 1 and 2 emissions are growing at a faster rate than our revenue. This is reflected in the emissions intensity measure we use of tCO₂e/£100,000 revenue. This indicator has increased this year from 112tCO₂e/£100,000 to 127tCO₂e/£100,000.

Methodology and approach

We have adopted the 'equity share' approach for Viridor companies. This means that emissions from joint venture operations can be accurately attributed to the company in proportion to the percentage of Viridor'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 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.

'Market' and 'Location' based methodology

In 2015 the Greenhouse Gas Protocol introduced the 'market-based' and 'location-based' methodologies for reporting Scope 2 emissions from imported energy. This change of reporting guidance allows organisations that contractually purchase electricity from generators where the supply is backed by appropriate certificates or other instruments to use an emission factor that is specific to the electricity being purchased. No such qualifying supply was procured by Pennon Group companies for 2016/17 and therefore we have decided to continue to report using only the location-based methodology this year, we intend to review this approach again next year.

Organisational boundary

The emissions listed here cover the Pennon Group of companies, each of which uses the financial control approach, except where Viridor use an equity share approach where a joint venture exists.

Operational Scopes

We have measured our Scope 1, 2 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. Certain aspects that relate to the disclosures of South West Water and Bournemouth Water's emissions have been subject to an independent audit of regulatory data conducted by CH2M. The assumptions methods and procedures that are followed in the development of the reported data have been tested and the data audited for accuracy and consistency.

Carbon offsets

We rely on self-generated renewable energy to reduce our overall Scope 2 emissions and 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 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.

Pennon Group plc greenhouse gas emissions

	2016/17	2015/16
Scope 1	1,576,428	1,351,192
Scope 2	144,707	157,089
Scope 3	60,760	56,764
Total gross emissions	1,781,895	1,565,044
Green tariff electricity offset	(1,774)	(2,041)
Exported renewable energy reduction (Up to total amount of electricity purchased and consumed by organisation)	(142,933)	(155,048)
Total annual net emissions	1,637,188	1,407,955
Biogenic emissions outside of scopes	1,692,423	1,767,878
Intensity measure: tCO ₂ e (Gross Scope 1+2)/£100,000 revenue	127.1	112

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 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 which we do not own or control and which are not classed as Scope 2 emissions.

Directors' report – other statutory disclosures continued

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.

In addition, we have 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 our anti-slavery and human trafficking web-based statement for the year is available at www.pennon-group.co.uk.

Research and development

Research and development within the Group involving water and waste treatment processes amounted to £0.2 million during the year (2015/16 £0.1 million).

Overseas branches

The Company has no overseas branches.

Pennon Group donations

During 2016/17 the Group provided a total of £136,000 in charitable donations

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2015/16 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 2016), which was valid as at 31 March 2017 and remains currently valid. No purchases were made during the year. As at 1 April 2016, 10,356 shares were held in treasury, with a nominal value of £4,215 and representing 0.003% of issued share capital. 1,913 treasury shares representing 0.0005% of issued share capital as at 1 April 2016 were reissued during the year under the Company's Executive Share Option Scheme for proceeds of £13,257.

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 2017:

- 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 175. 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) £55,978,817 (such amount to be reduced by any shares allotted or rights granted under (ii) below in excess of £55,978,817); and (ii) £111,957,635 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 2016 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 56 and 57, 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 1 to 51) and the Directors' report (pages 100 to 103) 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 54 to 73 and 100 to 103 was approved by the Board on 23 May 2017.

By Order of the Board



Helen Barrett-Hague
Group Company Secretary

23 May 2017

Our business continues to grow supported by ongoing investment in our assets

This includes improving and future proofing our services with projects such as the Mayflower Water Treatment Works in Plymouth and generating growth through the expansion of our fleet of Energy Recovery Facilities with four new plants due to be operational in Avonmouth, Beddington, Dunbar and Glasgow by 2020.

£191m

Capital investment in South West Water up from £134.1m in previous year

£195m

Capital investment in Viridor up from £182.8m in previous year

**Financial statements and
shareholder information**

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Continued
investment
in our assets

Independent auditor's report to the members of Pennon Group plc

Our opinion on the 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 2017 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 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	
Consolidated statement of comprehensive income	
Balance sheet	Balance sheet
Statement of changes in equity	Statement of changes in equity
Cash flow statement	Cash flow statement
Related notes 1 to 44 to the financial statements	Related notes 1 to 44 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"> • Valuation of non-current assets (Viridor) • Valuation of landfill related provisions (Viridor) • Revenue recognition across the Group's operations • Valuation of the provision for doubtful debts (SWW) • Completeness of provisions for uncertain tax positions and tax disclosures (Group, including SWW & Viridor).
Audit scope	<ul style="list-style-type: none"> • We performed a full scope audit of three components • The components where we performed full scope audit procedures accounted for 100% of Profit before taxation before non-underlying items, 100% of Revenue and 96% of Total assets.
Materiality	<ul style="list-style-type: none"> • Overall Group materiality of £12.5 million 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 our overall audit strategy; the allocation of resources in the audit; and direction of the efforts of the audit team. 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	Key observations communicated to the Audit Committee
<p>Valuation of non-current assets (Viridor)</p> <p><i>Refer to the Audit Committee report (page 63); accounting policies (page 119); and note 17 of the consolidated financial statements (page 139)</i></p> <p>The net book value of Viridor's property, plant and equipment is £1,121 million (2016: £1,012 million), as included in note 17. The Group is required to review the carrying value of assets when impairment indicators are identified. There is risk that assumptions and judgements used by management in determining whether there are any impairment indicators, or in performing impairment reviews when required, could be susceptible to management bias.</p> <p>During the year, as part of the Group-wide Shared Services Review, a decision to rationalise systems resulted in the derecognition of system related assets and a related charge to the income statement of £9.5 million.</p> <p>There is a risk that judgements used to calculate the derecognition charge could include management bias.</p>		<p>Our procedures include:</p> <ul style="list-style-type: none"> • We read management's paper on impairment indicators for other non-current assets, and evaluated whether indicators have been appropriately considered and assessed judgements for evidence of management bias • We compared the current year performance of Viridor with the forecasts produced in the prior year to corroborate management's assessment in relation to indicators of impairment • We inspected other external publicly available information on sector developments, such as EU led recycling targets, to corroborate management's assessment relating to indicators of impairment • We obtained management's analysis of the asset derecognition costs and discussed with management the methods applied to allocate costs and assess enduring values of the assets • We tested a sample of supporting information, including breakdowns of costs incurred, and documentation relating to process design and specification, to evidence the key judgements made by management in calculating the asset derecognition charge • We reperformed management's calculation of the derecognition charge to test for arithmetical accuracy • We tested whether the amounts retained in non-current assets reflected items that have a continuing use in the business by agreeing to supporting documentation, on a sample basis • We agreed whether disclosures made, both in the respect of the consideration of impairment and of the derecognition charge, are in accordance with IFRS. 	<p>We concluded that the assessment performed by management to identify any impairment indicators is appropriate. We concur with management's conclusion that no indicators exist at the balance sheet date.</p> <p>We concluded that, based on the evidence obtained we concur with the approach adopted and the charge recorded in the income statement.</p>
<p>Valuation of landfill related provisions (Viridor)</p> <p><i>Refer to the Audit Committee report (page 63); accounting policies (page 119); and note 32 of the consolidated financial statements (page 157)</i></p> <p>Landfill related provisions of £183.8 million (2016: £182.1 million) are disclosed 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 is a key estimate for the remediation provision.</p> <p>There is a risk that provisions could be misstated due to the complexity of factors to be assessed and if assumptions applied by management are inappropriate, including the impact of any management bias.</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 material estimates made for evidence of management bias, including agreeing anticipated cost savings to detailed plans and current performance • We benchmarked the discount and inflation 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 performed sensitivity analysis on these key assumptions • We tested the aftercare, restoration and remediation provision models, and verified that the models are arithmetically accurate • We compared the key assumptions used in the current models to those used in the prior year, and obtained evidence to corroborate that changes were appropriate. This included obtaining evidence to support the impact of future planned technological changes • We tested the appropriateness of journal entries impacting landfill related provisions, particularly those raised close to the balance sheet date. 	<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 to the members of Pennon Group plc

continued

Risk	Risk direction	Our response to the risk	Key observations communicated to the Audit Committee
<p>Revenue recognition across the Group's operations</p> <p><i>Refer to the Audit Committee report (page 63); accounting policies (page 119); and note 2 of the consolidated financial statements (page 120)</i></p> <p>The Group's material revenue streams relate to the provision of water and sewerage services by South West Water and revenue generated from the renewable energy, recycling and waste management services provided by Viridor. ISAs (UK & Ireland) presume there is a risk of fraud relating to revenue recognition. For the Group, given targets associated to financial performance and pressures to meet market expectations, there is an incentive to overstate revenue. This risk over revenue recognition specifically arises in the following judgemental areas, where there is opportunity to overstate revenue:</p> <p>South West 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 2017 is £72.2 million (2016: £67.8 million) For unmeasured revenue, the bills for each calendar year are raised in advance for the next financial year. 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</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 relating to 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 assessed whether there were any other billing runs for unmeasured revenue that should be excluded from 2016/17 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 revenue was recognised at the correct time in accordance with IFRS We performed analytical procedures by comparing revenue balances for the year against expectation and obtaining support for significant variances We tested a sample of transactions to underlying bills for both types of revenue In performing our journal testing, we paid increased attention to entries impacting revenue, focusing on non-system postings and those raised in the last two weeks of the year. 	<p>South West 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	Key observations communicated 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 based on appropriate assessment of the margin earned during the construction period and during the operational period. The determination of the margin allocated during the different phases of each service concession may involve management judgement • Recognising revenue in the correct period for invoices raised close to the balance sheet date may involve management judgement. 	<p>Viridor</p> <ul style="list-style-type: none"> • We compared the key assumptions and estimates to those made by management in recognising revenue in the prior year. We analysed revenue trends and corroborated unusual movements. We obtained customer confirmations for a sample of revenue • For material items within accrued income we reperformed the calculation of the income that had been earned on waste management contracts and powergen revenue to confirm the accuracy of the accrued income recorded by management • We tested the application of IFRIC12 in respect of construction revenue recognised and whether margins used to recognise revenue are reasonable based on the models used for each contract and comparing the margins to those generated in prior years and to latest projections for future years • We agreed whether the revenue recognition policies adopted comply with IFRSs • 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 • In performing our journal testing, we paid increased attention to entries impacting revenue, particularly those raised close to the balance sheet date. <p>Our procedures include:</p> <ul style="list-style-type: none"> • We performed a walkthrough of the process for calculating the bad debt provision and assessed the design effectiveness of key controls. • We tested the operating effectiveness of key 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, including assessing assumptions for evidence of management bias • We tested the appropriateness of journal entries and adjustments impacting the doubtful debt provision, particularly those raised close to the balance sheet date. 	<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><i>Refer to the Audit Committee report (page 63); accounting policies (page 119); and note 22 of the consolidated financial statements (page 145)</i></p> <p>As shown in note 22, there is a provision of £102.6 million (2016: £95.6 million) at the year end against gross trade debtors of £326.1 million (2016: £303.6 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>During the year management has performed a data mining exercise to refresh the detailed collection data by category of debt.</p> <p>There is a risk that the assumptions used by management in calculating the bad debt provision may be susceptible to management bias and the valuation of the provision against trade receivables may be misstated.</p>	<p>Our procedures include:</p> <ul style="list-style-type: none"> • We performed a walkthrough of the process for calculating the bad debt provision and assessed the design effectiveness of key controls. • We tested the operating effectiveness of key 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, including assessing assumptions for evidence of management bias • We tested the appropriateness of journal entries and adjustments impacting the doubtful debt provision, particularly those raised close to the balance sheet date. 	<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 to the members of Pennon Group plc

continued

Risk	Risk direction	Our response to the risk	Key observations communicated to the Audit Committee
<p>Completeness of provisions for uncertain tax positions and related tax disclosures (Group, including SWW & Viridor)</p> <p><i>Refer to the Audit Committee report (page 63); accounting policies (page 119); and note 27 of the consolidated financial statements (page 148)</i></p> <p>The Group's current tax liability of £26.8 million (2016: £37.1 million) shown in note 27, includes £18.6 million (2016: £37.1 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.</p> <p>In prior periods, significant management judgement has been required in estimating tax expected to be paid in respect of these open periods. However, during the year, the Group has reached resolution with HMRC on a number of areas. This has reduced the level of uncertainty over the year end tax liability and therefore the risk of material misstatement has reduced.</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 opinions management was 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 our 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 the settlement proposal agreed with HMRC and consideration of other open uncertain tax positions • 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 Group has recorded an appropriate provision for uncertain tax positions.</p> <p>We concluded that the tax amounts and disclosures in the Annual Report and Accounts for the year ended 31 March 2017 are appropriate.</p>

In the prior year, our auditor's report included a risk of material misstatement in relation to valuation of goodwill. In the current year, we concluded the likelihood of material misstatement has reduced as a further year of experience has provided management with more confidence that the business plan will be met, and the impairment test is less sensitive to changes in assumptions.

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 five reporting components of the Group, we performed an audit of the complete financial information of three components ('full scope components') which were selected based on their size or risk characteristics. These components include Pennon Group plc, Viridor and South West Water, and represent the principal business units within the Group.

For the current year, the full scope components contributed 100% (2016: 100%) of the Group's profit before taxation before non-underlying items, 100% (2016: 100%) of the Group's Revenue and 96% (2016: 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, has merged with South West Water and therefore balances are included within the South West Water component, which was designated as full scope for the current year audit. The second change was that the scope determined for Peninsula Insurance was changed from review scope to other procedures, reflecting the fact that, with the growth in Group activities, including profit before taxation before non-underlying items, this component is less than 1% of the Group.

Involvement with component teams

We perform audit procedures for the Group and its components at the South West Water and Viridor locations. The audit teams of Pennon Group plc and South West Water are led by the same audit partner. A separate team audits Viridor and is led by a separate audit partner. The Group 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 £12.5 million (2016: £10 million), which is 5% (2016: 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 £210.5 million (2016: £206.3 million).
Adjustments	Non-underlying items – increase basis by £39.5 million (2016: £5.0 million).
Materiality	Totals £250.0 million (2016: £211.3 million) profit before taxation before non-underlying items. Materiality of £12.5 million (5% of profit before taxation before non-underlying 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% (2016: 75%) of our planning materiality, namely £9.4 million (2016: £7.5 million). This is based on our assessment of the Group's internal control environment and the extent and nature of audit findings identified in the prior period and is consistent with the prior year.

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 £4.4 million to £8.4 million (2016: £1.5 million to £7.1 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 £0.6 million (2016: £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

Independent auditor's report to the members of Pennon Group plc

continued

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 103, 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.

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; and
- based on the work undertaken in the course of the audit:
 - 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;
 - the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

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>In light of the knowledge and understanding of the Company and its environment obtained in the course of the audit, we have identified no material misstatements in the Strategic Report or Directors' Report.</p> <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. 	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 103 and longer-term viability, set out on page 51; 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.

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:

- 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.

We have nothing material to add or to draw attention to.


Debbie O'Hanlon

(Senior statutory auditor)

for and on behalf of Ernst & Young LLP, Statutory Auditor

Reading

23 May 2017

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 2017

	Notes	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m	Before non-underlying items 2016 £m	Non-underlying items (note 6) 2016 £m	Total 2016 £m
Revenue	5	1,353.1	–	1,353.1	1,352.3	–	1,352.3
Operating costs	7						
Employment costs		(179.7)	(1.1)	(180.8)	(180.0)	(8.6)	(188.6)
Raw materials and consumables used		(115.8)	–	(115.8)	(114.7)	–	(114.7)
Other operating expenses		(571.6)	(9.6)	(581.2)	(609.2)	(1.6)	(610.8)
Earnings before interest, tax, depreciation and amortisation	5	486.0	(10.7)	475.3	448.4	(10.2)	438.2
Depreciation and amortisation	7	(181.4)	–	(181.4)	(186.6)	–	(186.6)
Operating profit	5	304.6	(10.7)	293.9	261.8	(10.2)	251.6
Finance income	8	36.3	16.0	52.3	42.1	5.2	47.3
Finance costs	8	(95.1)	(44.8)	(139.9)	(96.2)	–	(96.2)
Net finance costs	8	(58.8)	(28.8)	(87.6)	(54.1)	5.2	(48.9)
Share of post-tax profit from joint ventures	20	4.2	–	4.2	3.6	–	3.6
Profit before tax	5	250.0	(39.5)	210.5	211.3	(5.0)	206.3
Taxation (charge)/credit	9	(58.4)	28.4	(30.0)	(72.1)	34.1	(38.0)
Profit for the year		191.6	(11.1)	180.5	139.2	29.1	168.3
Attributable to:							
Ordinary shareholders of the parent		175.4	(11.1)	164.3	123.0	29.1	152.1
Perpetual capital security holders		16.2	–	16.2	16.2	–	16.2
Earnings per ordinary share (pence per share)	11						
– Basic				39.8			37.0
– Diluted				39.6			36.9

Consolidated statement of comprehensive income

For the year ended 31 March 2017

	Notes	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m	Before non-underlying items 2016 £m	Non-underlying items (note 6) 2016 £m	Total 2016 £m
Profit for the year		191.6	(11.1)	180.5	139.2	29.1	168.3
Other comprehensive (loss)/ income							
<i>Items that will not be reclassified to profit or loss</i>							
Remeasurement of defined benefit obligations	30	(23.6)	–	(23.6)	(26)	–	(26)
Income tax on items that will not be reclassified	9, 31	4.7	(1.4)	3.3	0.6	(3.0)	(2.4)
Total items that will not be reclassified to profit or loss		(18.9)	(1.4)	(20.3)	(2.0)	(3.0)	(5.0)
<i>Items that may be reclassified subsequently to profit or loss</i>							
Share of other comprehensive income from joint ventures	20	0.3	–	0.3	2.4	–	2.4
Cash flow hedges		4.9	–	4.9	5.0	–	5.0
Income tax on items that may be reclassified	9, 31	(1.0)	(0.3)	(1.3)	(1.0)	(0.8)	(1.8)
Total items that may be reclassified subsequently to profit or loss		4.2	(0.3)	3.9	6.4	(0.8)	5.6
Other comprehensive (loss)/ income for the year net of tax	36	(14.7)	(1.7)	(16.4)	4.4	(3.8)	0.6
Total comprehensive income for the year		176.9	(12.8)	164.1	143.6	25.3	168.9
Total comprehensive income attributable to:							
Ordinary shareholders of the parent		160.7	(12.8)	147.9	127.4	25.3	152.7
Perpetual capital security holders		16.2	–	16.2	16.2	–	16.2

The notes on pages 119 to 172 form part of these financial statements.

Balance sheets

At 31 March 2017

	Notes	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Assets					
Non-current assets					
Goodwill	15	385.0	385.0	-	-
Other intangible assets	16	67.1	63.8	-	-
Property, plant and equipment	17	4,103.2	3,897.3	0.2	0.1
Other non-current assets	19	308.0	267.8	1,011.6	905.5
Deferred tax assets	31	-	-	2.3	2.2
Derivative financial instruments	23	73.6	62.7	3.1	1.3
Investments in subsidiary undertakings	20	-	-	1,624.2	1,628.3
Investments in joint ventures	20	0.1	0.1	-	-
		4,937.0	4,676.7	2,641.4	2,537.4
Current assets					
Inventories	21	21.3	20.6	-	-
Trade and other receivables	22	340.8	323.5	127.3	77.4
Derivative financial instruments	23	14.1	9.5	1.1	0.5
Cash and cash deposits	25	598.1	632.2	372.5	429.7
		974.3	985.8	500.9	507.6
Liabilities					
Current liabilities					
Borrowings	28	(146.5)	(65.0)	(357.8)	(287.2)
Financial liabilities at fair value through profit	24	(2.4)	(2.2)	-	-
Derivative financial instruments	23	(17.3)	(17.4)	(2.1)	(2.7)
Trade and other payables	26	(286.5)	(264.6)	(6.3)	(5.9)
Current tax liabilities	27	(26.8)	(37.1)	(37.9)	(53.5)
Provisions	32	(40.4)	(50.4)	-	-
		(519.9)	(436.7)	(404.1)	(349.3)
Net current assets		454.4	549.1	96.8	158.3
Non-current liabilities					
Borrowings	28	(3,116.5)	(3,051.6)	(848.2)	(877.1)
Other non-current liabilities	29	(180.7)	(113.2)	(53.0)	(8.7)
Financial liabilities at fair value through profit	24	(48.4)	(51.0)	(1.4)	(1.6)
Derivative financial instruments	23	(25.2)	(38.5)	(1.3)	(9.1)
Retirement benefit obligations	30	(68.0)	(40.9)	(4.1)	(3.0)
Deferred tax liabilities	31	(269.6)	(272.0)	-	-
Provisions	32	(173.8)	(171.0)	-	-
		(3,882.2)	(3,738.2)	(908.0)	(899.5)
Net assets		1,509.2	1,487.6	1,830.2	1,796.2
Shareholders' Equity					
Share capital	33	168.4	167.8	168.4	167.8
Share premium account	34	217.4	213.3	217.4	213.3
Capital redemption reserve	35	144.2	144.2	144.2	144.2
Retained earnings and other reserves	36	684.4	667.5	1,005.4	976.1
Total shareholders' equity		1,214.4	1,192.8	1,535.4	1,501.4
Perpetual capital securities	37	294.8	294.8	294.8	294.8
Total equity		1,509.2	1,487.6	1,830.2	1,796.2

The profit for the year attributable to ordinary shareholders' equity dealt within the accounts of the parent Company is £162.9 million (2016 £91.4 million).

The notes on pages 119 to 172 form part of these financial statements.

The financial statements on pages 114 to 172 were approved by the Board of Directors and authorised for issue on 23 May 2017 and were signed on its behalf by:



Chris Loughlin, Chief Executive Officer 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 2017

	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 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
<i>Transactions with equity shareholders:</i>						
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	-	-	-	(11)	-	(11)
Proceeds from treasury shares reissued	-	-	-	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
Profit for the year	-	-	-	164.3	16.2	180.5
Other comprehensive loss for the year	-	-	-	(16.4)	-	(16.4)
Total comprehensive income for the year	-	-	-	147.9	16.2	164.1
<i>Transactions with equity shareholders:</i>						
Dividends paid	-	-	-	(138.5)	-	(138.5)
Adjustment for shares issued under the Scrip Dividend Alternative	0.3	(0.3)	-	6.9	-	6.9
Adjustment in respect of share-based payments (net of tax)	-	-	-	3.2	-	3.2
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	0.1	1.2	-	(2.6)	-	(1.3)
Proceeds from shares issued under the Executive Share Option Scheme	-	0.2	-	-	-	0.2
Proceeds from shares issued under the Sharesave Scheme	0.2	3.0	-	-	-	3.2
Total transactions with equity shareholders	0.6	4.1	-	(131.0)	(16.2)	(142.5)
At 31 March 2017	168.4	217.4	144.2	684.4	294.8	1,509.2

The notes on pages 119 to 172 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 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
<i>Transactions with equity shareholders:</i>						
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 reissued	-	-	-	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
Profit for the year (note 10)	-	-	-	162.9	16.2	179.1
Other comprehensive loss for the year	-	-	-	(1.1)	-	(1.1)
Total comprehensive income for the year	-	-	-	161.8	16.2	178.0
<i>Transactions with equity shareholders:</i>						
Dividends paid	-	-	-	(138.5)	-	(138.5)
Adjustment for shares issued under the Scrip Dividend Alternative	0.3	(0.3)	-	6.9	-	6.9
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)	-	-	-	1.2	-	1.2
Charge in respect of share options vesting	-	-	-	(2.1)	-	(2.1)
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	-	0.2	-	-	-	0.2
Proceeds from shares issued under the Executive Share Option Scheme	0.1	1.2	-	-	-	1.3
Proceeds from shares issued under the Sharesave Scheme	0.2	3.0	-	-	-	3.2
Total transactions with equity shareholders	0.6	4.1	-	(132.5)	(16.2)	(144.0)
At 31 March 2017	168.4	217.4	144.2	1,005.4	294.8	1,830.2

The notes on pages 119 to 172 form part of these financial statements.

Cash flow statements

For the year ended 31 March 2017

	Notes	Group		Company	
		2017 £m	2016 £m	2017 £m	2016 £m
Cash flows from operating activities					
Cash generated/(outflow) from operations	38	431.5	371.3	(159.0)	(41.7)
Interest paid	38	(76.4)	(79.1)	(39.1)	(35.3)
Tax paid		(36.4)	(45.0)	(8.4)	(10.7)
Net cash generated/(outflow) from operating activities		318.7	247.2	(206.5)	(87.7)
Cash flows from investing activities					
Interest received		14.5	14.9	49.6	51.3
Dividends received	44	4.5	6.0	247.0	140.7
Investments in subsidiary undertakings		-	-	-	(100.3)
Loan repayments received from joint ventures		0.3	275	-	-
Acquisitions, net of cash acquired		-	(91.0)	-	-
Purchase of property, plant and equipment		(354.1)	(283.7)	(0.2)	(0.1)
Proceeds from sale of property, plant and equipment		4.1	6.8	0.1	-
Net cash (used in)/received from investing activities		(330.7)	(319.5)	296.5	91.6
Cash flows from financing activities					
Proceeds from treasury shares reissued	33	-	2.5	-	2.5
Proceeds from issuance of ordinary shares		4.7	100.1	4.7	100.1
Purchase of ordinary shares by the Pennon Employee Share Trust		(2.6)	(11)	-	-
Return/ (deposit) of restricted funds		2.7	(30.3)	9.7	(9.7)
Proceeds from new borrowing		130.0	80.0	-	1.0
Repayment of borrowings		(39.0)	(96.5)	-	(66.8)
Finance lease sale and lease back		60.7	30.4	-	-
Finance lease principal repayments		(24.0)	(38.4)	-	-
Dividends paid		(131.6)	(123.2)	(131.6)	(123.2)
Perpetual capital securities periodic return	37	(20.3)	(20.3)	(20.3)	(20.3)
Net cash used in financing activities		(19.4)	(96.8)	(137.5)	(116.4)
Net decrease in cash and cash equivalents		(31.4)	(169.1)	(47.5)	(112.5)
Cash and cash equivalents at beginning of the year	25	405.7	574.8	420.0	532.5
Cash and cash equivalents at end of the year	25	374.3	405.7	372.5	420.0

The notes on pages 119 to 172 form part of these financial statements.

Notes to the financial statements

1. 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 2016/17 Pennon Group's business was operated through two main subsidiaries. South West Water Limited includes the merged water companies of South West Water and Bournemouth Water, providing water and wastewater services in Devon, Cornwall and parts of Dorset and Somerset and water only services in parts of Dorset, Hampshire and Wiltshire. Viridor Limited's business is recycling, energy recovery and waste management.

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), (w) and (o) 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 103.

The new standards or interpretations which were mandatory for the first time in the year beginning 1 April 2016 did not have a material impact on the net assets or results of the Group.

It is anticipated that adoption of the following standard could impact the Group's future results as set out below:

- IFRS 16 'Leases' no longer distinguishes between an on the balance sheet finance lease and an off the 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 affect primarily the accounting for the Group's operating leases. As at the reporting date, the group has non-cancellable operating lease commitments of £143 million, see note 41. The Group is assessing the extent to which these commitments will result in the recognition of an asset and a liability for future payments and how this will affect the group's profit and classification of cash flows. Existing borrowing covenants are not impacted by changes in accounting standards.

Other new standards or interpretations in issue, but not yet effective, including IFRS 15 'Revenue from contracts with customers' and IFRS 9 'Financial instruments' are not expected to have a material impact on the Group's net assets or results.

(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.

Notes to the financial statements

continued

2. Principal accounting policies continued

(c) Revenue recognition

Revenue represents the fair value of consideration receivable in the ordinary course of business for the provision of goods and services to customers, and is recognised to the extent that it can be reliably measured and that it is probable that economic benefits will flow to the Group.

Revenue excludes value added tax, trade discounts and revenue arising from transactions between Group companies. Revenue includes landfill tax.

In respect of ongoing, continuous services to customers, such as the provision of drinking water and wastewater services, revenue is recognised in line with the customer using those services. Where applicable, this includes both billed amounts for estimated usage and an estimation of the amount of unbilled usage at the period end.

Revenue in respect of construction services on long-term contracts, including the provision of service concession arrangements, is recognised based on the fair value of work performed during the year with reference to the total sales value and the stage of completion of those services.

Where a contract with a customer includes more than one service, such as a long-term service concession arrangement, revenue for each service is recognised in proportion to a fair value assessment of the total contract value split across the services provided.

Revenue in respect of goods, such as recyclate, is recognised when the significant risks and rewards of ownership have been transferred to the customer. For other services, encompassing waste management services, revenue is recognised once the services have been provided to the customer.

Revenue from the sale of electricity from our generating assets is measured based upon metered output delivered at rates specified under contract terms or prevailing market rates as applicable.

Payments received in advance of services provided are held within liabilities.

(d) Landfill tax

Landfill tax is recognised in both revenue and operating costs at the point waste is disposed of at a licensed landfill site.

(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 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 contracted.

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

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.

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 on a straight-line basis over the life of the lease.

(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.

Notes to the financial statements

continued

2. Principal accounting policies continued

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 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.

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 in 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 as appropriate.

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 where they arise 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 aftercare 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 reissued. Where such shares are subsequently reissued, 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.

Notes to the financial statements

continued

2. Principal accounting policies continued

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.

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 and to maintain 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 requires that no more than 20% of Group net borrowings should 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 Viridor Limited's EBITDA plus interest receivable on service concession arrangements) and interest cover. Existing covenants are not impacted by subsequent changes to accounting standards.

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 2017					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	116.0	181.5	258.5	1,322.7	1,878.7
Interest payments on borrowings	49.5	49.3	131.4	679.5	909.7
Finance lease liabilities including interest	44.3	43.0	202.3	2,021.3	2,310.9
Trade and other payables	286.5	44.3	-	-	330.8
Guarantees	187.5	-	-	-	187.5
Derivative financial liabilities					
Derivative contracts – net payments/(receipts)	8.6	7.0	(4.1)	(74.8)	(66.3)
31 March 2016					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	39.0	116.1	327.5	1,293.4	1,776.0
Interest payments on borrowings	47.9	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)
Company					
31 March 2017					
Non-derivative financial liabilities					
Borrowings excluding intercompany borrowings	74.9	149.5	148.1	511.5	884.0
Intercompany borrowings	282.9	39.1	-	-	322.0
Interest payments on borrowings	29.2	28.8	70.6	94.0	222.6
Trade and other payables	6.3	44.3	-	-	50.6
Guarantees	743.4	-	-	-	743.4
Derivative financial liabilities					
Derivative contracts – net payments	1.3	1.1	-	-	2.4
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

No liability is expected to arise in respect of the guarantees noted above. Guarantees are analysed in note 42.

Notes to the financial statements

continued

3. Financial risk management continued

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 69% (2016 67%) of Group net borrowings were at fixed rates (including at least 50% of South West Water's borrowings) 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.

20% (2016 22%) of the Group's net borrowings are RPI index-linked. 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.

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 2017 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 £0.3 million (2016 £0.1 million), for the equity sensitivity fair value, with derivative impacts excluded.

For 2017 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 (2016 £1.9 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 notes 19 and 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 board approved minimum criteria based on their short-term credit ratings and therefore of good credit quality.

(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 2017 the Group had cash and facilities, including restricted funds, of £1.4 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:

	2017 £m	2016 £m
Net borrowings (note 39)	2,664.9	2,484.4
Total equity	1,509.2	1,487.6
Total capital	4,174.1	3,972.0
Gearing ratio	63.8%	62.5%

The Water segment is also monitored on the basis of the ratio of its net borrowings to Regulatory Capital Value (RCV). Ofwat's optimum gearing for the K6 (2015-2020) regulatory period is set at 62.5%.

	Water Business	
	2017 £m	2016 £m
Regulatory Capital Value	3,290.6	3,150.2
Net borrowings	2,033.8	1,880.0
Net borrowings/Regulatory Capital Value	61.8%	59.7%

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.

(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.

Estimates

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 aftercare provision is particularly sensitive to the estimated volumes of leachate and their associated cost, together with the discount rate used to establish the provision.

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 2017 the Group's environmental and landfill restoration provisions were £183.8 million (2016 £182.1 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 2017 these assets had a net book value of £14.3 million (2016 £11.7 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 2015 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.

Notes to the financial statements

continued

4. Critical accounting judgements and estimates continued

Estimates continued

Taxation

The Group's current tax provision of £26.8 million, reduced from £37.1 million in 2015/16, includes £18.6 million related to prior year tax items (2016 £37.1 million).

In 2015/16 the Group reported significant judgement around uncertain tax items related to the interpretation of tax legislation regarding financial arrangements entered into in the normal course of business, which could have resulted in a range of outcomes of additional liabilities of c£20 million, to a reduction in liabilities of £52 million. Following engagement and subsequently resolution with HMRC across a number of areas, achieved through a process designed to expedite outstanding tax matters, these items are no longer an area of significant judgement and there is no such range related to ongoing uncertain tax items.

The Group has a small number of ongoing uncertain tax items related to capital allowances for expenditure incurred in the normal course of business, where the Group has paid in full the tax HMRC interpret as due, and therefore would receive up to £20 million (2015/16 £70 million) should these tax items 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. At the balance sheet date the Group recognised contract receivables of £217.6 million (2016 £201.9 million) and other intangible assets of £61.3 million (2016 £55.0 million) in relation to its service concession arrangements.

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 judgement is used in the allocation between these three elements, this assessment reflects external market conditions according to the type of service provided and project specific cash flow expectations, including the recovery of costs from the original contractor on our Glasgow concession.

Revenue recognition

The Group recognises revenue at the time of delivery of services. Payments received in advance of services delivered are recorded as liabilities.

South West Water raises bills and recognises revenue in accordance with its entitlement to receive revenue in line with the limits established by the Periodic Review price-setting process. For water and 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. The accrued income balance in this area at the balance sheet date was £77.7 million (2016 £67.8 million).

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. Revenue is accrued from the sale of electricity from our generating assets based upon metered output delivered at rates specified under contract terms or prevailing market rates as applicable. The total accrued income balance in relation to these areas at the balance sheet date was £42.8 million (2016 £37.8 million).

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 2017 the Group's current trade receivables were £321.6 million (2016 £303.6 million), against which £98.1 million (2016 £95.6 million) had been provided for impairment (note 22).

Judgements

Impairment of non-financial assets

In order to determine whether impairments, or reversals of previous impairments, are required for non-financial assets, the Group assesses whether there are any indicators for further impairment or reversal during the year. The assessment includes a review of changes in markets and discount rates over the year, together with a review of CGU business performance against expectations. The 2016/17 review concluded there were no indicators of further impairment or reversal.

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. See note 6 for further details.

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. The waste management business is the recycling, energy recovery and waste management 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 borrowings 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.

	2017 £m	2016 £m
Revenue		
Water	561.0	547.0
Waste management	793.5	806.2
Other	12.8	12.0
Less intra-segment trading*	(16.2)	(12.9)
	1,353.1	1,352.3
Segment result		
Operating profit before depreciation, amortisation and non-underlying items (EBITDA)		
Water	349.1	335.2
Waste management	138.3	116.5
Other	(1.4)	(3.3)
	486.0	448.4
Operating profit before non-underlying items		
Water	235.4	224.5
Waste management	71.1	40.9
Other	(1.9)	(3.6)
	304.6	261.8
Profit before tax and non-underlying items		
Water	173.9	165.7
Waste management	60.4	30.7
Other	15.7	14.9
	250.0	211.3
Profit before tax		
Water	187.4	160.5
Waste management	50.2	25.7
Other	(27.1)	20.1
	210.5	206.3

* 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 2017					
Assets (excluding investments in joint ventures)	3,495.0	2,099.9	1,856.8	(1,540.5)	5,911.2
Investments in joint ventures	-	0.1	-	-	0.1
Total assets	3,495.0	2,100.0	1,856.8	(1,540.5)	5,911.3
Liabilities	(2,667.2)	(1,697.4)	(1,578.0)	1,540.5	(4,402.1)
Net assets	827.8	402.6	278.8	-	1,509.2
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

Segment liabilities of the water and waste management segments comprise of operating liabilities and borrowings. The other segment liabilities include the Group taxation liabilities.

	Notes	Water £m	Waste management £m	Other £m	Group £m
Other information					
31 March 2017					
Amortisation of other intangible assets	7	0.5	2.7	-	3.2
Capital expenditure	17	190.9	186.5	0.1	377.5
Depreciation	7	113.5	64.6	0.1	178.2
Finance income (before non-underlying items)	8	1.5	26.3	8.5	36.3
Finance costs (before non-underlying items)	8	62.3	12.3	20.5	95.1
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

	2017 £m	2016 £m
Revenue		
United Kingdom	1,287.6	1,296.1
Rest of European Union	10.3	10.5
China	45.1	38.8
Rest of World	10.1	6.9
	1,353.1	1,352.3

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 in the year and business trends over time. This presentation of results is consistent with internal performance monitoring.

	Notes	2017 £m	2016 £m
Operating costs			
Restructuring costs ^(a)	17, 32	(10.7)	(10.2)
Total operating costs		(10.7)	(10.2)
Remeasurement of fair value movement in derivatives ^(b)	8	16.0	5.2
Unwind of synthetic derivative ^(c)	8	(44.8)	-
Deferred tax change in rate ^(d)	31	21.3	33.1
Tax credit arising on non-underlying items	9	7.1	1.0
Net non-underlying (charge)/ credit		(11.1)	29.1

- (a) During the year a one-off charge of £10.7 million was made relating to restructuring costs associated with the Group-wide Shared Services Review. The £10.7 million charge consists of a £9.5 million non-cash charge to other operating expenses relating to a rationalisation of systems leading to an asset de-recognition, and a £1.1 million charge to manpower costs and a £0.1 million charge to other operating costs in relation to restructuring provisions. The charge is considered non-underlying due to its size and non-recurring nature.

Last year a one-off charge of £10.2 million was made to the restructuring provision reflecting announced reorganisations across the Group.

- (b) In the year a credit of £16.0 million was recognised relating to non-cash derivative fair value movements associated with derivatives that are not designated as being party to an accounting hedge relationship. These movements are non-underlying due to the nature of the item being market dependant and potentially can be significant in value (size).

- (c) Since 2011 the Group has received a fixed interest rate on a £200 million financial asset and paid an index-linked interest rate on a £200 million loan, designed to improve the Group's overall interest rate performance. The counterparty to both instruments was Peninsula MB Limited (PMB). In combination, these instruments were accounted for as a derivative, with a net interest income of £8 million p.a., c£7 million in 2016/17, cash settled.

In periods of index underperformance, losses arose in PMB which were group relieved with the Group. Following a change in legislation, which saw the value of the derivative to the Group moving from a liability of £4 million to a liability of c£40 million, the Group made the decision to exit the transaction.

On 10 February 2017 the Company unwound this transaction. The derivative had been due to end in 2027, however, following a change in the economic benefit of this derivative due to a change in legislation which impacted the derivative's future cash flows, the Company exercised its option to unwind the transaction early.

The process for unwinding the derivative resulted in the Group acquiring a financial asset for £283 million and a financial liability for £239 million from Nomura Structured Holdings plc. The counterparty to both these transactions was PMB. Simultaneously, the Company also acquired the remaining 25% of PMB's share capital from Nomura Structured Holdings plc, for a consideration of £36,000, with all PMB's liabilities being due to the Company from that point. The Company has since settled these liabilities through intercompany transactions with PMB. PMB has ceased all operating activities and will be liquidated in due course. The net consideration due to Nomura Structured Holdings plc in respect of these transactions is £44 million with an agreed payment date of June 2018. The impact for the Group is a net cost of £35 million post tax.

PMB is a private limited company, incorporated in England and Wales on 5 December 2011 as a subsidiary of Nomura Structured Holdings plc, part of the 'Nomura Group'. Prior to the transaction on 10 February 2017, PMB's share capital was 75% owned by the Company and 25% owned by Nomura Structured Holdings plc, who had control of PMB for accounting purposes.

The group relief claimed by the Group has been treated as an uncertain tax item and has been substantially provided for over recent years. Following the conclusion of discussions with HMRC, no further amounts are required to be recognised by the Group. A tax credit of £8 million relates to the overall cost to unwind this derivative transaction.

Post the unwind of the transaction the Group's interest will no longer include the c£8 million p.a. income, c£7 million in 2016/17, and the underlying tax charge will reduce by a similar amount.

The liability recognised is non-underlying by its size and nature.

- (d) Following the enactment during the year the rate of corporation tax reduced from 18% to 17% from April 2020, resulting in a one-off credit of £21.3 million being recognised in the income statement. In addition a charge of £1.7 million has been recognised in the statement of comprehensive income and a credit of £0.1 million was recognised directly in equity.

Last year the rate of corporation tax reduced from 20% to 19% from April 2017, reducing further to 18% from April 2020, resulting in a one-off credit of £33.1 million recognised in the income statement. In addition, a charge of £3.8 million was recognised in the statement of comprehensive income and a charge of £0.1 million was recognised directly in equity.

These movements are non-underlying as are dependent on changes in UK tax law and are non-underlying due to their size.

Notes to the financial statements

continued

7. Operating costs

	Notes	2017 £m	2016 £m
Employment costs before non-underlying items	13	179.7	180.0
Raw materials and consumables		115.8	114.7
Other operating expenses before non-underlying items include:			
Profit on disposal of property, plant and equipment		(7.5)	(4.3)
Operating lease rentals payable:			
– Plant and machinery		17.2	16.9
– Property		8.8	9.0
Research and development expenditure		0.2	0.1
Trade receivables impairment	22	7.4	8.4
Depreciation of property, plant and equipment:			
– Owned assets		136.5	140.0
– Under finance leases		41.7	42.9
Amortisation of other intangible assets	16	3.2	3.7

Operating costs include a £10.7 million charge (2016 £10.2 million charge) relating to non-underlying items, as detailed in note 6.

Fees payable to the Company's auditors in the year were:

	2017 £000	2016 £000
Fees payable to the Company's auditors and its associates for the audit of parent Company and consolidated financial statements	91	94
Fees payable to the Company's auditors and its associates for other services:		
The audit of Company's subsidiaries	583	635
Audit related assurance services	50	50
Other non-audit services	77	122
Total fees	801	901
Fees payable to the Company's auditors in respect of Pennon Group pension schemes:		
Audit	32	30

Expenses reimbursed to the auditors in relation to the audit of the Group were £51,000 (2016 £45,000).

A description of the work of the Audit Committee is set out in its report on pages 63 to 66 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	2017			2016		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowing and overdrafts	(49.4)	-	(49.4)	(48.7)	-	(48.7)
Interest element of finance lease rentals	(31.9)	-	(31.9)	(33.5)	-	(33.5)
Other finance costs	(3.5)	-	(3.5)	(2.8)	-	(2.8)
Interest receivable	-	3.2	3.2	-	6.3	6.3
Interest receivable on shareholder loans to joint ventures	-	10.2	10.2	-	10.7	10.7
	(84.8)	13.4	(71.4)	(85.0)	17.0	(68.0)
Notional interest						
Interest receivable on service concession arrangements	-	16.1	16.1	-	16.7	16.7
Retirement benefit obligations	30 (1.2)	-	(1.2)	(1.8)	-	(1.8)
Unwinding of discounts in provisions	32 (9.1)	-	(9.1)	(9.4)	-	(9.4)
	(10.3)	16.1	5.8	(11.2)	16.7	5.5
Net gains on derivative financial instruments arising from the combination of non-derivative instruments	-	6.8	6.8	-	8.4	8.4
Net finance cost before non-underlying items	(95.1)	36.3	(58.8)	(96.2)	42.1	(54.1)
Non-underlying items						
Fair value remeasurement of non-designated derivative financial instruments providing commercial hedges	6 -	16.0	16.0	-	5.2	5.2
Unwind of synthetic derivative	6 (44.8)	-	(44.8)	-	-	-
Net finance cost after non-underlying items	(139.9)	52.3	(87.6)	(96.2)	47.3	(48.9)

In addition to the above, finance costs of £12.9 million (2016 £9.4 million) have been capitalised on qualifying assets included in property, plant and equipment and other intangible assets.

9. Taxation

Notes	Before non-underlying items 2017 £m	Non-underlying items (note 6) 2017 £m	Total 2017 £m	Before non-underlying items 2016 £m	Non-underlying items (note 6) 2016 £m	Total 2016 £m
Analysis of charge in year						
Current tax charge	39.5	(9.4)	30.1	32.9	(1.7)	31.2
Deferred tax – other	18.9	2.3	21.2	39.2	0.7	39.9
Deferred tax arising on change of rate of corporation tax	-	(21.3)	(21.3)	-	(33.1)	(33.1)
Total deferred tax charge/ (credit)	31 18.9	(19.0)	(0.1)	39.2	(32.4)	6.8
Tax charge for year	58.4	(28.4)	30.0	72.1	(34.1)	38.0

UK corporation tax is calculated at 20% (2016 20%) of the estimated assessable profit for the year.

UK corporation tax is stated after a credit relating to prior year current tax of £1.8 million (2016 credit of £1.4 million) and a prior year deferred tax charge of £1.1 million (2016 charge of £15.9 million).

The 2017 deferred tax credit includes a credit of £21.3 million (2016 charge includes a credit of £33.1 million) reflecting a reduction in the rate of UK corporation tax.

Notes to the financial statements

continued

9. Taxation continued

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:

	2017 £m	2016 £m
Profit before tax	210.5	206.3
Profit before tax multiplied by the standard rate of UK corporation tax of 20% (2016 20%)	42.1	41.3
Effects of:		
Expenses not deductible for tax purposes	(1.3)	1.6
Financial transaction deemed ineligible	10.7	12.0
Joint ventures profits not taxed	(0.9)	(0.7)
Change in rate of corporation tax	(21.3)	(33.1)
Adjustments to tax charge in respect of prior years	(0.7)	14.5
Depreciation charged on non-qualifying assets	1.9	2.4
Other	(0.5)	-
Tax charge for year	30.0	38.0

The average applicable tax rate for the year before non-underlying items was 23% (2016 34%). The reduction from 2016 reflects a higher charge for uncertain tax items in 2016. The average applicable tax rate for the year after non-underlying items was 14% (2016 18%).

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised:

	2017 £m	2016 £m
Amounts recognised directly in other comprehensive income		
Deferred tax (credit)/ charge on defined benefit pension schemes	(3.3)	2.4
Deferred tax charge on cash flow hedges	1.3	1.8
Amounts recognised directly in equity		
Deferred tax (credit)/ charge on share-based payments	(0.3)	0.3
Current tax credit on perpetual capital securities periodic return	(4.1)	(4.1)

10. Profit of the Parent Company

	2017 £m	2016 £m
Profit attributable to ordinary shareholders' equity dealt within the accounts of the parent company	162.9	91.4

As permitted by Section 408 of the Companies Act 2006 no income statement or statement of comprehensive income is presented for the Company.

11. Earnings per share

Basic earnings per share are calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in the employee share trust (note 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:

	2017	2016
Number of shares (millions)		
For basic earnings per share	413.0	410.9
Effect of dilutive potential ordinary shares from share options	1.9	1.8
For diluted earnings per share	414.9	412.7

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:

	2017			2016		
	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	164.3	39.8	39.6	152.1	37.0	36.9
Deferred tax charge before non-underlying items	18.9	4.5	4.6	39.2	9.5	9.5
Non-underlying items (net of tax)	11.1	2.7	2.6	(29.1)	(7.0)	(7.1)
Earnings before non-underlying items and deferred tax	194.3	47.0	46.8	162.2	39.5	39.3

12. Dividends

	2017 £m	2016 £m
Amounts recognised as distributions to ordinary equity holders in the year		
Interim dividend paid for the year ended 31 March 2016: 10.46p (2015 9.98p) per share	43.1	39.8
Final dividend paid for the year ended 31 March 2016: 23.12p (2015 21.82p) per share	95.4	89.7
	138.5	129.5
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2017: 11.09p per share	45.9	
Proposed final dividend for the year ended 31 March 2017: 24.87p per share	103.6	
	149.5	

The proposed interim and final dividends have not been included as liabilities in these financial statements.

The proposed interim dividend for 2017 was paid on 4 April 2017 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

Notes to the financial statements

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13. Employment costs

	Notes	2017 £m	2016 £m
Wages and salaries		157.1	158.0
Social security costs		16.6	15.3
Pension costs	30	18.8	20.1
Share-based payments	33	2.9	2.8
Non-underlying items	6, 30	1.1	8.6
Total employment costs		196.5	204.8
Charged:			
Employment costs (excluding non-underlying items) – consolidated income statement		179.7	180.0
Non-underlying items – consolidated income statement	6	1.1	8.6
Capital schemes – property, plant and equipment		15.7	16.2
Total employment costs		196.5	204.8

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.

	2017	2016
Employees (average full time equivalent number)		
The average monthly number of employees (including Executive Directors) was:		
Water	1,589	1,706
Waste management	3,153	3,230
Other	57	51
Group totals	4,799	4,987

The total number of employees at 31 March 2017 was 4,788 (2016 5,033).

14. Directors' emoluments

	2017 £000	2016 £000
Executive Directors:		
Salary	1,205	1,152
Performance-related bonus paid or payable	381	416
Share-based payments	421	555
Other emoluments, including payments in lieu of pension provision	312	258
Non-Executive Directors	471	529
	2,790	2,910

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 £102,000 (2016 £220,000). Total gains made by Directors on the exercise of share options were £17,000 (2016 £2,000).

Total emoluments include £476,000 (2016 £1,200,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2017 one Director (2016 one) is accruing retirement benefits under defined benefit pension schemes in respect of which the Group contributed £35,000 (2016 £29,000).

At 31 March 2017 no Director (2016 one) is a member of the Group's defined contribution pension scheme in respect of which the Group contributed £40,000 (2016 £52,000).

At 31 March 2017 two Directors received payments in lieu of pension provision (2016 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 74 to 99.

15. Goodwill

	£m
Cost:	
At 1 April 2015	339.3
Recognised on acquisition of subsidiaries	45.7
At 31 March 2016	385.0
At 31 March 2017	385.0
Carrying amount:	
At 1 April 2015	339.3
At 31 March 2016	385.0
At 31 March 2017	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.

The acquisition of Peninsula MB Limited, as detailed in note 6, did not give rise to the recognition of goodwill.

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 recognised on acquisition of Bournemouth Water in 2016, is assessed using level 2 fair value hierarchy techniques, with reference to the market value of the merged water business, using a market based observable premium to Regulated Capital Value.

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 those used reflect management's prudent estimate of a rate that investors would require if they were to choose a similar investment ranging from 6-9% across the CGUs business activities.

The base cash flow projections have been derived from 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. Long-term growth rates of 3%, based on forecast of growth in waste management markets and the UK economy, are applied to cash flows beyond the seven year period, with overheads expected to grow at 1% based on ongoing efficiency expectations of 2% per annum.

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.

The results of tests performed during the year demonstrate significant headroom in all CGUs, and it is judged that no reasonable change in the key assumptions would cause the carrying amount of the CGUs to exceed the recoverable amount.

Notes to the financial statements

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16. Other intangible assets

	Service concession arrangements £m	Customer contracts £m	Patents £m	Other £m	Total £m
Acquired intangible assets					
Cost:					
At 1 April 2015	48.1	32.7	0.2	-	81.0
Additions	6.9	-	-	0.3	7.2
Recognised on acquisition of subsidiaries	-	1.6	-	2.3	3.9
At 31 March 2016	55.0	34.3	0.2	2.6	92.1
Additions	6.5	-	-	-	6.5
At 31 March 2017	61.5	34.3	0.2	2.6	98.6
Accumulated amortisation:					
At 1 April 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
Charge for year	0.2	2.4	-	0.6	3.2
At 31 March 2017	0.2	29.9	0.2	1.2	31.5
Carrying amount:					
At 1 April 2015	48.1	8.2	0.1	-	56.4
At 31 March 2016	55.0	6.8	-	2.0	63.8
At 31 March 2017	61.3	4.4	-	1.4	67.1

Service concession arrangements, once available for use, are amortised over the useful life of each contract. The average remaining life is 23 years (2016 24 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 two years (2016 three years).

Patents are amortised over their estimated useful lives which at acquisition was 13 years. The average remaining life is nil years (2016 two 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 (2016 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 (2016 £2.1 million) have been capitalised on qualifying assets, at an average borrowing rate of 3.5% (2016 4.2%).

17. Property, plant and equipment

Group	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
Cost:							
At 1 April 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	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	4.31	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
Additions	9.8	12.7	1.2	47.0	7.1	299.7	377.5
Assets adopted at fair value	-	5.4	14.1	5.1	-	-	24.6
Grants and contributions	-	(1.6)	-	-	-	-	(1.6)
Disposals	(3.5)	(1.2)	(0.2)	(10.7)	-	(9.5)	(25.1)
Transfers/reclassifications	8.7	14.6	(2.2)	62.9	-	(84.0)	-
At 31 March 2017	539.4	1,854.8	706.4	2,734.2	71.7	372.3	6,278.8
Accumulated depreciation:							
At 1 April 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
Charge for year	13.5	24.4	12.8	126.1	4.5	-	181.3
Disposals	(1.0)	(1.3)	(0.2)	(9.3)	-	-	(11.8)
At 31 March 2017	384.7	246.8	240.0	1,246.7	57.4	-	2,175.6
Net book value:							
At 1 April 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
At 31 March 2017	154.7	1,608.0	466.4	1,487.5	14.3	372.3	4,103.2

Of the total depreciation charge of £181.3 million (2016 £185.3 million), £1.6 million (2016 £1.4 million) has been charged to capital projects, £1.5 million (2016 £1.0 million) has been offset by deferred income and £178.2 million (2016 £182.9 million) has been charged against profits. Asset lives and residual values are reviewed annually. During the year borrowing costs of £10.8 million (2016 £7.3 million) have been capitalised on qualifying assets, at an average borrowing rate of 3.5% (2016 4.1%).

Groups of assets forming cash generating units are reviewed for indicators of impairment. No indicators of impairment were identified during the year.

In 2016 an impairment of non-strategic landfill sites of £60.9 million and a £60.9 million reversal of assets was recognised.

Asset lives are reviewed annually. No significant changes were required in 2016/17. In 2015/16 the annual review, encompassing internal assessments and external benchmarking, resulted in upper end of the range of useful lives for water mains and sewers increasing from 100 to 120 years and for Energy Recovery Facilities from 30 to 40 years.

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17. Property, plant and equipment continued

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 2016	409.5	439.8	515.9	0.2	1,365.4
At 31 March 2017	409.0	436.7	574.8	0.2	1,420.7
Accumulated depreciation:					
At 31 March 2016	52.6	107.2	252.6	-	412.4
At 31 March 2017	58.2	111.6	276.0	-	445.8
Net book amount:					
At 31 March 2016	356.9	332.6	263.3	0.2	953.0
At 31 March 2017	350.8	325.1	298.8	0.2	974.9

	Fixed and mobile plant, vehicles and computers £m
Company	
Cost:	
At 1 April 2015	0.3
Additions	0.1
Disposals	(0.1)
At 31 March 2016	0.3
Additions	0.2
Disposals	(0.2)
At 31 March 2017	0.3
Accumulated depreciation:	
At 1 April 2015	0.2
Charge for year	0.1
Disposals	(0.1)
At 31 March 2016	0.2
Charge for year	-
Disposals	(0.1)
At 31 March 2017	0.1
Net book value:	
At 1 April 2015	0.1
At 31 March 2016	0.1
At 31 March 2017	0.2

Asset lives and residual values are reviewed annually.

18. Financial instruments by category

The accounting policies for financial instruments that have been applied to line items are:

	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 2017							
Financial assets							
Trade receivables	22	-	-	-	-	223.5	223.5
Other receivables	19,22	-	-	-	314.3	-	314.3
Derivative financial instruments	23	6.2	2.8	78.7	-	-	87.7
Cash and cash deposits	25	-	-	-	598.1	-	598.1
Total		6.2	2.8	78.7	912.4	223.5	1,223.6
Financial liabilities							
Borrowings	28	-	-	-	(3,263.0)	-	(3,263.0)
Derivative financial instruments	23	-	(40.0)	(2.5)	-	-	(42.5)
Trade payables	26	-	-	-	-	(107.4)	(107.4)
Other payables	26,29	-	-	-	-	(48.5)	(48.5)
Total		-	(40.0)	(2.5)	(3,263.0)	(155.9)	(3,461.4)
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	67.0	-	-	72.2
Cash and cash deposits	25	-	-	-	632.2	-	632.2
Total		1.8	3.4	67.0	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)
Company							
31 March 2017							
Financial assets							
Amounts owed by subsidiaries	19,22	-	-	-	1,137.7	-	1,137.7
Other receivables	22	-	-	-	0.3	-	0.3
Derivative financial instruments	23	2.9	1.3	-	-	-	4.2
Cash and cash deposits	25	-	-	-	372.5	-	372.5
Total		2.9	1.3	-	1,510.5	-	1,514.7
Financial liabilities							
Amounts due to subsidiaries	26	-	-	-	(0.8)	-	(0.8)
Borrowings	28	-	-	-	(1,206.0)	-	(1,206.0)
Derivative financial instruments	23	-	(3.4)	-	-	-	(3.4)
Trade payables	26	-	-	-	-	(0.2)	(0.2)
Other payables	29	-	-	-	-	(44.3)	(44.3)
Total		-	(3.4)	-	(1,206.8)	(44.5)	(1,254.7)
31 March 2016							
Financial assets:							
Amounts owed by subsidiaries	19,22	-	-	-	974.2	-	974.2
Other receivables	22	-	-	-	7.4	-	7.4
Derivative financial instruments	23	1.8	-	-	-	-	1.8
Cash and cash deposits	25	-	-	-	429.7	-	429.7
Total		1.8	-	-	1,411.3	-	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)

Notes to the financial statements

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19. Other non-current assets

Non-current receivables

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Amounts owed by subsidiary undertakings	-	-	1,011.6	905.1
Amounts owed by related parties (note 44)	87.2	78.3	-	-
Service concession arrangements	210.1	179.4	-	-
Other receivables	10.7	10.1	-	0.4
	308.0	267.8	1,011.6	905.5

Non-current receivables were due:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Between 1 and 2 years	19.4	36.7	85.8	66.4
Over 2 years and less than 5 years	23.7	29.4	269.9	250.4
Over 5 years	264.9	201.7	655.9	588.7
	308.0	267.8	1,011.6	905.5

The fair values of non-current receivables were:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Amounts owed by subsidiary undertakings	-	-	1,115.7	1,000.5
Amounts owed by related parties	156.9	145.4	-	-
Service concession arrangements	210.1	179.4	-	-
Other receivables	10.7	10.1	-	0.4
	377.7	334.9	1,115.7	1,000.9

The Group has a number of service concession arrangements with local authority clients in the waste management sector to build and operate recycling assets and energy recovery facilities. The terms of the contracts, including pricing and performance obligations, are established at the outset and the contracts are typically for a duration of 25 years. The assets revert to the local authority at the end of the contract. At 31 March 2017 the average remaining duration of the service concession arrangements was 22 years.

The fair value of amounts owed by related parties is based on cash flows using a rate based on the borrowings rate of 2.25% (2016 2.50%). 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 12.5% (2016 12.3%).

Other receivables include site development and pre-contract costs of £4.1 million (2016 £9.6 million).

There is no concentration of risk in non-current receivables. A significant proportion of the debt is due from local government authorities or joint venture companies which principally operate under long-term local government authority contracts.

20. Investments

Subsidiary undertakings

	£m
Company	
At 1 April 2015	1,523.6
Additions	104.7
At 31 March 2016	1,628.3
Additions	100.0
Disposals	(104.1)
At 31 March 2017	1,624.2

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 the Company 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.

On 10 February 2017 the Company acquired the controlling interest in Peninsula MB Limited for £36,000, bringing its shareholding of Peninsula MB Limited's issued share capital to 100%. The acquisition was a component of a wider transaction to unwind a historic derivative position as set out in note 6 to the financial statements.

Joint ventures

	Shares £m
Group	
At 1 April 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
Share of post-tax profit	4.2
Share of other comprehensive profit	0.3
Dividends received	(4.5)
At 31 March 2017	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 recovery 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

	2017			2016		
	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	13.5	63.2	40.0	14.4	61.2	24.3
Other current assets	10.5	4.2	6.7	9.5	27.4	17.5
Total current assets	24.0	67.4	46.7	23.9	88.6	41.8
Borrowings	-	-	-	-	-	-
Other current liabilities	(4.6)	(35.9)	(13.8)	(3.7)	(43.2)	(11.4)
Total current liabilities	(4.6)	(35.9)	(13.8)	(3.7)	(43.2)	(11.4)
Non-current						
Assets	117.7	303.9	283.5	122.6	288.8	289.7
Borrowings	(105.5)	(321.9)	(319.7)	(114.0)	(331.4)	(322.1)
Other liabilities	(32.9)	(48.4)	(44.2)	(38.0)	(43.2)	(53.6)
Total non-current liabilities	(138.4)	(370.3)	(363.9)	(152.0)	(374.6)	(375.7)
Net liabilities	(1.3)	(34.9)	(47.5)	(9.2)	(40.4)	(55.6)
Net debt	(92.0)	(258.7)	(279.7)	(99.6)	(270.2)	(297.8)
Associated shareholder loans	17.1	80.3	100.9	17.8	73.6	94.6
Net debt (excluding shareholder loans)	(74.9)	(178.4)	(178.8)	(81.8)	(196.6)	(203.2)

Notes to the financial statements

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20. Investments continued

Summarised statement of comprehensive income

	2017			2016		
	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	46.8	145.5	59.4	46.7	148.0	56.2
EBITDA	29.4	6.3	40.2	31.3	6.2	34.3
Depreciation and amortisation	(8.1)	(1.3)	(12.4)	(7.9)	(1.2)	(10.7)
Interest receivable on service concession arrangements	-	22.5	-	-	23.4	-
Other net interest charge	(8.2)	(27.5)	(29.7)	(9.0)	(29.6)	(30.0)
Pre-tax profit/(loss)	13.1	-	(1.9)	14.4	(1.2)	(6.4)
Income tax (expense)/income	(2.2)	(2.5)	1.9	(1.2)	1.1	(1.4)
Post-tax profit/(loss)	10.9	(2.5)	-	13.2	(0.1)	(7.8)
Other comprehensive income/(loss)	6.0	8.0	8.1	1.1	4.5	(0.2)
Total comprehensive income/(loss)	16.9	5.5	8.1	14.3	4.4	(8.0)
Dividends paid by joint venture	(9.0)	-	-	(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.

Reconciliation of summarised financial information

Reconciliation of the summarised financial information presented to the carrying amount of its interest in the joint venture/associate.

	2017			2016		
	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	(9.2)	(40.4)	(55.6)	(11.5)	(44.8)	(47.6)
Profit/(loss) for the year	10.9	(2.5)	-	13.2	(0.1)	(7.8)
Other comprehensive income/(loss)	6.0	8.0	8.1	1.1	4.5	(0.2)
Dividends paid	(9.0)	-	-	(12.0)	-	-
Closing net liabilities	(1.3)	(34.9)	(47.5)	(9.2)	(40.4)	(55.6)
Interest in joint venture	(0.7)	(17.4)	(17.8)	(4.6)	(20.2)	(20.9)
Share of net liabilities not recognised	0.8	17.4	17.8	4.7	20.2	20.9
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	
	2017 £m	2016 £m	2017 £m	2016 £m
Raw materials and consumables	21.3	206	-	-

22. Trade and other receivables – current

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Trade receivables	321.6	3036	-	-
Less: provision for impairment of receivables	(98.1)	(95.6)	-	-
Net trade receivables	223.5	2080	-	-
Amounts owed by related parties	17.0	179	-	-
Amounts owed by subsidiary undertakings	-	-	126.1	69.1
Other receivables	15.6	14.3	0.4	7.4
Prepayments and accrued income	84.7	833	0.8	0.9
	340.8	3235	127.3	77.4

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:

	2017 £m	2016 £m
Group		
Past due 1 – 30 days	34.1	37.8
Past due 31 – 120 days	26.6	18.7
More than 120 days	148.2	148.8

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 has 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:

	2017 £m	2016 £m
At 1 April	95.6	86.8
Arising on acquisition	-	1.0
Provision for receivables impairment	7.4	8.4
Receivables written off during the year as uncollectable	(4.9)	(0.6)
At 31 March	98.1	95.6

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23. Derivative financial instruments

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Derivatives used for cash flow hedging				
Non-current assets	1.4	2.4	0.9	-
Current assets	4.8	1.0	0.4	-
Current liabilities	(16.0)	(14.7)	(2.1)	(2.7)
Non-current liabilities	(24.0)	(32.2)	(1.3)	(4.9)
Derivatives used for fair value hedging				
Non-current assets	2.2	1.3	2.2	1.3
Current assets	0.6	0.5	0.7	0.5
Current liabilities	-	-	-	-
Non-current liabilities	-	-	-	-
Derivatives not in a hedge accounting relationship				
Non-current assets	70.0	59.0	-	-
Current assets	8.7	8.0	-	-
Current liabilities	(1.3)	(2.7)	-	-
Non-current liabilities	(1.2)	(6.3)	-	(4.2)

The fair value of 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 (2016 £nil).

During the year a £10.8 million charge (2016 £7.9 million) was recognised in profit and loss relating to cash flow hedges previously recognised through other comprehensive income and recorded in the hedging reserve.

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 2017 69% of Group net borrowings were at fixed rate (2016 67%).

At 31 March 2017 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 2.9 years (2016 £1,078.0 million, with 3.9 years). The weighted average interest rate of the swaps for their nominal amount was 2.0% (2016 2.0%).

Derivatives deemed held for trading at 31 March 2016 included a derivative with a fair value of £4.2 million which did not qualify for hedge accounting under IAS 39, but was designed to improve the Group's overall interest rate performance. During the year this derivative position was unwound as set out in note 6.

The periods for which cash flow hedges are expected to affect future profit or loss are as follows:

	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Due over 5 years £m	Total £m
Group					
31 March 2017					
Assets	0.4	0.4	0.4	0.1	1.3
Liabilities	(16.0)	(12.1)	(11.3)	(0.6)	(40.0)
31 March 2016					
Liabilities	(14.4)	(10.8)	(20.7)	(0.5)	(46.4)
Company					
31 March 2017					
Assets	0.4	0.4	0.4	0.1	1.3
Liabilities	(2.1)	(1.3)	-	-	(3.4)
31 March 2016					
Liabilities	(2.7)	(1.9)	(2.7)	(0.2)	(7.5)

In addition, the Group has cash flow hedges that are expected to affect future amounts recognised in property, plant and equipment, amounting to assets of £4.9 million (2016 £2.9 million).

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Assets				
Derivatives used for cash flow hedging	6.2	3.4	1.3	-
Derivatives used for fair value hedging	2.8	1.8	2.9	1.8
Derivatives not in a hedge accounting relationship	78.7	67.0	-	-
Total assets	87.7	72.2	4.2	1.8
Liabilities				
Derivatives used for cash flow hedging	40.0	46.9	3.4	7.5
Derivatives not in a hedge accounting relationship	2.5	4.8	-	-
Total liabilities	42.5	51.7	3.4	7.5

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	
	2017 £m	2016 £m	2017 £m	2016 £m
Level 3 inputs				
Liabilities				
Derivatives deemed held for trading	-	4.2	-	4.2

The following table presents the changes in level 3 financial instruments for the year:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Level 3 inputs				
At 1 April	(4.2)	(3.6)	(4.2)	(3.6)
Gains recognised in net finance costs	6.8	8.4	6.8	8.4
Unwind loss on financial instrument (note 6)	(4.8)	-	(8.5)	-
Amounts to be settled post unwind of financial instrument (notes 6 and 29)	4.3	-	4.3	-
Amounts settled during the year	(2.1)	(9.0)	36.6	(9.0)
At 31 March	-	(4.2)	-	(4.2)

24. Financial instruments at fair value through profit

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Current liabilities	(2.4)	(2.2)	-	-
Non-current liabilities	(48.4)	(51.0)	(1.4)	(1.6)

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.

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25. Cash and cash deposits

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Cash at bank and in hand	101.2	44.5	99.4	92.7
Short-term bank deposits	78.0	31.1	78.0	31.1
Other deposits	418.9	556.6	195.1	305.9
Total cash and cash deposits	598.1	632.2	372.5	429.7

Group short-term deposits have an average maturity of 1 day.

Group other deposits have an average maturity of 53 days.

Group other deposits include restricted funds of £223.8 million (2016 £216.8 million) to settle long-term lease liabilities (note 28) and £nil million (2016 £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	
	2017 £m	2016 £m	2017 £m	2016 £m
Cash and cash deposits as above	598.1	632.2	372.5	429.7
Less: deposits with a maturity of three months or more (restricted funds)	(223.8)	(226.5)	-	(9.7)
	374.3	405.7	372.5	420.0

26. Trade and other payables – current

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Trade payables	107.4	95.9	0.2	0.3
Amounts owed to subsidiary undertakings	-	-	0.8	0.3
Amounts owed to joint ventures (note 44)	4.2	3.9	-	-
Other tax and social security	50.6	52.3	0.3	0.3
Accruals and other payables	124.3	112.5	5.0	5.0
	286.5	264.6	6.3	5.9

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

27. Current tax liabilities

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Current year creditor	8.2	-	-	-
Prior year tax items	18.6	37.1	37.9	53.5
	26.8	37.1	37.9	53.5

28. Borrowings

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Current				
Short-term loans	74.9	0.3	74.9	-
European Investment Bank	41.1	38.7	-	-
Amounts owed to subsidiary undertakings (note 44)	-	-	282.9	287.2
	116.0	39.0	357.8	287.2
Obligations under finance leases	30.5	26.0	-	-
Total current borrowings	146.5	65.0	357.8	287.2
Non-current				
Bank and other loans	328.8	403.2	248.6	323.3
Private placements	560.5	553.8	560.5	553.8
Bond 2040	133.6	133.3	-	-
RPI index-linked bonds	416.4	412.2	-	-
European Investment Bank	323.4	234.5	-	-
Amounts owed to subsidiary undertakings (note 44)	-	-	39.1	-
	1,762.7	1,737.0	848.2	877.1
Obligations under finance leases	1,353.8	1,314.6	-	-
Total non-current borrowings	3,116.5	3,051.6	848.2	877.1
Total borrowings	3,263.0	3,116.6	1,206.0	1,164.3

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%. This instrument was transferred to South West Water Limited in April 2016.

The fair values of non-current borrowings, valued using level 2 measures (as set out in note 23) were:

	2017		2016	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Group				
Bank and other loans	328.8	336.4	403.2	403.2
Private placements	560.5	614.0	553.8	600.0
Bond 2040	133.6	198.7	133.3	198.4
RPI index-linked bond	416.4	496.2	412.2	364.6
European Investment Bank	323.4	282.3	234.5	209.3
	1,762.7	1,927.6	1,737.0	1,775.5
Obligations under finance leases	1,353.8	1,217.3	1,314.6	1,163.0
	3,116.5	3,144.9	3,051.6	2,938.5
Company				
Bank and other loans	248.6	256.4	323.3	323.3
Private placements	560.5	614.0	553.8	600.0
Amounts owed to subsidiary undertakings (note 44)	39.1	39.1	-	-
	848.2	909.5	877.1	923.3

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

The maturity of non-current borrowings was:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Between 1 and 2 years	207.7	141.7	188.6	74.6
Over 2 year and less than 5 years	408.3	427.0	148.1	225.8
Over 5 years	2,500.5	2,482.9	511.5	576.7
	3,116.5	3,051.6	848.2	877.1

The weighted average maturity of non-current borrowings was 20 years (2016 22 years).

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28. Borrowings continued

Finance lease liabilities – minimum lease payments were:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Within 1 year	44.3	41.1	-	-
Over 1 year and less than 5 years	245.3	220.5	-	-
Over 5 years	2,021.3	2,130.7	-	-
	2,310.9	2,392.3	-	-
Less: future finance charges	(926.6)	(1,051.7)	-	-
Present value of finance lease liabilities	1,384.3	1,340.6	-	-

The maturity of finance lease liabilities was:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Within 1 year	30.5	26.0	-	-
Over 1 year and less than 5 years	175.4	124.8	-	-
Over 5 years	1,178.4	1,189.8	-	-
	1,384.3	1,340.6	-	-

Included above are accrued finance charges arising on obligations under finance leases totalling £146.3 million (2016 £138.8 million), of which £2.0 million (2016 £1.7 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, £79.3 million at 31 March 2017 (2016 £71.7 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, £142.4 million at 31 March 2017 (2016 £142.3 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	
	2017 £m	2016 £m	2017 £m	2016 £m
Floating rate:				
Expiring within 1 year	60.0	100.0	60.0	50.0
Expiring after 1 year	725.0	975.0	180.0	240.0
	785.0	1,075.0	240.0	290.0

In addition at 31 March 2017 the Group had undrawn uncommitted short-term bank facilities of £15.0 million (2016 £25.0 million) available to the Company or South West Water Limited.

29. Other non-current liabilities

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Amounts owed to subsidiary undertakings	-	-	8.7	8.7
Deferred income	114.5	91.2	-	-
Other payables	66.2	22.0	44.3	-
	180.7	113.2	53.0	8.7

Deferred income includes amounts relating to the adoption at fair value of assets transferred from customers in the water segment.

Other payables includes an amount of £44.3 million (2016 £nil) due to Nomura Structured Holdings plc on unwind of a synthetic derivative (see note 6).

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.

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 principal plan within the Group is the Pennon Group Pension Scheme, which is a funded defined benefit, final salary pension scheme in the UK. The Group's pension schemes are established under trust law and comply with all relevant UK legislation.

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 £5.3 million (2016 £7.5 million).

Defined benefit schemes

Assumptions

The principal actuarial assumptions at 31 March were:

	2017 %	2016 %	2015 %
Rate of increase in pensionable pay	3.2	2.9	2.9
Rate of increase for current and future pensions	2.0	2.9	2.9
Rate used to discount schemes' liabilities and expected return on schemes' assets	2.55	3.30	3.35
Inflation	3.2	2.9	2.9

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 2015 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:

	2017	2016	2015
Male	24.8	25.1	25.0
Female	27.2	27.3	27.2

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

	2017	2016	2015
Male	26.2	26.5	26.4
Female	29.5	29.6	29.5

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%	+/- 0.6%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.2%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.3%
Inflation	+/- 0.5%	+/- 6.4%
Life expectancy	+/- 1 year	+/- 4.5%

The sensitivity analysis shows the effect of changes in the principal assumptions used for the measurement of the pension liability. The method used to calculate the sensitivities is approximate and has been determined taking into account the duration of the liabilities and the overall profile of each scheme's membership. This is the same approach as has been adopted in previous years.

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30. Retirement benefit obligations continued

The amounts recognised in the balance sheet were:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Present value of financial obligations	(956.0)	(826.0)	(58.0)	(50.7)
Fair value of plan assets	903.4	792.7	53.9	47.7
Deficit of funded plans	(52.6)	(33.3)	(4.1)	(3.0)
Impact of minimum funding asset ceiling	(15.4)	(7.6)	-	-
Net liability recognised in the balance sheet	(68.0)	(4.09)	(4.1)	(3.0)

The movement in the net defined benefit obligation over the accounting period is as follows:

	2017			2016		
	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	(833.6)	792.7	(40.9)	(752.3)	692.7	(59.6)
Arising on acquisition	-	-	-	(86.6)	88.5	1.9
Current service cost	(12.0)	-	(12.0)	(12.6)	-	(12.6)
Past service cost and gains and losses on settlements	(1.5)	-	(1.5)	-	-	-
Interest (expense)/income	(27.4)	26.2	(1.2)	(27.3)	25.5	(1.8)
	(40.9)	26.2	(14.7)	(39.9)	25.5	(14.4)
Remeasurements:						
Return/ (loss) on plan on assets excluding amounts included in interest expense	-	106.0	106.0	-	(19.7)	(19.7)
Gain from change in demographic assumptions	12.2	-	12.2	-	-	-
(Loss)/ gain from change in financial assumptions	(133.1)	-	(133.1)	2.7	-	2.7
Experience gains	(8.7)	-	(8.7)	14.4	-	14.4
	(129.6)	106.0	(23.6)	17.1	(19.7)	(2.6)
Contributions:						
Employers	-	11.2	11.2	-	33.8	33.8
Plan participants	(1.1)	1.1	-	(1.1)	1.1	-
Payments from plans:						
Benefit payments	33.8	(33.8)	-	29.2	(29.2)	-
	32.7	(21.5)	11.2	28.1	5.7	33.8
At 31 March	(971.4)	903.4	(68.0)	(833.6)	792.7	(40.9)

The movement in the Company's net defined benefit obligation over the accounting period is as follows:

	2017			2016		
	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
1 April	(50.7)	47.7	(3.0)	(50.8)	46.6	(4.2)
Current service cost	(0.2)	-	(0.2)	(0.3)	-	(0.3)
Interest (expense)/income	(1.8)	1.7	(0.1)	(1.7)	1.5	(0.2)
	(2.0)	1.7	(0.3)	(2.0)	1.5	(0.5)
Remeasurements:						
Return/ (loss) return on plan on assets excluding amounts included in interest expense	-	6.0	6.0	-	(0.9)	(0.9)
Gain from change in demographic assumptions	1.0	-	1.0	-	-	-
Loss from change in financial assumptions	(9.0)	-	(9.0)	-	-	-
Experience gains	0.5	-	0.5	0.3	-	0.3
	(7.5)	6.0	(1.5)	0.3	(0.9)	(0.6)
Contributions:						
Employers	-	0.7	0.7	-	2.3	2.3
Payments from plans:						
Benefit payments	2.2	(2.2)	-	1.8	(1.8)	-
	2.2	(1.5)	0.7	1.8	0.5	2.3
31 March	(58.0)	53.9	(4.1)	(50.7)	47.7	(3.0)

Changes in the effect of the asset ceiling during the year were:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Irrecoverable asset at start of the year	7.6	10.1	-	-
Interest on irrecoverable surplus	0.2	0.3	-	-
Actuarial gains/ (losses)	7.6	(2.8)	-	-

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:

	2017			2016		
	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %
Equities	243.7	1.9	27	247.9	-	31
Government bonds	168.8	-	19	87.2	-	11
Other bonds	170.0	-	19	134.2	-	17
Diversified growth	96.8	-	11	170.8	-	22
Property	52.1	8.8	7	50.4	8.3	7
Insurance linked security	47.2	-	5	-	-	-
Other (including cash funds)	100.2	13.9	12	80.0	13.9	12
	878.8	24.6	100	770.5	22.2	100

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30. Retirement benefit obligations continued

Other assets at 31 March 2017 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:

	2017			2016		
	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %
Equities	13.0	-	24	14.3	-	30
Government bonds	10.5	-	19	8.0	-	17
Other bonds	10.1	-	19	9.7	-	20
Diversified growth	6.2	-	12	5.6	-	12
Property	4.2	-	8	4.0	-	8
Insurance linked security	3.8	-	7	-	-	-
Other	6.1	-	11	6.1	-	13
	53.9	-	100	47.7	-	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 2016 triennial actuarial valuation of the principal defined benefit scheme has been agreed, with the actuarial valuation deficit and schedule of contributions being in line with the 2013 triennial actuarial valuation, requiring deficit recovery contributions of c.£12 million per annum from 2019 to 2022. The Group has made a deficit recovery contribution of £0.5 million to the main scheme during the year (2016 £23.7 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 2018.

31. Deferred tax

Deferred tax is provided in full on temporary differences under the liability method using enacted tax rates.

Movements on deferred tax were:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Liabilities/(assets) at 1 April	272.0	235.9	(2.2)	(3.0)
Charged to the income statement	18.9	39.2	-	0.5
(Credited)/charged to equity	(2.3)	4.5	-	0.5
Change of rate in income statement – non-underlying	(21.3)	(33.1)	(0.1)	(0.2)
Other non-underlying charges in the income statement	2.3	0.7	-	-
Arising on acquisition	-	24.8	-	-
Liabilities/(assets) at 31 March	269.6	272.0	(2.3)	(2.2)

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 £19.7 million to recognise the change in the rate of corporation tax enacted on 15 September 2016 to reduce the rate at 1 April 2020 from 18% to 17%. This credit includes a credit of £21.3 million recognised in the income statement and a debit of £1.6 million recognised in equity.

The movements in deferred tax assets and liabilities were:

Group

Deferred tax liabilities

	Accelerated tax depreciation £m	Fair value adjustments £m	Revenue on service concession arrangements £m	Other £m	Total £m
At 1 April 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
Charged/(credited) to the income statement	15.8	(1.9)	4.8	(0.4)	18.3
Non-underlying (credit)/charge to the income statement	(17.6)	(0.6)	(2.8)	(0.1)	(21.1)
Reclassifications	(0.1)	-	-	-	(0.1)
At 31 March 2017	241.8	22.1	41.7	0.4	306.0

Deferred tax assets

	Long term liabilities including provisions £m	Retirement benefit obligations £m	Derivatives £m	Share based payments £m	Tax losses £m	Fair value adjustment £m	Other £m	Total £m
At 1 April 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)
(Credited)/charged to the income statement	(1.2)	(0.6)	-	-	0.1	0.5	1.8	0.6
Non-underlying (credit)/charge to the income statement	(0.1)	(0.2)	2.6	-	0.1	0.5	(0.8)	2.1
(Credited)/charged to equity	-	(4.7)	1.0	(0.2)	-	-	-	(3.9)
Non-underlying charge/(credit) to equity	-	1.4	0.3	(0.1)	-	-	-	1.6
Reclassifications	(0.2)	-	0.9	-	-	-	(0.6)	0.1
At 31 March 2017	(6.4)	(11.5)	(2.4)	(1.6)	(1.7)	(10.0)	(2.8)	(36.4)
Net liability:								
At 31 March 2016								272.0
At 31 March 2017								269.6

Notes to the financial statements

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31. Deferred tax continued

Company

Deferred tax assets

	Retirement benefit obligations £m	Derivatives £m	Share based payments £m	Other £m	Total £m
At 1 April 2015	(0.8)	(16)	(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)
(Credited)/ charged to the income statement	-	-	(0.1)	0.1	-
Non-underlying credit to income statement	(0.1)	-	-	-	(0.1)
(Credited)/charged to equity	(0.3)	0.1	(0.1)	-	(0.3)
Non-underlying charge to equity	0.2	0.1	-	-	0.3
At 31 March 2017	(0.7)	(1.1)	(0.4)	(0.1)	(2.3)

Deferred tax (charged)/credited to equity during the year was:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Remeasurement of defined benefit obligations	3.3	(2.4)	0.1	(0.2)
Cash flow hedges	(1.3)	(1.8)	(0.2)	(0.3)
Deferred tax on other comprehensive loss/(gain)	2.0	(4.2)	(0.1)	(0.5)
Share-based payments	0.3	(0.3)	0.1	(0.1)
	2.3	(4.5)	-	(0.6)

32. Provisions

	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Total £m
Group				
At 1 April 2016	182.1	11.7	27.6	221.4
Charged to the income statement	6.2	-	0.6	6.8
Non-underlying charge (note 6)	-	1.2	-	1.2
Capitalised	7.1	-	-	7.1
Utilised	(11.6)	(6.4)	(4.3)	(22.3)
At 31 March 2017	183.8	6.5	23.9	214.2

The amount charged to the income statement includes £9.1 million (2016 £9.4 million) charged to finance costs as the unwinding of discounts in provisions.

The analysis of provisions between current and non-current is:

	2017 £m	2016 £m
Current	40.4	50.4
Non-current	173.8	171.0
	214.2	221.4

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. The Group has applied a discount rate of 4.75% (2016 4.75%) and an inflation rate of 2.5% (2016 2.5%).

The restructuring provision relates principally to severance costs and will be utilised within one year.

Other provisions include underperforming contracts of £11.1 million (2016 £15.6 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. The weighted average contract life of underperforming contracts is 3 years.

Notes to the financial statements

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33. Share capital

Allotted, called-up and fully paid

	Number of shares		£m
	Treasury shares	Ordinary shares	
Group and Company			
At 1 April 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 reissued to the Pennon Employee Share Trust	(143,538)	143,538	-
For consideration of £0.1 million, shares reissued under the Executive Share Option Scheme	(8,305)	8,305	-
For consideration of £1.3 million, shares reissued 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
Shares issued under the Scrip Dividend Alternative	-	771,563	0.3
For consideration of £1.3 million, shares issued to the Pennon Employee Share Trust	-	143,479	0.1
For consideration of £0.2 million, shares issued under the Executive Share Option Scheme	-	24,457	-
For consideration of £0.0 million, shares reissued under the Executive Share Option Scheme	(1,913)	1,913	-
For consideration of £3.2 million, shares issued under the Company's Sharesave Scheme	-	611,284	0.2
At 31 March 2017 ordinary shares of 40.7p each	8,443	413,893,293	168.4

The 12,084,337 share issuance last year 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 reissued 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 17% 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	
			2017	2016
6 July 2009	386p	2012 - 2016	-	44
28 June 2010	431p	2013 - 2017	41	41
29 June 2011	536p	2014 - 2018	29	150
29 June 2012	588p	2015 - 2017	91	103
3 July 2013	538p	2016 - 2018	103	540
14 July 2014	611p	2017 - 2019	609	687
24 June 2015	683p	2018 - 2020	1,132	1,291
29 June 2016	709p	2019 - 2021	748	-
			2,753	2,856

The number and weighted average exercise price of Sharesave options are:

	2017		2016	
	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	2,856	619	2,330	561
Granted	798	709	1,364	683
Forfeited	(205)	661	(170)	622
Exercised	(610)	533	(623)	545
Expired	(86)	639	(45)	596
At 31 March	2,753	660	2,856	619

The weighted average price of the Company's shares at the date of exercise of Sharesave options during the year was 878p (2016 779p). The options outstanding at 31 March 2017 had a weighted average exercise price of 660p (2016 619p) and a weighted average remaining contractual life of 1.9 years (2016 2.1 years).

The aggregate fair value of Sharesave options granted during the year was £0.9 million (2016 £1.7 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model at the date of issue of the options were:

	2017	2016
Weighted average share price	854	854
Weighted average exercise price	709	683
Expected volatility	18.0%	17.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.3%	0.8%
Expected dividend yield	4.2%	4.0%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous three 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:

	2017		2016	
	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	1,198	761	1,195	744
Granted	378	920	420	811
Vested	(128)	653	-	-
Lapsed	(427)	721	(417)	764
At 31 March	1,021	850	1,198	761

The awards outstanding at 31 March 2017 had a weighted exercise price of 850p (2016 761p) and a weighted average remaining contractual life of 1.3 years (2016 1.3 years).

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continued

33. Share capital continued

The aggregate fair value of awards granted during the year was £1.7 million (2016 £1.7 million) determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2017	2016
Weighted average share price	920p	811p
Expected volatility	18.0%	17.0%
Risk-free rate	0.3%	0.8%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous three 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:

	2017		2016	
	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	307	759	316	758
Granted	146	944	154	791
Vested	(122)	745	(152)	790
Lapsed	(6)	701	(11)	776
At 31 March	325	848	307	759

The awards outstanding at 31 March 2017 had a weighted average exercise price of 848p (2016 759p) and a weighted average remaining contractual life of 1.4 years (2016 1.6 years). The Company's share price at the date of the awards ranged from 791p to 950p.

The aggregate fair value of awards granted during the year was £1.3 million (2016 £1.2 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 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
Adjustment for shares issued under the Scrip Dividend Alternative	(0.3)
Shares issued under the Sharesave Scheme	3.0
Shares issued to the Pennon Employee Share Trust	1.2
Shares issued under the Executive Share Option Scheme	0.2
At 31 March 2017	217.4

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 2015	144.2
At 31 March 2016	144.2
At 31 March 2017	144.2

36. Retained earnings and other reserves

	Own shares £m	Hedging reserve £m	Retained earnings £m	Total £m
Group				
At 1 April 2015	(18)	(350)	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	(21)	(31.8)	701.4	667.5
Profit for the year	-	-	164.3	164.3
Other comprehensive loss for the year	-	5.1	(20.0)	(14.9)
Transfer from hedging reserve to property, plant and equipment	-	(1.5)	-	(1.5)
Dividends paid relating to 2016	-	-	(138.5)	(138.5)
Adjustment for shares issued under the Scrip Dividend Alternative	-	-	6.9	6.9
Credit to equity in respect of share-based payments (net of tax)	-	-	3.2	3.2
Charge in respect of share options vesting	2.1	-	(2.1)	-
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	(2.6)	-	-	(2.6)
At 31 March 2017	(2.6)	(28.2)	715.2	684.4

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 330,000 ordinary shares (2016 309,000 ordinary shares) held by the trust at 31 March 2017 was £2.9 million (2016 £2.5 million).

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36. Retained earnings and other reserves continued

	Hedging reserve £m	Retained earnings £m	Total £m
Company			
At 1 April 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 reissued	-	2.5	2.5
At 31 March 2016	(5.0)	981.1	976.1
Profit for the year	-	162.9	162.9
Other comprehensive loss for the year	0.3	(1.4)	(1.1)
Dividends paid relating to 2016	-	(138.5)	(138.5)
Adjustment for shares issued under the Scrip Dividend Alternative	-	6.9	6.9
Credit to equity in respect of share-based payments (net of tax)	-	1.2	1.2
Charge in respect of share options vesting	-	(2.1)	(2.1)
At 31 March 2017	(4.7)	1,010.1	1,005.4

37. Perpetual capital securities

	£m
Group and Company	
At 1 April 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
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 2017	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 2017, 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	
	2017 £m	2016 £m	2017 £m	2016 £m
Continuing operations				
Profit for the year	180.5	168.3	179.1	107.6
Adjustments for:				
Share-based payments	2.9	2.8	1.1	0.8
Profit on disposal of property, plant and equipment	(7.5)	(4.3)	-	-
Depreciation charge	178.2	182.9	0.1	0.1
Amortisation of intangible assets	3.2	3.7	-	-
Non-underlying provision charge	10.7	10.2	-	-
Non-underlying remeasurement of fair value movement in derivatives	(16.0)	(5.2)	-	-
Non-underlying unwind of synthetic derivative	44.8	-	83.5	-
Share of post-tax profit from joint ventures	(4.2)	(3.6)	-	-
Finance income (before non-underlying items)	(36.3)	(42.1)	(51.1)	(52.3)
Finance costs (before non-underlying items)	95.1	96.2	37.1	37.2
Dividends receivable	-	-	(247.0)	(140.7)
Taxation charge/(credit)	30.0	38.0	(3.3)	44.9
Changes in working capital:				
Increase in inventories	(0.7)	(5.5)	-	-
(Increase)/decrease in trade and other receivables	(13.1)	10.5	(158.1)	(37.4)
Increase in service concession arrangements receivable	(22.2)	(15.6)	-	-
Increase/(decrease) in trade and other payables	8.5	(27.0)	0.1	0.3
Increase/(decrease) in retirement benefit obligations from contributions	2.3	(21.2)	(0.5)	(2.2)
Decrease in provisions	(24.7)	(16.8)	-	-
Cash generated/(outflow) from operations	431.5	371.3	(159.0)	(41.7)

Reconciliation of total interest paid:

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Interest paid in operating activities	76.4	79.1	39.1	35.3
Interest paid in investing activities	12.9	9.4	-	-
Total interest paid	89.3	88.5	39.1	35.3

Notes to the financial statements

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39. Net borrowings

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Cash and cash deposits	598.1	632.2	372.5	429.7
Borrowings – current				
Bank and other loans	(74.9)	-	-	-
Other current borrowings	(41.1)	(39.0)	-	-
Finance lease obligations	(30.5)	(26.0)	-	-
Amounts owed to subsidiary undertakings	-	-	(357.8)	(287.2)
Total current borrowings	(146.5)	(65.0)	(357.8)	(287.2)
Borrowings – non-current				
Bank and other loans	(1,439.3)	(1,502.5)	(848.2)	(877.1)
Other non-current borrowings	(323.4)	(234.5)	-	-
Finance lease obligations	(1,353.8)	(1,314.6)	-	-
Total non-current borrowings	(3,116.5)	(3,051.6)	(848.2)	(877.1)
Total net borrowings	(2,664.9)	(2,484.4)	(833.5)	(734.6)

40. Subsidiary, joint venture and associate undertakings at 31 March 2017

Principal subsidiary companies	Registered office address	Country of incorporation, registration and principal operations
Water		
South West Water Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
South West Water Finance Plc	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Source Contact Management Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Water Services Limited ⁽²⁾	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Waste management		
Viridor Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Exeter Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Suffolk Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (West Sussex) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Management Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor EnviroScot Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Viridor Resource Management Limited	First Floor Offices, Riverside House, Sir Thomas Longley Road, Medway City, Rochester, ME2 4FN	England
Viridor Waste Kent Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Oxfordshire Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor EFW (Runcorn) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Landfill Restoration) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Somerset) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Thames) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Greater Manchester) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Polymer Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Trident Park Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Glasgow) Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Viridor (Lancashire) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Peterborough Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor South London Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Clyde Valley Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Other		
Peninsula Insurance Limited ⁽¹⁾	Level 5, Mill Court, La Charroterie, St Peter Port, GY1 1EJ	Guernsey

(1) Captive insurance company established with the specific objective of financing risks emanating from within the Group.

(2) 80% of share capital owned by Pennon Group plc. All shares in issue are ordinary shares.

Notes to the financial statements

continued

40. Subsidiary, joint venture and associate undertakings at 31 March 2017 continued

Other trading companies	Registered office address	Country of incorporation
Dragon Waste Limited (81%)	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula Leasing Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula Properties (Exeter) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula Trustees Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Defined Contribution Pension Trustee Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Pension Trustees Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Share Plans (Guernsey) Limited*	Albert House, South Esplanade, St Peter Port, GY1 1AW	Guernsey
Pennon Share Schemes Trustees Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Trustee Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Raikes Lane Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Source Collections Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Source for Business Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
SSWB Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Somerset) Pension Scheme & Life Assurance Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England

Other dormant companies	Registered office address	Country of incorporation
A.A. Best & Sons Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Acetip	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Albion Water (Shotton) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Alderney Water Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Analaq Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Aquacare (BWH) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Astley Minerals Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Avon Valley Water Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Basecall Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Bournemouth Water Investments Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Bournemouth Water Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
BWH Enterprises Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Centre for Environmental Research Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
City Reclamation Services Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Corby Skip Hire Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
DMP (Holdings) Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
ELE Datasystems	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Exe Continental	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Greater Manchester Sites Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Greenhill Environmental Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England

Other dormant companies	Registered office address	Country of incorporation
Handside Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Haul Waste Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Hodgejoy Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Industrial Waste Disposals (Sheffield) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Lavelle & Sons Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Mac-Glass Recycling Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Oakley Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Oakley Skip Hire Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Parkwood Environmental Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Parkwood Group Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Parkwood Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pearsons Group Holdings Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula MB Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Peninsula Water Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Power Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon South West Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pennon Waste Management Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
pHOX Systems Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pilsworth Forest (1996) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Pilsworth Forest Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Roseland Plant Co. Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Rydon Properties Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Seal Security Systems Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Sheffield Waste Disposal Company Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Shore Recycling (Ozone) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
SWW Pension Trustees Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Thames Incineration and Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Thames Incineration Services Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Thames Tankering Services Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Thames Waste Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
The Metropolitan Water Company Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Tokenmarch Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Cheshire) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Community Recycling MK) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Community Recycling MKH) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Erith) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Martock) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor (Winsford) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Contracting Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Electrical Recycling (Holdings) Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Viridor Electrical Recycling Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Viridor Enterprises Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Glass Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor London Recycling Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor New England (Efw) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Resource (Peterborough) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Resource Transport Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England

Notes to the financial statements

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40. Subsidiary, joint venture and associate undertakings at 31 March 2017 continued

Other dormant companies	Registered office address	Country of incorporation
Viridor South Lanarkshire Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Viridor South West Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Adapt) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Allwaste Disposal) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Atherton) Holdings Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Atherton) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Bristol Holdings) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Bristol) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Bury) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Corby) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Earls Barton) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (East Anglia) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Medway Holdings) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Medway) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Sheffield) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Thetford) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste (Wastenot Recycling) Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste 2 Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Disposal Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Hampshire Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Viridor Waste Wootton Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
VWM (Scotland) Limited	1 Exchange Crescent, Conference Square, Edinburgh, EH3 8UL	Scotland
Waste Treatment Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
Water West Limited*	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England
West Hampshire Water Limited	Peninsula House, Rydon Lane, Exeter, EX2 7HR	England

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

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.

Joint ventures and associate

All joint ventures, the associate and the subsidiary undertakings of Lakeside Energy from Waste Holdings Limited, Viridor 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 Viridor Waste Management Limited			
Viridor Laing (Greater Manchester) Holdings Limited	12,000 ordinary shares	50%	
Viridor Laing (Greater Manchester) Limited			Waste management
Shares in Viridor Laing (Greater Manchester) Holdings Limited are held by Viridor 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 Viridor 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.

41. Operating lease commitments

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
The future aggregate minimum lease payments under non-cancellable operating leases are:				
Within 1 year	10.6	10.7	-	-
Over 1 year and less than 5 years	28.2	29.2	-	-
Over 5 years	104.5	80.0	-	-
	143.3	119.9	-	-

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.

Notes to the financial statements

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42. Contingent liabilities

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Guarantees:				
Borrowing facilities of subsidiary undertakings	-	-	555.9	421.1
Performance bonds	187.5	159.7	187.5	159.7
Other	-	4.0	-	4.0
	187.5	163.7	743.4	584.8

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 last year to pay further consideration in respect of a previously acquired business when the outcome of planning applications was 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 2017 of certain subsidiaries: Peninsula Leasing Limited and Viridor Waste 2 Limited since these companies qualify for the exemption.

Other contractual and litigation uncertainties

The Group establishes provisions in connection with contracts and 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. Matters where it is uncertain that these conditions are met are:

- The Group's joint venture Viridor Laing (Greater Manchester) Ltd is party to a PFI contract with the Greater Manchester Waste Disposal Authority (the Authority). The authority has announced its intention to terminate this contract. The Group is in negotiation with the Authority with the aim of delivering an orderly exit from the contract.
- The Group is subject to litigation from time to time as a result of its activities, including a prosecution from the Health and Safety Executive in relation to the fatality of a Viridor employee at Derriford, Plymouth in 2015.

Uncertain tax items

Management judgement is required to estimate the tax provisions relating to uncertain tax items that remain to be agreed with HMRC.

In 2015/16 the Group reported significant judgement around uncertain tax items related to the interpretation of tax legislation regarding financial arrangements entered into in the normal course of business, which could have resulted in a range of outcomes of additional liabilities of c£20 million, to a reduction in liabilities of £52 million. Following engagement and subsequently resolution with HMRC across a number of areas, achieved through a process designed to expedite outstanding tax matters, these items are no longer an area of significant judgement and there is no such range related to ongoing uncertain tax items. The Group has a small number of ongoing uncertain tax items related to capital allowances for expenditure incurred in the normal course of business, where the Group has paid in full the tax HMRC interpret as due, and therefore would receive up to £20 million (2015/16 £70 million) should these tax items be concluded in the Group's favour.

43. Capital commitments

	Group		Company	
	2017 £m	2016 £m	2017 £m	2016 £m
Contracted but not provided	401.1	374.4	-	-

44. 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:

	2017 £m	2016 £m
Sales of goods and services		
Viridor Laing (Greater Manchester) Limited	80.1	87.3
INEOS Runcorn (TPS) Limited	15.8	18.5
Purchase of goods and services		
Viridor Laing (Greater Manchester) Limited	–	0.3
Lakeside Energy from Waste Limited	10.4	12.1
INEOS Runcorn (TPS) Limited	6.6	4.3
Dividends received		
Lakeside Energy from Waste Holdings Limited	4.5	6.0

Year-end balances

	2017 £m	2016 £m
Receivables due from related parties		
Viridor Laing (Greater Manchester) Limited (loan balance)	40.2	36.8
Lakeside Energy from Waste Limited (loan balance)	8.6	8.9
INEOS Runcorn (TPS) Limited (loan balance)	37.8	35.5
	86.6	81.2
Viridor Laing (Greater Manchester) Limited (trading balance)	15.3	11.3
Lakeside Energy from Waste Limited (trading balance)	1.0	1.0
INEOS Runcorn (TPS) Limited (trading balance)	1.3	2.7
	17.6	15.0
Payables due to related parties		
Lakeside Energy for Waste Limited (trading balance)	2.7	2.3
INEOS Runcorn (TPS) Limited (trading balance)	1.5	1.6
	4.2	3.9

The £866 million (2016 £81.2 million) receivable relates to loans to related parties included within receivables and due for repayment in instalments between 2017 and 2033. Interest is charged at an average of 13.0% (2016 13.0%).

Company

The following transactions with subsidiary undertakings occurred in the year:

	2017 £m	2016 £m
Sales of goods and services (management fees)	11.2	10.5
Purchase of goods and services (support services)	0.5	0.4
Interest receivable	39.6	38.6
Interest payable	0.1	0.1
Dividends received	247.0	140.7

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.

Notes to the financial statements

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44. Related party transactions continued

Year-end balances

	2017 £m	2016 £m
Receivables due from subsidiary undertakings		
Loans	1,124.3	965.6
Trading balances	13.4	8.6

Interest on £70.0 million of the loans has been charged at a fixed rate of 4.5%, on £428.0 million at a fixed rate of 5.0% and on £28.0 million at a fixed rate of 6.0% (2016 £70.0 million at 4.5%, £373.6 million nil at 5.0%, £28.0 million at 6.0% and £0.5 million at 1.4%). Interest on £497.8 million of the loans is charged at 12 month LIBOR +1.0% (2016 £443.5 million) and on £0.5 million at base rate +1.0%. These loans are due for repayment in instalments over the period 2016 to 2043.

Interest on £100.0 million of the loans has been charged at 1 month LIBOR + 1.0% (2016 £50.0 million). This loan is expected to be repaid in 2017/18. During the year there were no provisions (2016 nil) in respect of loans to subsidiaries not expected to be repaid.

	2017 £m	2016 £m
Payables due to subsidiary undertakings		
Loans	322.0	287.2
Trading balances	9.5	14.6

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

Five-year financial summary

	2017	2016	2015	2014	2013
	£m	£m	£m	£m	£m
Income statement					
Revenue	1,353.1	1,352.3	1,357.2	1,321.2	1,201.1
Operating profit before non-underlying items	304.6	261.8	246.6	257.5	245.6
Net finance costs before non-underlying items	(58.8)	(54.1)	(40.8)	(53.9)	(61.4)
Share of profit in joint ventures	4.2	3.6	4.9	3.7	5.8
Profit before tax and non-underlying items	250.0	211.3	210.7	207.3	190.0
Net non-underlying items before tax	(39.5)	(5.0)	(13.7)	(48.6)	(176.4)
Taxation (charge)/credit	(30.0)	(38.0)	(54.7)	(0.6)	7.0
Profit for the year	180.5	168.3	142.3	158.1	20.6
Attributable to:					
Ordinary shareholders of the parent	164.3	152.1	126.3	142.5	20.6
Perpetual capital security holders	16.2	16.2	16.0	15.6	-
Dividends proposed/declared	149.5	138.5	129.5	117.0	103.9
Earnings per ordinary share (basic):					
From continuing operations					
Earnings per share	39.8p	37.0p	32.3p	38.8p	5.7p
Deferred tax before non-underlying items	4.5p	9.5p	4.7p	(7.0)p	(4.0)p
Non-underlying items (net of tax)	2.7p	(7.0)p	2.8p	10.8p	38.6p
Earnings per share before non-underlying and deferred tax	47.0p	39.5p	39.8p	42.6p	40.3p
Declared dividends per share	35.96p	33.58p	31.80p	30.31p	28.46p
Capital expenditure					
Acquisitions	-	91.0	-	-	14.8
Property, plant and equipment	377.5	284.2	301.4	360.8	410.1
Balance sheet					
Non-current assets	4,937.0	4,676.7	4,325.9	4,076.6	3,846.0
Net current assets	454.4	549.1	586.0	241.9	378.5
Non-current liabilities	(3,882.2)	(3,738.2)	(3,557.8)	(3,120.9)	(3,152.4)
Net assets	1,509.2	1,487.6	1,354.1	1,197.6	1,072.1
Number of employees (average for year)					
Water	1,589	1,706	1,408	1,356	1,354
Waste management	3,153	3,230	3,101	3,044	3,180
Other businesses	57	51	49	51	50
	4,799	4,987	4,558	4,451	4,584

Shareholder information

Financial calendar

Financial year end	31 March
28th Annual General Meeting	6 July 2017
Ex-dividend date for 2017 final dividend	6 July 2017*
Record date for 2017 final dividend	7 July 2017*
2017 final dividend payable	1 September 2017*
2017/18 half-yearly results announcement	29 November 2017
2018 interim dividend payable	April 2018
2018 final results announcement	25 May 2018
29th Annual General Meeting	5 July 2018
2018 final dividend payable	September 2018

Scrip dividend alternative*

Ordinary shares quoted ex-dividend	6 July 2017
Record date for final dividend	7 July 2017
Posting of scrip dividend offer	21 July 2017
Final date for receipt of forms of mandate	14 August 2017
Posting of dividend cheques and share certificates	31 August 2017
Final cash dividend payment date	1 September 2017
First day of dealing in the new ordinary shares	1 September 2017

* Subject to obtaining shareholder approval at the 2017 Annual General Meeting to the payment of a final dividend for the year ended 31 March 2017.

Shareholder analysis at 31 March 2017

Holding of shares	Number of shareholders	% of total shareholders	% of ordinary shares
1-100	2,418	12.17	0.02
101-1,000	8,354	42.03	1.07
1,001-5,000	7,614	38.31	4.04
5,001-50,000	1,111	5.59	3.03
50,001-100,000	95	0.48	1.64
100,001 +	283	1.42	90.21
	19,875		

	Number of accounts	% of total accounts	% of total shares
Individuals	17,474	87.92	6.59
Companies	135	0.68	0.30
Trust companies (pension funds etc.)	10	0.05	0.01
Banks and nominees	2,256	11.35	93.09
	19,875		

Major shareholdings

The net position on 31 March 2017 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
Lazard Asset Management LLC	33,187,671	8.02%
Pictet Asset Management SA	25,599,217	6.18%
Ameriprise Financial, Inc.	20,328,154	4.91%
The Capital Group Companies, Inc.	20,106,888	4.86%
RARE Infrastructure Limited	19,366,782	4.68%
AXA Investment Managers SA	18,088,394	4.37%
Invesco Limited	17,212,959	4.16%
UBS Investment Bank	16,610,004	4.01%

No changes to interests in the Company's issued share capital have been disclosed to the Company between 31 March 2017 and 22 May 2017 (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 geographic rate and will vary by provider).

Lines are open 8.30am-5.30pm Monday-Friday, excluding public holidays in England and Wales.

Overseas telephone: **+44 371 664 9234** (calls outside the United Kingdom will be charged at the applicable international rate).

Email: **pennon@capita.co.uk**

Website: **signalshares.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).

ShareGift 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, or by contacting ShareGift on 020 7930 3737 (www.sharegift.org.uk).

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 2017 Annual General Meeting for the payment of a final dividend for the year ended 31 March 2017, full details of the scrip dividend alternative and how to participate will be sent to shareholders on 21 July 2017. 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.signalshares.com**.

Shareholder information

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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.signalshares.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 confirmations 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.signalshares.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!

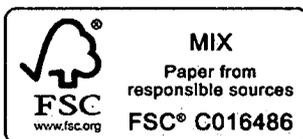
5,000 people contact the Financial Conduct Authority about share fraud each year, with victims losing an average of £20,000

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.



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